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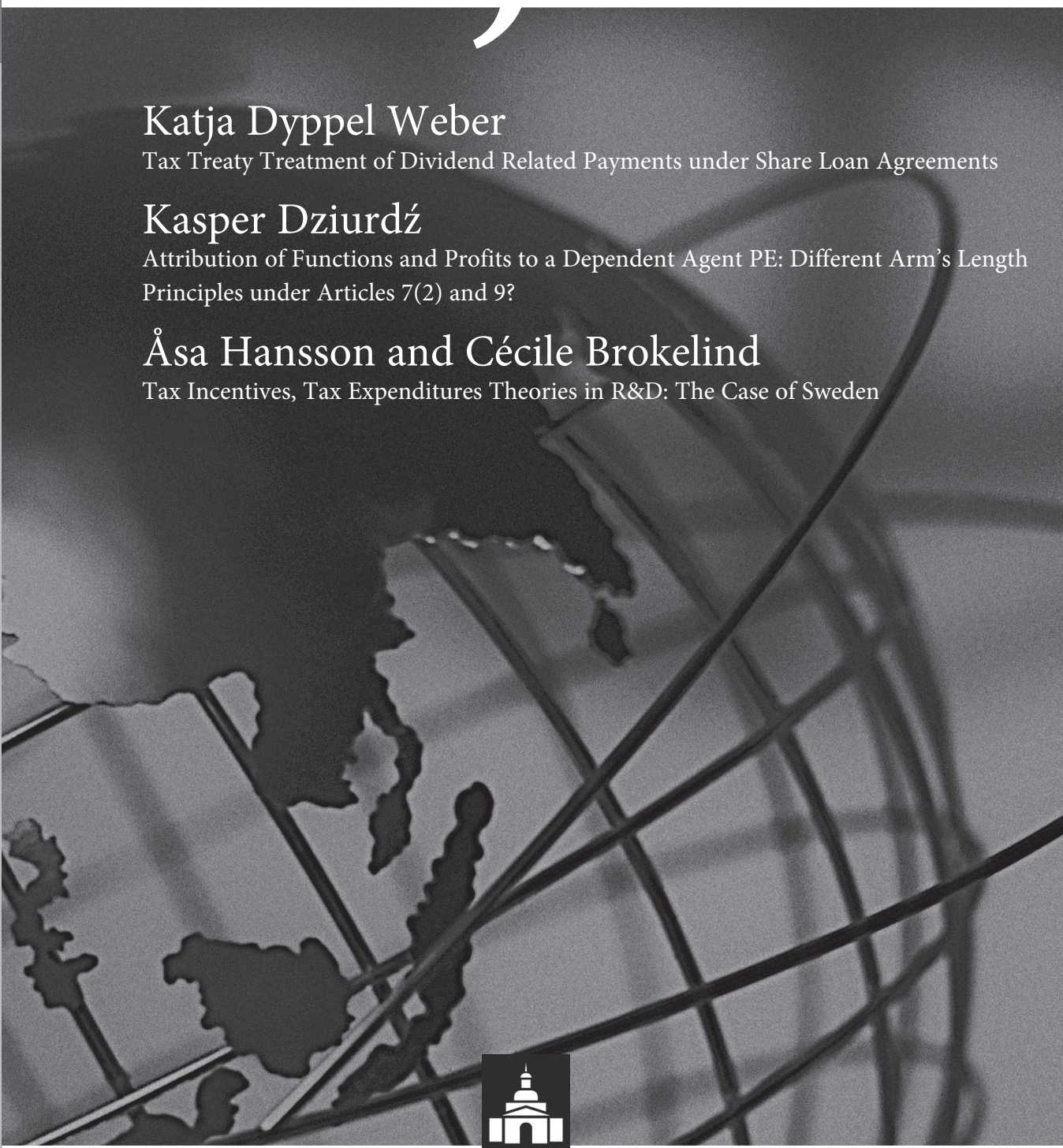

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Attribution of Functions and Profits to a Dependent Agent PE: Different Arm's Length Principles under Articles 7(2) and 9?

This article argues that under the OECD Model, conceptually, there should be no difference between the arm's length principles of articles 7(2) and 9, and analyses how control functions as significant people functions can still lead to a net profit attribution to a dependent agent PE above zero.

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1. Introduction

Dealing with fictions is challenging. A company is a creation of law and thus a legal fiction,[1] although its legal existence and personality is widely recognized both for tax and non-tax purposes. An enterprise which is carried on by an individual, a company or any other body of persons as a whole performs functions, owns assets and assumes risks. It cannot enter into legally binding contracts with itself in order to assign functions, assets or risks to a particular part of the enterprise. Nevertheless, in allocating taxing rights under article 7 of the OECD Model Tax Convention (OECD Model),[2] it is necessary to attribute profits to a particular part or parts of the enterprise, namely to a permanent establishment (PE). For that purposes the PE must be treated as a separate and independent enterprise under article 7(2) even though, legally, it is not separate and independent. What is not legally "real" is made "real" in order to attribute profits based on the arm's length principle, which is itself a fiction. Moreover, the concept of a PE as defined in article 5 is a legal fiction by itself. It only presupposes certain presence for its legal existence, for example, a place of business or physical presence. Although under article 5(5) and (6) a dependent agent PE is "deemed" or "not […] deemed" to exist, and even though under article 5(4) a PE is "deemed not to include" certain

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1. *See*, for example, J. Malherbe & P. Daenen, *Permanent Establishments Claim Their Share of Profits: Does the Taxman Agree?*, 64 Bull. Intl. Taxn. 7, pp. 359-366, at sec. 1. (2010), Journals IBFD.
2. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.

fixed places of business, a PE under article 5(1), without using the word "deemed", is also merely deemed to exist for tax treaty purposes. Accordingly, a dependent agent concluding contracts on behalf of his principal is as real as a fixed place of business, and a fixed place of business PE under article 5(1) is as fictitious as a dependent agent PE under article 5(5).

For purposes of attributing profits to a dependent agent PE under article 7(2), two different persons must be distinguished:

- the principal, who is a resident of the residence state,[3] on behalf of whom the dependent agent acts and to whom the dependent agent PE in the source state belongs; and
- the dependent agent, who may be a resident of the residence state, the source state or a third state, who acts on behalf of the principal and thereby establishes, for the principal, the dependent agent PE in the source state.

If the dependent agent is an associated enterprise of the principal, the dependent agent must be treated as an independent enterprise under article 9 and the principal's dependent agent PE must be treated as a separate and independent enterprise under article 7(2). This means that both vis-à-vis the dependent agent and the dependent agent PE the profits must be attributed at arm's length. In that case whether or how much profit can be attributed to the dependent agent PE is disputed:

- Under the "single taxpayer" or "zero-sum" approach,[4] in all circumstances the payment of an arm's length reward to the dependent agent, which is attributable as a deductible

3. For purposes of this article, the residence state is always the residence state of the principal and, thus, the source state is always "the other Contracting State", in which the dependent agent PE is established.

4. *See* to that effect or in that direction, for example, U. Andresen, *Vertreterbetriebsstätte*, in *Betriebsstätten-Handbuch*, at mns. 10.220 and 10.233-10.234 (F. Wassermeyer, U. Andresen & X. Ditz, Cologne: Dr. Otto Schmidt 2006); P. Baker & R.S. Collier, General Report, in *The Attribution of Profits to Permanent Establishments – Cahiers de Droit Fiscal International*, Vol. 91b, pp. 21-67, at sec. 1.2.6. (Netherlands: Sdu Fiscale & Financiële Uitgevers 2006); P. Baker & R.S. Collier, *2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments*, 63 Bull. Intl. Taxn. 5, pp. 199-203, at sec. 3.5. (2009), Journals IBFD; F. Barreiros Rosalem, *The Agent Permanent Establishment Reconsidered: Application of Arts. 5, 7, and 9 of the OECD Model Convention*, 17 Intl. Transfer Pricing J. 1, pp. 12-33 (2010), Journals IBFD; S. Bendlinger, *Sinn und Zweck der Vertreterbetriebsstätte*, 63 Österreichische Steuerzeitung 6, pp. 140-145, at sec. 4. (2010); C. Brodersen & H. von Kolczynski, *The Commissionaire: A Tax-Focused Evaluation from Germany*, 25 Intertax 25, pp. 201-210, at p. 205 (1997); M. Burkert, *Reallokation von betrieblichen Funktionen und Risiken im international tätigen Konzern*, in *Unternehmenspolitik und Internationale Besteuerung – Festschrift für Lutz Fischer zum 60. Geburtstag*, pp. 509-538, at p. 528 (H.-J. Kleineidam ed., Berlin: Erich Schmidt 1999); H. Diebel & H. Reiser, *Die steuerliche Optimierung des Auslandsvertriebs*, in *Handbuch der internationalen Steuerplanung*, 3rd ed., pp. 253-272, at p. 265 (S. Grotherr ed., Herne: NWB 2011); X. Ditz in *Doppelbesteuerungsabkommen*, Art. 7 (2008), mns. 195-199 (J. Schönfeld & X. Ditz eds., Cologne: Dr. Otto Schmidt 2013); X. Ditz & S.-E. Bärsch, *Gewinnabgrenzung bei Vertreterbetriebsstätten nach dem AOA – ein Plädoyer für die Nullsummentheorie*, 22 Internationales Steuerrecht 11, pp. 411-417 (2013); F. Eisele, *Grenzüberschreitende Funktionsverlagerung*, pp. 341-344 (Herne/Berlin: NWB 2003); M. Görl, *Die Vertreterbetriebsstätte der Doppelbesteuerungsabkommen – ein Geburtsfehler des Art. 5 OECD-Musterabkommen*, in *Unternehmenssteuerrecht und Internationales Steuerrecht – Gedächtnisschrift für Dirk Krüger*, pp. 113-125, at pp. 121-123 (G. Strunk, F. Wassermeyer & B. Kaminski eds., Bonn: Stollfuß 2006); B. Gröhs, *Kommissionärsstrukturen im Internationalen Steuerrecht*, in *Besteuerung und Bilanzierung international tätiger Unternehmen – 30 Jahre Steuerrecht an der Wirtschaftsuniversität Wien*, pp. 147-165, at sec. III. (W. Gassner & M. Lang eds., Vienna: Linde 1998); F.E.F. Hey, *Tochtergesellschaft mit Vertriebsfunktion als ständiger Vertreter*, 40 Recht der Internationalen Wirtschaft 10, pp. 887-891, at p. 891 (1994); H.-K. Kroppen in *Jahrbuch der Fachanwälte für Steuerrecht 1997/98*, pp. 157-158 (Deutsches Anwaltsinstitut e.V. ed., Herne/Berlin: NWB 1998); H.-K. Kroppen in *DBA-Kommentar*, 10th suppl., Art. 7 OECD-MA, at mns. 198-203 (D. Gosch, H.-K. Kroppen & S. Grotherr eds., Herne: NWB 2002); H.-K. Kroppen, *Neue Rechtsentwicklungen bei der Betriebsstätte nach Abkommensrecht*, in *Körperschaftsteuer – Internationales Steuerrecht – Doppelbesteuerung – Festschrift für Franz Wassermeyer zum 65. Geburtstag*, pp. 691-708, at pp. 703-708 (R. Gocke, D. Gosch & M. Lang eds., Munich: C.H. Beck 2005); H.-K. Kroppen,

expense to the dependent agent PE, fully extinguishes the profits attributable to the PE. The compensation to the dependent agent, if arm's length under article 9, is considered to adequately reward the dependent agent for its functions performed, assets used and risks assumed in the source state. Since there are no other functions performed, assets used and risks assumed in the source state, there can be no further profits to attribute. Once it has been established that the dependent agent has been rewarded at arm's length, the net profit attribution to the dependent agent PE is zero. In other words, if article 9 correctly attributed functions, assets, risks and thus profits to the dependent agent based on all the activities performed in the source state, article 7(2) cannot attribute, based on the same activities performed in the source state, additional functions, assets, risks and thus profits to the dependent agent PE.

– Under the "dual taxpayer" approach,[5] in contrast, the compensation to the dependent agent does not necessarily correspond to the profits attributable to the dependent agent

Der "Authorized OECD Approach" zur Gewinnaufteilung zwischen Stammhaus und Betriebsstätte, in *Unternehmensbesteuerung – Festschrift für Norbert Herzig zum 65. Geburtstag*, pp. 1071-1094, at pp. 1093-1094 (W. Kessler, G. Förster & C. Watrin eds., Munich: C.H. Beck 2010); J. Kuppens & D. Oosterhoff, *Business Restructuring and Permanent Establishments*, 13 Intl. Transfer Pricing J. 4, pp. 183-188, at sec. 5. (2006), Journals IBFD; C.H. Lee, *Instability of the Dependent Agency Permanent Establishment Concept*, 27 Tax Notes Intl. 11, pp. 1325-1334, at pp. 1333-1334 (9 Sept. 2002); D. Oosterhoff & J. Tiele, *Commissionaire/Agency Permanent Establishment Structures*, 17 Intl. Transfer Pricing J. 6, pp. 430-437, at sec. 5.2. (2010), Journals IBFD; A. Pleijsier, *The Agency Permanent Establishment: Allocation of Profits. Part Three*, 29 Intertax 8/9, pp. 275-283, especially at sec. 5. (2001); C. Plott, *Auswirkungen der Vertriebsstruktur – Möglichkeiten und Grenzen der Gestaltung*, in *Handbuch Verrechnungspreise*, 2nd ed., pp. 277-307, at pp. 292-293 (S. Bernegger, W. Rosar & F. Rosenberger eds., Vienna: Linde 2012); A. Roth, *Aktuelle Fragen der Betriebsstättenbesteuerung unter Berücksichtigung des Entwurfs eines Betriebsstättenerlasses*, in *Steuerberater-Jahrbuch 1997/98*, pp. 427-447, at pp. 432-433 (N. Herzig, M. Günkel & U. Niemann eds., Cologne: Dr. Otto Schmidt 1998); B. Runge in *Steuerberater-Jahrbuch 1997/98*, pp. 499-500 (N. Herzig, M. Günkel & U. Niemann eds., Cologne: Dr. Otto Schmidt 1998); B. Runge, *Der neue Betriebsstättenerlass*, in *Internationale Betriebsstättenbesteuerung*, pp. 131-146, at pp. 134-135 (D.J. Piltz & H. Schaumburg eds., Cologne: Dr. Otto Schmidt 2001); H. Schaumburg, *Internationales Steuerrecht*, 3rd ed., pp. 1010-1012, at mns. 18.58-18.59 (Cologne: Dr. Otto Schmidt 2011); and K. Sieker, *Ist einer Vertreterbetriebsstätte ein Gewinn zuzurechnen?*, 51 Betriebs-Berater 19, pp. 981-986, at pp. 984-986 (1996).

5. *See* to that effect or in that direction, for example, B.J. Arnold, *Tax Treaty News*, 63 Bull. Intl. Taxn. 2, pp. 42-44, at sec. 3. (2009), Journals IBFD; K.-H. Baranowski, *Steuerfolgen bei Einschaltung eines „Ständigen Vertreters"*, Internationale Wirtschafts-Briefe 8, pp. 369-378 = Fach 3, Deutschland, Gruppe 2, pp. 719-728, at pp. 724-728 (1997); K.-H. Baranowski in *Steuerberater-Jahrbuch 1997/98*, pp. 500-501 (N. Herzig, M. Günkel & U. Niemann eds., Cologne: Dr. Otto Schmidt 1998); D. Endres, *Die Vertreterbetriebsstätte im Konzern*, 5 Internationales Steuerrecht 1, pp. 1-5, at p. 4 (1996); G. Frotscher, *Internationales Steuerrecht*, 3rd ed., p. 151, at mn. 304 (Munich: C.H. Beck 2009); S. Griemla, *Welcher Gewinn ist einer Vertreterbetriebsstätte zuzuordnen?*, 14 Internationales Steuerrecht 24, pp. 857-864 (2005); D. Hack, *Vom Eigenhändler zum Kommissionär*, 61 Österreichische Steuerzeitung 10, pp. 229-237, at sec. 7. (2008); H. Moshammer & M. Tumpel, *Attribution of Profits to a Dependent Agent PE*, in *Dependent Agents as Permanent Establishments* (M. Lang, P. Pistone, J. Schuch, C. Staringer & A. Storck eds., Vienna: Linde, forthcoming); D. Niehaves in *Außensteuergesetz/Doppelbesteuerungsabkommen*, 2nd ed., II MA Art 7, mns. 111-144 (F. Haase ed., Heidelberg: C.F. Müller 2012); H. Pijl, *The Zero-Sum Game, the Emperor's Beard and the Authorized OECD Approach*, 46 Eur. Taxn. 1, pp. 29-35, at secs. 4.-5. and 9. (2006), Journals IBFD; H. Pijl, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, 65 Bull. Intl. Taxn. 6, pp. 294-306, at sec. 4.4. (2011), Journals IBFD; P. Plansky, *Die Gewinnzurechnung zu Betriebsstätten im Recht der Doppelbesteuerungsabkommen*, pp. 231-232 (Vienna: Linde, 2010); C.E.C.M.A. Torro, *Different Methods of Attributing Profits to Agency PEs*, 53 Tax Notes Intl. 5, pp. 421-445, at sec. V. (2 Feb. 2009); R.J. Vann, *Reflections on Business Profits and the Arm's-Length Principle*, in *The Taxation of Business Profits Under Tax Treaties*, pp. 133-169, at pp. 165-166 (B.J. Arnold, J. Sasseville & E.M. Zolt eds., Toronto: Canadian Tax Foundation 2003); R.J. Vann, *Tax Treaties: The Secret Agent's Secrets*, 51 British Tax Rev. 3, pp. 345-382, especially at p. 379 (2006); K. Vogel, *Tax Treaty News*, 61 Bull. Intl. Taxn. 11, pp. 474-475, at sec. 3. (2007), Journals IBFD; and F. Wassermeyer in *Doppelbesteuerung: DBA*, 108th suppl., Art. 5 MA, mn. 217, and 106th suppl., Art. 7 MA, mn. 309 (F. Wassermeyer ed., Munich: C.H. Beck 2009).

> PE. Even when the compensation to the dependent agent is considered to adequately reward the dependent agent for its functions performed, assets used and risks assumed, there can be other assets and risks (for example, excess inventory risks) which legally do not belong to the dependent agent. If those additional assets and risks relate to functions (for example, active decisions related to inventory levels) performed by the dependent agent in the source state on behalf of the principal, they may be attributed, together with a profit element, to the dependent agent PE. Accordingly, the compensation to the dependent agent, even if arm's length under article 9, may not fully extinguish the profits attributable under article 7(2) to the dependent agent PE, and thus there may be a net profit attribution to the PE above (or, in cases of losses, below) zero.

This article examines the differences between the "single taxpayer" and the "dual taxpayer" approach. First, the "Authorized OECD Approach" (AOA) on the attribution of profits to a PE is outlined (*see* section 2.). Afterwards, whether there are differences between the arm's length principles of articles 7(2) and 9 is examined (*see* section 3.). If there are such differences because article 9 focuses on legally binding contracts while article 7(2) focuses on people functions, this could explain why, under the "dual taxpayer" approach, the allocation of profits to the dependent agent under article 9 can lead to different results than the attribution of profits to the dependent agent PE under article 7(2). However, this article argues that, conceptually, there should be no difference between the arm's length principles of articles 7(2) and 9. Nevertheless, legally binding contracts relevant for non-tax purposes may lead to differences in the actual conduct, i.e. in what people actually do or might do in the future (*see* section 4.). Insofar the real and identifiable events in a PE context may differ when compared to situations between legally separate and independent enterprises. Subsequently, this article considers that both under articles 7(2) and 9, assets and risks can be separated from functions if they are substituted by appropriate control functions (*see* section 5.). This means that when the principal outsources functions to the dependent agent at arm's length within the meaning of article 9, the principal exercises control functions over the dependent agent's activities. In order to attribute to the dependent agent PE net profits above (or, in the case of losses, below) zero, it is thus necessary to attribute control functions exercised by the principal, together with the related assets and risks (*see* section 6.). As control functions are exercised by people and thus are people functions, this article finally analyses how people functions can be attributed to a fixed place of business PE (*see* section 7.) and to a dependent agent PE (*see* section 8.).

2. Attribution of Profits under the AOA

Since under article 7(2) a legal fiction – a PE – is treated as a hypothetically separate and independent enterprise, how far can this fiction of separateness and independence reach? A legally separate and independent enterprise can sell goods, provide services, enter into licence agreements, guarantee or insure risks, borrow and lend money, and has an individual creditworthiness. Is the same true for a PE when it is treated as a hypothetically separate and independent enterprise? The OECD deals with these issues in the 2008 "Report on the Attribution of Profits to Permanent Establishments" (the 2008 Report)[6] and the "2010 Report

6. OECD Ctr. for Tax Policy and Admin., *Report on the Attribution of Profits to Permanent Establishments* (OECD 2008), International Organizations' Documentation IBFD. *See also* OECD Ctr. for Tax Policy and Admin., *The 2008 Update to the OECD Model Tax Convention* (OECD 2008), International Organizations' Documentation IBFD.

on the Attribution of Profits to Permanent Establishments" (the 2010 Report),[7] the latter of which refers to the new version of article 7 which was introduced with the 2010 update to the OECD Model.[8] In these Reports the OECD prefers a far-reaching fiction of separateness and independence of a PE, i.e. the "functionally separate entity" approach as the AOA.[9] Although currently most tax treaties follow previous versions of article 7, this article only deals with the 2010 version. It does not analyse the extent to which the conclusions reached herein are also relevant for previous versions of article 7, and the 2008 Report, although it was the basis for preparing the 2010 Report, it is not explicitly referred to.[10]

In attributing profits to a PE under the AOA, a two-step analysis is required: First, a functional and factual analysis must be performed in order to hypothesize appropriately the PE and the remainder of the enterprise – even though not legally separate – as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Accordingly, the economically significant activities and responsibilities undertaken by the PE must be identified. Second, the remuneration of any dealings between the hypothesized enterprises is determined by applying by analogy the article 9 transfer pricing tools, as articulated in the OECD Transfer Pricing Guidelines 2010 (the Guidelines),[11]

7. OECD Ctr. for Tax Policy and Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), International Organizations' Documentation IBFD.
8. OECD Ctr. for Tax Policy and Admin., *The 2010 Update to the Model Tax Convention* (OECD 2010), International Organizations' Documentation IBFD.
9. *See* on the AOA, for example, Baker & Collier, *2008 OECD Model*, *supra* n. 4; M. Bennett, *The Attribution of Profits to Permanent Establishments: The 2008 Commentary on Art. 7 of the OECD Model Convention*, 48 Eur. Taxn. 9, pp. 467-471 (2008), Journals IBFD; M. Bennett, *Article 7 – New OECD Rules for Attributing Profit to Permanent Establishments*, in *The 2010 OECD Updates: Model Tax Convention & Transfer Pricing Guidelines – A Critical Review*, pp. 21-36 (D. Weber & S. van Weeghel eds., Kluwer L. Intl. 2011); R. Bernales, T*he Authorized OECD Approach: An Overview*, in *Taxation of Business Profits in the 21st Century*, pp. 135-181 (C. Gutiérrez & A. Perdelwitz eds., IBFD 2013), Online Books IBFD; X. Ditz, *Betriebsstättengewinnabgrenzung nach dem „Authorised OECD Approach" – Eine kritische Analyse*, 1 Internationale Steuer-Rundschau 2, pp. 48-55 (2012); P. Fris, E. Llinares & S. Gonnet, *PEs and transfer pricing: the playing field in international taxation redefined*, Tax Planning International Transfer Pricing 12, pp. 1-6 (2008); H. Kahle & J. Mödinger, *Betriebsstättenbesteuerung: Zur Anwendung und Umsetzung des Authorised OECD Approach*, 100 Deutsche Steuer-Zeitung 22, pp. 802-812 (2012); Kroppen, Der „Authorized OECD Approach", *supra* n. 4; L. Nouel, *The New Article 7 of the OECD Model Tax Convention: The End of the Road?*, 65 Bull. Intl. Taxn. 1, pp. 5-12 (2011), Journals IBFD; R. Russo, *Application of Arm's Length Principle to Intra-Company Dealings: Back to the Origins*, 12 Intl. Transfer Pricing J. 1, pp. 7-15 (2005), Journals IBFD; W. Schön, *Attribution of Profits to PEs and the OECD 2006 Report*, 46 Tax Notes Intl. 10, pp. 1059-1072 (4 June 2007); W. Schön, *Gewinnabgrenzung bei Betriebsstätten*, in *Besteuerung von Unternehmen im Wandel*, pp. 71-113 (J. Lüdicke ed., Cologne: Dr. Otto Schmidt 2007); L.A. Sheppard, *Revenge of the Source Countries?*, 37 Tax Notes Intl. 13, pp. 1127-1140, at pp. 1132-1138 (28 Mar. 2005). *See also* on dependent agent PEs, for example, M. Naumann & H. Förster, *Abschmelzen (Stripping) von Funktionen im Konzern, steuerlich vergebliche Liebesmüh'? – zur Verlagerung von Funktionen am Beispiel von Vertriebstochtergesellschaften*, 13 Internationales Steuerrecht 7, pp. 246-252 (2004); critically Griemla, *supra* n. 5, at secs. 3.4. and 4.
10. Moreover, the 2010 Report consists of four parts (part I: general considerations; part II: special considerations for applying the AOA to PEs of banks; part III: special considerations for applying the AOA to PEs of enterprises carrying on global trading of financial instruments; part IV: special considerations for applying the AOA to PEs of insurance companies) and many of the general considerations of the first part are repeated, summarized or elaborated on in the other parts. In this article, references are predominantly made to the first part of the 2010 Report, but that does not mean or imply that the other parts are silent on these issues.
11. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (22 July 2010). *See also*, for example, C. Silberztein, *The 2010 update to the OECD Transfer Pricing Guidelines*, in *The 2010 OECD Updates: Model Tax Convention & Transfer Pricing Guidelines – A Critical Review*, pp. 147-160

by reference to the functions performed, assets used and risk assumed by the hypothesized enterprises. The result of these two steps will be to allow the calculation of the profits (or losses) of the PE from all its activities, including transactions with other related and unrelated enterprises and dealings with other parts of the enterprise.[12]

In a PE context, no single part of an enterprise legally owns assets, assumes risks, possesses capital or contracts with separate enterprises. Since the legal position is thus unhelpful, instead of a legal analysis, another mechanism, a functional analysis is used under the AOA for attributing risks, economic ownership of assets and capital to the hypothetically separate and independent PE, for associating with the PE the rights and obligations arising out of transactions with separate enterprises and for recognizing and determining the nature of the dealings between the PE and other parts of the enterprise of which the PE is a part. The AOA attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE[13] and also attributes to the PE the economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE. Furthermore, the AOA sets forth approaches to attribute capital, including "free" capital, to the PE to support the functions it has performed, the risks assumed and assets attributed to it, as well as criteria for the recognition and characterisation of dealings between the PE and other parts of the enterprise to which it belongs.[14] This means, in short, that under the AOA assets and risks follow functions, and capital follows functions, assets and risks.

The AOA recognizes that a PE, even though it is not legally separate and independent and thus cannot enter into legally binding contracts, can be attributed assets, risks and capital, and it can enter into dealings with other parts of the enterprise. But the fiction of separateness and independence has limits: A PE cannot guarantee all the risks assumed as a result of the functions performed by another part of the enterprise or the creditworthiness of the rest of the enterprise, and vice versa, and thus intra-entity guarantee payments are not recognized.[15] Such payments, however, occur between legally separate and independent enterprises and are also recognized between associated enterprises.[16] It thus appears that there are differences between the full legal independence of an enterprise and the hypothetical independence of a PE. While the fact that a PE is not legally separate and independent can be disregarded for some purposes (for example, for hypothesizing a sale of goods), it cannot be disregarded for other purposes (for example, for hypothesizing guarantee payments). Furthermore, an important assumption under the AOA is that assets and risks follow functions. A legally separate enterprise, however, can separate functions from assets and risks, for example, by outsourcing functions to a third party or by concluding insurance agreements.[17] Is there thus

(D. Weber & S. van Weeghel eds., Kluwer L. Intl. 2011); D. Oosterhoff & B. Wingerter, *The New OECD Guidelines: The Good, the Bad and the Ugly*, 18 Intl. Transfer Pricing J. 2, pp. 103-113 (2011), Journals IBFD.

12. Part I, para. 10 *2010 Report*.
13. *See* critically Schön, *Attribution of Profits*, *supra* n. 9, at pp. 1065-1071; W. Schön, *Persons and Territories: on the International Allocation of Taxing Rights*, 55 British Tax Rev. 6, pp. 554-562, at pp. 560-561 (2010).
14. Part I, paras. 14-15 *2010 Report*.
15. Part I, paras. 29, 33 and 99-104 *2010 Report*; *see also* part II, paras. 30-31, 54, 65-66 and 80-83, part III, paras. 204-205 and 230-231, and part IV, para. 84.
16. Para. 7.13 *2010 Guidelines*.
17. *See*, for example, J. van Wanrooij, *Comments on the Proposed Article 7 of the OECD Model Convention*, 37 Intertax 5, pp. 298-306, at p. 303 (2009).

a difference between the arm's length principles of articles 7(2) and 9 because only legally separate enterprises, including associated enterprises, can rely on legally binding contracts?[18]

3. Different Arm's Length Principles under Articles 7(2) and 9?

Article 9 allows for the adjustment of profits if conditions are made or imposed between associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. The analysis of the nature of the controlled transactions between associated enterprises and whether the conditions thereof (including prices, but not only prices) differ from the conditions that would be obtained in comparable uncontrolled transactions is referred to as a "comparability analysis" and is at the heart of the application of the arm's length principle.[19] According to the Guidelines, when determining comparability of situations:[20]

> […] attributes or "comparability factors" that may be important […] include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

Since "in arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties",[21] the contractual terms may be an important comparability factor in making comparisons under article 9 of the conditions in controlled transactions between associated enterprises with the conditions in uncontrolled transactions. Moreover, an analysis of the contractual terms and thus of the legal rights and obligations of the associated enterprises in performing their functions "should be a part of the functional analysis", which is again an important comparability factor.[22] It thus appears that the Guidelines attach great importance to legally binding contracts, "and the terms of contracts play a major role".[23] In addition, the actual transactions between associated enterprises, as they have been structured by them, can be disregarded or substituted by other transactions only in exceptional cases.[24] Accordingly, "restructuring the controlled transaction under review […] generally is inappropriate" and thus, for example, the tax administration generally "should not disregard the controlled taxpayer's purported assignment of risk".[25]

So far as legally binding contracts and the assignment of functions, assets and risks under such contracts between associated enterprises are an important factor in determining the relevant conditions in controlled transactions under article 9, there could be differences between the arm's length principles of articles 7(2) and 9. In a PE context, there can be no legally binding contracts which would assign functions, assets and risks to a particular

18. Unlike article 7(2), article 9 does not by itself allocate profits to a contracting state. It rather authorizes the tax authorities, for the purpose of calculating tax liabilities, to re-write the accounts of associated enterprises if the transactions between such enterprises have not taken place on an arm's length basis, and otherwise prohibits such re-writing by having a restrictive effect on the domestic rules which determine the taxable income. Nevertheless, both articles 7(2) and 9 rely on the arm's length principle, and thus the issue arises whether they rely on the same arm's length principle.
19. Para. 1.6 *2010 Guidelines*.
20. Para. 1.36 *2010 Guidelines*.
21. Para. 1.52 *2010 Guidelines*; *see also* paras. 9.11 and 9.166.
22. Para. 1.52 *2010 Guidelines*; *see also* para. 1.42.
23. Para. 1.964 *2010 Guidelines*.
24. Paras. 1.64 and 9.168 *2010 Guidelines*.
25. Para. 1.69 *2010 Guidelines*.

part of the enterprise. The enterprise as a whole legally exercises functions, owns assets and assumes risks. Moreover, while employees are assigned to associated enterprises on the basis of employment contracts, in a PE context, the enterprise as a whole is the employer of the employees. Article 7(2) thus needs another mechanism for assigning functions, assets, risks and people to a particular part of the enterprise by focusing on non-contractual criteria. Under the AOA, a functional and factual analysis has been chosen for that purpose.[26] As soon as article 7(2) focuses on non-contractual criteria while article 9 focuses on legally binding contracts, the arm's length principles of articles 7(2) and 9 can lead to different results and, therefore, to a different allocation of taxing rights. This could be an argument for the "dual taxpayer" approach, which presupposes a possibly different allocation of profits to the dependent agent and to the dependent agent PE.

Nevertheless, contractual terms can be challenged under article 9: "It is […] important to examine whether the conduct of the [associated] parties conforms to the terms of the contract". If the parties' conduct "indicates that the contractual terms have not been followed or are a sham […], further analysis is required to determine the true terms of the transaction".[27] Accordingly, the Guidelines state that "it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk."[28] In addition, transactions between associated enterprises as they have been structured by them can be disregarded and re-characterized in accordance with their substance, or substituted by other transactions by adjusting the conditions to reflect the economic and commercial reality:

- "where the economic substance of a transaction differs from its form"; or
- "where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price".[29]

Therefore, for example, the tax administration can disregard the purported assignment of risk if "there is good reason to doubt the economic substance".[30] Whether or to which extent comparability adjustments are made or transactions are, exceptionally, disregarded or substituted by other transactions,[31] in the end depends not on the contractual terms but on the economic substance of the contractual agreements as it is best evidenced by the parties' actual conduct.[32]

26. Part I paras. 14-15 *2010 Report*.
27. Paras. 1.53 and 9.13 *2010 Guidelines*.
28. Para. 1.48 *2010 Guidelines*; *see also* paras. 9.14 and 9.166.
29. Para. 1.65 *2010 Guidelines*; *see also* para. 9.169.
30. Para. 1.69 *2010 Guidelines*; *see also* paras. 1.48-1.49 and 9.12.
31. On the difference between making a comparability adjustment and not recognizing the risk allocation in a controlled transaction, *see* paras. 1.69 and 9.34-9.38 *2010 Guidelines*.
32. Also according to the Revised Discussion Draft on Intangibles, legal ownership of intangibles based on the terms and conditions of legal arrangements (including registrations and licence agreements) must be consistent with the conduct of the associated parties as it is confirmed through a detailed functional analysis. *See* OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* paras. 66, 71 and 91 (30 July 2013), with reference to para. 1.53 *2010 Guidelines*. It is thus the economic substance of the legal arrangements which is important under article 9, and the conduct by itself is decisive if no legal arrangements are in place. *See also* OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* para. 71 (30

When the 2010 Report is compared to the Guidelines, the considerations in giving effect to dealings and transactions are very similar. In fact, legally binding contracts can be substituted by other documentation both under articles 7(2) and 9. For purposes of applying article 9, not only no written contracts may exist between the associated enterprises, but no written terms of a transaction may exist at all. In such cases "the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises".[33] Even if the associated enterprises do not conclude legally binding contracts which would indicate a transaction and do not establish correspondence and other communications, the arm's length principle of article 9 can be applied on the basis of the actual conduct. Under article 7(2), no legally binding contracts exist from the outset but such contracts can be substituted by accounting records, pro-forma contracts or quasi-contractual arrangements and other internal documentation. Such documentation, even though not legally binding, can express the intention of assigning functions, assets and risks to a particular part of the enterprise.[34] For intra-entity cost contribution arrangements, pro-forma contracts may even be essential under the AOA.[35] If no such documentation is prepared (for example, because no PE was anticipated) and thus no written terms of a dealing exist, the "contractual relationship" in a PE context will have to be deduced, following, by analogy, the Guidelines, from the "conduct and the economic principles that generally govern relationships between independent enterprises".[36] Although there are no legally binding contracts in a PE context which would indicate a dealing, the arm's length principle of article 7(2) can still be applied on the basis of the actual conduct. Consequently, neither the existence of legally binding contracts under article 9 nor the lack of such contracts under article 7(2) should be overrated.

July 2013), which provides for a meaning of the "legal owner" based on the facts and circumstances in cases where no legal ownership of an intangible is identified. In this context, moreover, *see* J. Monsenego, *The Substance Requirement in the OECD Transfer Pricing Guidelines: What Is the Substance of the Substance Requirement?*, 21 Intl. Transfer Pricing J. 1, pp. 9-23, at sec. 2. (2014), Journals IBFD ("it is suggested that the substance requirement be interpreted identically irrespective of the existence of an agreement", "at the end of the day, […] it is the economic substance of an intercompany transaction that ultimately determines the transfer prices").

33. Paras. 1.52 and 9.11 *2010 Guidelines*; *see also* para. 67 *Revised Discussion Draft on Intangibles*.

34. *See*, for example, Malherbe & Daenen, *supra* n. 1, at sec. 4.4.1.8. ("knowing how contracts within a group are drafted, it is not possible to see why a similar document intended to govern a relationship between PE and head office should not be given the same presumptive force once 'documentation' is required in lieu of decisions"); Kroppen, *Der „Authorized OECD Approach"*, *supra* n. 4, at pp. 1087-1088; H.-K. Kroppen, *Betriebsstättengewinnermittlung*, 14 Internationales Steuerrecht 3, pp. 74-75, at p. 74 (2005); S. Schnorberger, J. Sassmann & M. Shekhovtsova, *Betriebsstättengewinnermittlung nach dem OECD-Ansatz: Der Grundfall der Vertriebsbetriebsstätte*, 23 Internationales Steuerrecht 3, pp. 81-86, at pp. 83 and 86. *See also*, however, Schön, *Attribution of Profits*, *supra* n. 9, at pp. 1068-1071; Vann, *Reflections*, *supra* n. 5, at p. 164.

35. In order to have the development of an intangible asset recognized as a cost contribution arrangement-type activity in which a PE is a participant, convincing contemporaneous documentation may be required, even the type of documentation that would have been created to document an actual cost contribution arrangement structured in accordance with the Guidelines. *See* part I, paras. 213-215 *2010 Report*. Presumably, such documentation will not only be relevant for verifying whether the profit determination relating to the PE's dealings is consistent with the arm's length principle. It will also affect the very existence of, the characterisation of and the terms of the dealings itself, namely whether the PE will obtain an effective ownership interest in the intangible asset developed by the cost contribution arrangement or whether, absent convincing contemporaneous documentation, there will be a need for royalty payments or other consideration. *See*, in this context, part I, para. 225 *2010 Report*.

36. Part I, para. 69 *2010 Report*.

Only because legally binding contracts can be substituted by other means, it is possible to hypothesize dealings between different parts of an enterprise. In a PE context, "the starting point for the evaluation of a potential 'dealing' will normally be the accounting records and internal documentation of the PE showing the purported existence of such a 'dealing'. Under the AOA, that 'dealing' as documented by the enterprise will be recognised for the purposes of attributing profit, provided it relates to a real and identifiable event", as determined by a functional and factual analysis.[37] For that purposes the guidance on the contractual terms and the recognition of actual transactions in the Guidelines can be applied by analogy.[38] "So, by analogy, the 'contractual terms' are the accounting records [and other observable conduct], together with any contemporaneous internal documentation".[39] Again, "an accounting record and contemporaneous documentation showing a dealing […] would be a useful starting point for the purposes of attributing profits".[40] Such documentation should be given effect, "notwithstanding its lack of legal effect",[41] especially to the extent that:

- "the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis"; and
- "the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price".[42]

In this respect, the 2010 Report refers once again to the guidance on the contractual terms and the recognition of actual transactions in the Guidelines.[43] Accordingly, the tax administration generally "should not disregard the actual dealings or substitute other dealings for them".[44]

Based on the 2010 Report and the Guidelines, articles 7(2) and 9 require very similar considerations in verifying that legally binding contracts or accounting records and internal documentation confirm to the economic substance and the actual conduct. Transactions between legally separate enterprises have legal consequences both for tax and non-tax purposes. Dealings between a PE and the rest of the enterprise usually have no legal consequences for the enterprise as a whole. This difference, however, initially should not be decisive from a tax treaty perspective. Just as law created the concept of a company, something fictitious[45] but separate from individuals as ultimate shareholders, article 7(2) hypothesizes different parts of an enterprise as being separate and independent. If the written terms of an agreement are the same, if the actual conduct is the same, if the real and identifiable events are the same, if all the facts of the particular case are the same, why should there be a difference in treatment between articles 7(2) and 9 depending on whether or not the agreement is legally binding for non-tax purposes? Whether there are legal consequences other than for tax, or whether the fiction of separateness and independence is stipulated only by a tax treaty and only for

37. Part I, para. 177 *2010 Report*
38. Part I, paras. 178-180 *2010 Report*, with reference to paras. 1.48-1.49 and 1.52-1.54 *2010 Guidelines*.
39. Part I, para. 179 *2010 Report*; *see also* part I, para. 195.
40. Part I, paras. 36 and 181 *2010 Report*; para. 26 *OECD Model: Commentary on Article 7* (2010).
41. Id.
42. Id.
43. Part I, paras. 36 and 181-182 *2010 Report*, with reference to paras. 1.48-1.54 and 1.64-1.69 *2010 Guidelines*.
44. Part I, para. 182 *2010 Report*.
45. *See supra* n. 1.

tax treaty purposes, should not matter so far as those legal differences do not result in factual differences, i.e. in a different conduct.

Actually, agreements between different parts of an enterprise can sometimes be legally binding. If a partnership having legal capacity or even a company under a "check-the-box" regulation is treated as transparent for tax purposes, it may be regarded as constituting a PE for its partners or shareholders, respectively. In such cases it is possible that a single part of the enterprise (the partnership/company as the PE or a partner/shareholder as the head office) legally owns assets, assumes risks, possesses capital or contracts with separate enterprises. While the legal fiction of separateness and independence stipulated by private law is effectively disregarded for tax purposes because the entity is treated as transparent, article 7(2) again requires adhering to that initial fiction.[46] If in such cases the "nature" of a PE under article 7(2) is no different than that of a legally separate enterprise under article 9, there can be no argument based on an allegedly different "nature" of a PE which would support different arm's length principles under articles 7(2) and 9.

4. Legal Fictions May Lead to Differences in the Actual Conduct

Conceptually, there should be no difference between the arm's length principles of articles 7(2) and 9.[47] For the attribution of profits to a PE it should be irrelevant that an enterprise generally cannot enter into legally binding contracts with itself in order to assign functions, assets and risks to a particular part of the enterprise. By hypothesizing a PE as a separate and independent enterprise, that legal difference of a PE when compared to a separate enterprise is "legally eliminated" by article 7(2). However, differences in the outcome between articles 7(2) and 9 can be based on differences in the actual conduct. If the actual conduct is different, if the real and identifiable events are different and, therefore, if the facts of the particular case are different, this can lead to different results.

What is the actual conduct or where is the borderline between legal fictions and reality, or between artificial constructs and real facts? Is, for example, the existence of a company by itself a non-legal fact and thus part of the actual conduct? In a strict sense it is not, as only the paper on which the articles of incorporation are written, the process of drafting these articles, the opening of a bank account, the entry in the commercial register, the meetings of the shareholders, the behaviour of the managers, for example, by putting down of the company's name on paper in all future contracts, the behaviour of the company's clients and creditors against the background of the shareholders' limited liability and the capital

46. *See also* C. Looks & J. Maier in *Betriebsstättenbesteuerung*, 2nd ed., at pp. 278-279, mn. 721 (U. Löwenstein, C. Looks & O. Heinsen eds., Munich: C.H. Beck 2011); W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax Journal 1, pp. 67-114, at pp. 96 and 107 (2009), Journals IBFD; G. Strunk in *Steuerrecht international tätiger Unternehmen*, 4th ed., at pp. 712-713, mn. 4.32 (J.M. Mössner et al., Cologne: Dr. Otto Schmidt 2012).

47. *See also*, for example, Malherbe & Daenen, *supra* n. 1, at sec. 4.2. ("conceptually, there is, or there should be, no difference in the tax outcome whether an investment is made directly by a non-resident through a PE or indirectly through a subsidiary incorporated in the source state"); Kroppen, *Der „Authorized OECD Approach"*, *supra* n. 4, at p. 1087 ("es [sollte] auf der Ebene der Doppelbesteuerungsabkommen keinen Unterschied danach geben […], ob eine bestimmte Aktivität von einer Tochtergesellschaft oder eine[r] Betriebsstätte wahrgenommen wird"). Under the current OECD Model, however, dealings between a PE and other parts of an enterprise are only recognized under article 7(2) and thus will not trigger source taxation for the purposes of any other provisions of the convention. *See*, for example, part I, paras. 11, 173 and 203, and part IV, para. 166 *2010 Report*; paras. 28-29 *OECD Model: Commentary on Article 7* (2010). *See also* Bennett, *Article 7 – New OECD Rules*, *supra* n. 9, at pp. 32-34.

maintenance rules, etc., are real and identifiable events, not legal constructs. But this also means that people act differently if legal fictions are widely recognized, or if agreements are legally sustainable and enforceable. Such legal fictions and agreements thus have effects and repercussions on the actual conduct. In cases where the separateness and independence of a legal fiction is widely recognized both for tax and non-tax purposes, and where that legal construct can conclude legally binding and enforceable agreements, often another conduct will occur than where such separateness and independence is stipulated and recognized only for tax treaty purposes.

There may be thus important differences in the actual conduct between, on the one hand, enterprises being separate and independent both for tax and non-tax purposes and, on the other hand, enterprises being separate and independent only for tax treaty purposes, i.e. especially a PE under article 7(2). As a PE is not legally separate and independent, the PE cannot, for example, separately assume operational risks such as product liability risks and warranty risks for product defects and recalls without recourse to other parts of the enterprise.[48] As soon as such risks have materialized and the PE, which has designed and produced and therefore is responsible for the unsafe or defective product, does not have the capacity to assume the financial burden, other parts of the enterprise will have to step into the breach. Legally, the enterprise as a whole remains responsible and liable for product safety and warranty, has a certain creditworthiness vis-à-vis its impaired customers and creditors, needs or needs not to declare insolvency,[49] and generally[50] all the assets of the enterprise are available to meet third-party claims. It is factually not possible to keep other parts of the enterprise safe from such risks and thus to keep the risks stemming from the activities of the PE completely within the PE. Rather, all the parts of the enterprise simultaneously guarantee, from the perspective of article 7(2) in a subordinate manner, all the risks and liabilities of all the other parts of the enterprise, and thus the risks and liabilities may inevitably fall back on all the parts of the enterprise.[51] Insofar the actual conduct, i.e. what in the end the impaired customers and creditors will receive from their claims and what the enterprise will have to pay, may necessarily be different than between legally separate enterprises which, in general, are separately liable only for their own risks.

Nevertheless, this does not necessarily explain why other parts of the enterprise should not be able to primarily assume risks stemming from the activities of the PE, or why it should not be possible to hypothesize insurance dealings between different parts of an enterprise. It is not unusual for legally separate enterprises to insure themselves against operational risks such as product liability risks and warranty risks for product defects and recalls. Similarly, in a PE context, a regular insurance premium could be deducted at the level of the PE and attributed as a profit, for example, to the head office, such dealing being evidenced at least in a pro-forma insurance contract and regular bank transfers if separate bank accounts are maintained. In the event of materialized risks, the head office would indemnify the PE and,

48. *See*, for example, Vann, *Reflections*, *supra* n. 5, at p. 164.
49. *See*, however, on territorial (secondary) insolvency proceedings, Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160, 30 June 2000, pp. 1-18; therefore critically Malherbe & Daenen, *supra* n. 1, at sec. 4.4.1.5.
50. An exception would be "trusteed assets" in the insurance industry; *see*, for example, part IV, paras. 61-62, 122, 131 and 136-141 *2010 Report*.
51. *See also*, in this direction, Pijl, *The Zero-Sum Game*, *supra* n. 5, at sec. 8. ("PEs cannot economically meaningfully guarantee each other's creditworthiness, as the guarantee rests on the capital of the enterprise as a whole").

as a consequence, would primarily bear the financial burden, even though those risks would still be related to the activities of the PE. This would mean that as part of the actual conduct, all third-party claims related to those risks would have to be paid or reimbursed by the head office, and in the worst case the head office, not the PE, would have to sell all its property and assets in order to indemnify the PE. Such insurance dealings would not violate the premise that capital and financial capacity is needed to support guaranteed risks, that capital and risks are not segregated from each other within a single legal enterprise and thus that, under the AOA, capital follows risks.[52] As soon as the risks stemming from the activities of the PE can be insured by the head office, the head office would effectively bear the risks, and both capital *and* risks would be attributed to the head office. As a result, the different parts of the enterprise would maintain the same creditworthiness.[53] Whether insurance dealings or other hedging dealings are recognized under article 7(2) should only depend on the actual conduct, and there might be factual reasons for denying such dealings, for example, because insuring operational risks at arm's length might require functions often not exercised outside of the insurance industry, such as the pooling and diversification of risks and the correct estimation of the insurance premiums.[54]

What makes things difficult is that contracts have legal effect already at the time of their conclusion but the real and identifiable events related to those contracts may occur only later when the contracts are effectively executed. When, for example, risks are contractually assigned to a particular person, the legal effects step in early, but the real and substantial consequences might become visible only when the risks materialize, if they materialize at all. To a certain degree, legally binding contracts, in contrast to pro-forma contracts, might secure the parties' actual conduct in the future, thus guarantee that the parties will adhere to the terms of the contract and execute the contract accordingly. Such assurance will also be provided between associated enterprises so far as, for example, transactions have potential effect on creditors, or directors can be held personally liable for non-conforming to the contracts if to the disadvantage of the enterprise. In contrast, without such legally binding contracts and thus especially in a PE context, it might be necessary to wait for real and identifiable events to occur so far as pro-forma contracts will not be able to similarly secure the enterprise's actual conduct in the future. That could also explain why the AOA puts so much emphasis on "real and identifiable event[s]",[55] requires "greater scrutiny of dealings […] [and] of documentation" and a "threshold […] to be passed" before a dealing is recognized,[56] and even considers

52. Part I, paras. 29 and 104 *2010 Report*; *see also* part II, paras. 65-66 and 180, and part III, paras. 204-205 and 253.
53. *See*, in that respect, part I, para. 71 *2010 Report*.
54. However, the 2010 Report is reluctant in recognizing insurance dealings between different parts of an insurance company; *see* part IV, paras. 177-179 and 195 *2010 Report*; previously OECD, *Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment: Part IV (Insurance)* (27 June 2005), part IV, paras. 183-196; OECD, *Report on the Attribution of Profits to Permanent Establishments: Part IV (Insurance) – Revised Public Discussion Draft* (22 Aug. 2007), part IV, paras. 174-177 and 193. *See also* on captive insurance from a Dutch perspective D. Oosterhoff, *OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings*, 16 Intl. Transfer Pricing J. 3, pp. 190-199, at sec. 3.2.3. (2009), Journals IBFD; and in general A. Skaar, *Taxation Issues Relating to Captive Insurance Companies* (IBFD 1998), Online Books IBFD.
55. Part I, paras. 35, 177 and 194 *2010 Report*.
56. Part I, paras. 34-35 and 175-176 *2010 Report*. *See also* para. 25 *OECD Model: Commentary on Article 7* (2010).

"intra-entity dealings […] perhaps more susceptible to being disregarded or restructured than transactions between associated enterprises".[57]

However, the fact that legally binding contracts concluded between separate enterprises are legally binding and enforceable while pro-forma contracts within an enterprise are not, need not necessarily establish differences in the actual conduct. In some circumstances associated enterprises may not act in accordance with and not enforce their contractual obligations while, in a PE context, the different parts of an enterprise may adhere to pro-forma contracts even though, legally, they would not be required to do so. Such experience or empirical evidence may diminish the value of legally binding contracts between associated enterprises or, depending on how one looks at it, increase the value of pro-forma contracts in a PE context. Therefore, depending on whether real and identifiable events can potentially be identified earlier (for example, in the case of a delivery of goods) or later (for example, in the case of risks which are unlikely to materialize), and depending on whether or to which extent legal rights and obligations arising from legally binding contracts can potentially secure the parties' actual conduct in the future more than pro-forma contracts within an enterprise are able to do, there might or might not be differences in the outcome when the conceptually identical arm's length principles of articles 7(2) and 9 are applied.

Article 7(2) hypothesizes the PE and the remainder of the enterprise as if they were separate and independent enterprises, each undertaking functions, owning or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Conceptually, there should be no difference between the arm's length principles of articles 7(2) and 9. However, the fiction of separateness and independence under article 7(2) might not be able to overcome factual differences in the (future) actual conduct. Some of those differences are caused or can be explained by the fact that contracts and transactions between legally separate enterprises, including legal fictions like, for example, the concept of a company as such, are widely recognized for non-tax purposes and thus influence the actual conduct in a non-tax world.

5. Do Assets and Risks Always Follow (Control) Functions?

Under the AOA it is assumed that assets and risks follow functions. Even dealings presented in the taxpayer's documentation are not recognized if they violate the principles of the AOA "by, for example, purporting to transfer risks in a way that segregates them from functions".[58] A legally separate enterprise, however, can separate functions from assets and risks, for example, by outsourcing functions to a third party or by concluding insurance agreements.[59] In arm's length transactions it is thus possible to contractually separate functions from assets and risks, and vice versa. This is what actually happens when a dependent agent is appointed. Certain functions are outsourced to the dependent agent while assets and risks remain with the principal. Why must assets and risks follow functions in a PE context even though article 7(2) provides for a fiction of separateness and independence and adheres to the arm's length principle?[60] Or why is it possible to outsource functions to a dependent agent under article

57. Part I, para. 176 *2010 Report*.
58. Part I, paras. 36 and 181 *2010 Report*.
59. *See supra* n. 17.
60. This article only deals which risks related to people functions, although there are also risks which are uncontrollable and thus beyond human control, such as natural disasters.

9 but the principal's assets and risks presumably, under the "dual taxpayer" approach, must follow these outsourced functions to the dependent agent PE under article 7(2)?

At a microscopic level, enterprises "outsource" functions and by that separate them from assets and risks on a daily basis, namely by hiring employees. In such cases, functions are physically performed by an employee, who is a separate person, instead of the employer and thus the employer receives services which he has, so to speak, "outsourced" to another person by employment contract. Nevertheless, substantial assets and risks belong to the employer. Since the employer supervises and controls the performance of the employee's work and thus has control over the exposure to the responsibility and risk for the work, he is prepared to bear that responsibility and risk. By supervising the employee's activities and controlling the performance, the employer exercises specific control functions, namely employer functions, which relate to his assets and risks. At a macroscopic level, however, no "outsourcing" of functions takes place, and hiring employees is commonly not even referred to as "outsourcing". As the employee performs the work and exercises all functions on behalf of the employer, is highly integrated into the employer's business and is supervised and controlled by the employer, the employee is regarded as being part of the employer's enterprise.

By outsourcing functions, new control functions emerge. A legally separate and independent enterprise will be prepared to take on substantial assets and risks even though related functions are performed by a third party if it has some control over those assets and risks, namely by having a certain degree of control over the functions performed by the third party.[61] This view is supported by the Guidelines and the 2010 Report:[62]

> An additional factor [to the parties' conduct] to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control.

In this context:[63]

> […] "control" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party. While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).

The Guidelines explain the importance of control functions in more detail in relation to the transfer pricing aspects of business restructurings by providing examples involving a fund manager, a contract researcher and a contract manufacturer.[64] Although the Guidelines

61. *See also* Pijl, *The Zero-Sum Game*, *supra* n. 5, at sec. 3. ("in commercial economic terms, no party is prepared to bear a risk that he cannot influence by his actions"); similarly H. Pijl, *Morgan Stanley: Issues regarding Permanent Establishments and Profit Attribution in Light of the OECD View*, 62 Bull. Intl. Taxn. 5, pp. 174-182, at sec. 2.1. (2008), Journals IBFD.
62. Para. 1.49 *2010 Guidelines*; part I, para. 179 *2010 Report*; *see also* para. 9.22 *2010 Guidelines*.
63. Paras. 9.23-9.24 *2010 Guidelines*.
64. Paras. 9.25-9.27 *2010 Guidelines*; *see also* paras. 9.190-9.194.

regard the examination of which party has relatively more control over the risk not as a determinative factor for the allocation of risks (the financial capacity to assume, i.e. to take on, risks is mentioned as another relevant factor)[65] and do not intend to set a standard under article 9 whereby risks would always follow capital or people functions,[66] the Guidelines accept that significant day-to-day monitoring and administration functions can be outsourced and thus separated from risks provided that, amongst other things, they are substituted by appropriate control functions.[67] In this context, the notion of "control" is wide and need not be with the person who is "closer" to the risk-creating activity.[68]

Also the Revised Discussion Draft on Intangibles[69] adheres to the view that control functions are a key consideration under article 9. In applying the arm's length principle it is:[70]

> […] necessary to determine, by means of a functional analysis, which member(s) [of an MNE group] performed and exercised control over development, enhancement, maintenance and protection functions, which member(s) provided necessary funding and other assets, and which member(s) bore and exercised control over the various risks associated with the intangible. […] It is not essential that the legal owner physically perform all of the functions related to the development, enhancement, maintenance, and protection of an intangible through its own employees […]. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. […] In such cases, however, the party performing the outsourced functions should operate under the control of the legal owner. In assessing what member of the MNE group in fact controls the performance of the relevant functions, principles analogous to those [related to the meaning of "control" in the context of business restructurings][71] apply.

As regards the allocation of risks, the Revised Discussion Draft on Intangibles again refers to the guidance on business restructurings, including the principles related to the meaning of "control".[72] If the legal owner outsources functions related to the development, enhancement, maintenance and protection of an intangible, and also outsources the control functions over those already outsourced functions, the Revised Discussion Draft claims that "the

65. Para. 9.20 *2010 Guidelines*. Under the premise of the AOA that within an enterprise capital follows risks, the financial capacity of a hypothesized PE needs to be determined based on the attributed risks, and not the other way round. It thus appears that the notion of "financial capacity to assume risks" emphasized by the Guidelines would not be a useful factor for attributing risks to a PE under article 7(2). As a consequence, the notion of "control" could be considered as being an even more important factor for attributing risks under article 7(2) than it actually is under article 9. In this context, *see also* E. Kamphuis, *Proposed OECD Risk Allocation Examination Process And Its Implications for Transfer Pricing Design*, 18 Transfer Pricing Report 92, sec. 3.4.2. (28 May 2009): "[Under the AOA] the SPF [significant people functions] […] determine the risk allocation and, subsequently, the amount of equity capital […]. In case of legally distinct enterprises, one can not re-allocate equity capital from one enterprise to the other just because the latter performs the risk control function, except for non-recognition cases […]. For that reason, the OECD had to consider, as separate criteria, both the risk control function and the financial capacity to bear a risk, in defining the economic substance risk allocation method."
66. Para. 9.21 *2010 Guidelines*.
67. *See*, however, critically A. Eigelshoven & A. Ebering in *Handbuch Internationale Verrechnungspreise*, 15th suppl., OECD Guidelines, Chapter I, mns. 98-105 (H.-K. Kroppen ed., Cologne: Dr. Otto Schmidt, Oct. 2012).
68. Even an insurer could thus be considered to be in control of the insured risks. The insurer has no substantial influence on the risk-creating activity exercised by the insured person, but an investor need not have substantial influence on the investment decisions taken by a fund manager either. The insurer, however, actually is able to influence his risk position in many respects, for example, by correctly estimating the insurance premiums and deciding to take on, or not to take on, certain specific risks, and thus the insurer has some control over the risks which it bears.
69. OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (30 July 2013).
70. Paras. 74 and 76 *Revised Discussion Draft on Intangibles*.
71. Paras. 9.23-9.28 *2010 Guidelines*.
72. Para. 85 *Revised Discussion Draft on Intangibles*, with reference to paras. 9.10-9.46 *2010 Guidelines*; *see also* paras. 146 and 172 *Revised Discussion Draft on Intangibles*.

legal owner likely would not be entitled to any ongoing benefit attributable to the outsourced functions".[73] Outsourcing all those functions, however, does not necessarily mean that no functions, assets and risks remain. When control functions are outsourced, usually new functions emerge, including the decision to outsource to a particular party with predefined objectives and with the provision of funding, and the decision not to terminate the contract with that party based on a continuing assessment of the outcome. Admittedly, these new functions, although important for assuming risks in third-party transactions, may be relatively minimal and thus difficult to grasp within fully-integrated multinational enterprises.[74]

Under the AOA it is also possible, in certain circumstances, to effectively "outsource" functions from one part of the enterprise to another part of the enterprise:[75]

> A PE may "assume" a risk and may subsequently use the services of another part of the enterprise to "manage" that risk, without necessarily transferring the risk to that other part of the enterprise. In that sense, the risk (which is still allocated to the PE) could be separated from the function of managing the risk (which is done at the other part of the enterprise). On the other hand, a risk may be considered transferred to another part of the enterprise if there is documentation evidencing the intention to engage in a "dealing" in the form of a transfer of the risk to that other part, and that other part thereafter performs the significant people function relevant to the management of the risk. However, documentation by itself would not affect such a transfer, since a part of the enterprise which has not initially assumed a risk cannot be deemed to have subsequently taken over the risk unless it is also managing the risk. In this sense, risk cannot be separated from function under the authorised OECD approach.

Accordingly, the risk initially assumed by the PE can be separated from the function of managing the risk by "outsourcing" the latter function to another part of the enterprise. In order to subsequently transfer the risk to another part of the enterprise, however, a threshold needs to be passed, i.e. the part of the enterprise which wants to take over the risk must also manage the risk.

In addition, the 2010 Report acknowledges that between legally separate enterprises, the performance of development functions in the creation of an intangible "does not of itself determine the legal ownership. Rather, the key issue is which enterprise acts as the entrepreneur in deciding both to initially assume and subsequently bear the risk associated with the development of the intangible property."[76] In other words, the development functions may be outsourced without losing the ownership of the intangible property and the risk associated with the development.[77] This is also true in a PE context: "It may be that one part of the enterprise is a research centre for the enterprise and therefore has performed most or all of the functions by which […] [an] intangible […] has been created. However, that does not necessarily mean that […] the research centre PE […] is treated as the economic owner or joint economic owner of the intangible".[78] Rather, "the significant people functions relevant to the determination of the economic ownership of internally created intangibles are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible

73. Para. 77 *Revised Discussion Draft on Intangibles*; *see also* para. 80.
74. In this context, *see also* paras. 102-105 BIAC Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (30 Sept. 2013).
75. Part I, para. 70 *2010 Report*.
76. Part I, para. 84 *2010 Report*.
77. *See also* para. 9.26 *2010 Guidelines*.
78. Part I, para. 83 *2010 Report*; *see also* part I, paras. 201 and 205.

property."[79] Those functions include the "taking (or taking part in) the initial decision to develop the intangible"[80] and the active management of a research and development programme, for example, by "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".[81]

Even if it is assumed that assets and risks always follow functions, there may be different functions to follow. Often control functions are more important in allocating assets and risks than "day-to-day functions". Although the 2010 Report, the Guidelines and the Revised Discussion Draft on Intangibles are not fully aligned with each other in respect of what control functions are or which control functions need to be considered to which extent,[82] the arm's length principles of articles 7(2) and 9, conceptually, should be the same. Since control functions are important, it is necessary to differentiate between the outsourced functions performed by the dependent agent and the control functions performed by the principal when attributing profits to a dependent agent PE under article 7(2).

6. Attribution of Profits to a Dependent Agent PE

Under the "single taxpayer" or "zero-sum" approach, the functions performed by the dependent agent on behalf of the principal are decisive for pricing the arm's length compensation to the dependent agent under article 9 as well as for attributing profits to the dependent agent PE under article 7(2). If those functions performed by the dependent agent have been rewarded at arm's length, there are no other functions performed in the source state and, therefore, no further profits to attribute to the dependent agent PE. This approach presupposes that both under articles 7(2) and 9 all assets and risks which relate to the functions performed in the source state are already rewarded with the compensation to the dependent agent. Even though there might be other assets and risks which are legally borne by the principal, those assets and risks do not follow the functions performed in the source state and thus cannot be attributed to the dependent agent PE.

Surprisingly, however, many authors[83] who favour the "single taxpayer" approach admit that where an employee of the principal establishes a dependent agent PE,[84] it is possible to

79. Part I, para. 85 *2010 Report*.
80. Part I, para. 90 *2010 Report*.
81. Part I, para. 88 *2010 Report*.
82. Cf., for example, part I, para. 88 *2010 Report*; para. 9.26 *2010 Guidelines*; para. 79 *Revised Discussion Draft on Intangibles*. *See also*, critically, K. Broemel, *Konzerninterne Auftragsforschungsverhältnisse im Spannungsfeld aktueller Entwicklungen bei der Zurechnung von immateriellen Wirtschaftsgütern*, 22 Internationales Steuerrecht 7, pp. 249-255 (2013).
83. *See*, for example, Andresen, *supra* n. 4, at mn. 10.235; Baker & Collier, General Report, *supra* n. 4, at secs. 1.2.6. and 3.5.; Burkert, *supra* n. 4, at p. 528; Ditz, *supra* n. 4, at mn. 199; Ditz & Bärsch, *supra* n. 4, at p. 416; Eisele, *supra* n. 4, at p. 344, fn. 396; Kroppen, *DBA-Kommentar*, *supra* n. 4, at mns. 199 and 203; Kroppen, *Neue Rechtsentwicklungen*, *supra* n. 4, at p. 705; Kroppen, *Der „Authorized OECD Approach"*, *supra* n. 4, at p. 1094; Pleijsier, *supra* n. 4, at sec. 5.; Roth, *supra* n. 4, at p. 432, and at p. 502; Runge, *Der neue Betriebsstättenerlass*, *supra* n. 4, at p. 134; Schaumburg, *supra* n. 4, at p. 1012, mn. 18.59; Sieker, *supra* n. 4, at pp. 985-986; implicitly B. Runge, *Besteuerung von Betriebsstätten im Inland und EU-Ausland*, in *Die deutsche Unternehmensbesteuerung im europäischen Binnenmarkt*, pp. 939-980, at p. 972 (M. Maßbaum, D. Meyer-Scharenberg & H. Perlet eds., Berlin: Luchterhand 1994). *See also* the summary of discussions in A. Deitmer, I. Dörr & A. Rust, *Invitational Seminar on Tax Treaty Rules Applicable to Permanent Establishments – in Memoriam of Prof. Dr Berndt Runge*, 58 Bull. Intl. Taxn. 5, pp. 183-189, at sec. 5. (2004), Journals IBFD.
84. *See*, for example, *OECD Draft Tax Convention on Income and on Capital: Commentary on Article 5* heading before para. 4 (30 July 1963), Models IBFD ("dependent agents and employees"); *OECD Model Tax*

attribute to the PE profits which exceed the compensation to the dependent agent, i.e. the respective remuneration of the employee. Provided that the employee has no blood, shareholder or other close relationship to the principal, the remuneration can be considered to adequately reward the employee for his employment services, i.e. the functions performed, assets used and risks, if any, assumed by the employee. As the employee, by providing his employment services, also acts as a dependent agent, the remuneration of the employee can be considered to adequately reward the dependent agent for his services, i.e. the functions performed, assets used and risks, if any, assumed by the dependent agent. All this is happening, so to speak, at arm's length.[85] What is the difference, for purposes of attributing profits to a PE, between the arm's length situation of a dependent agent PE established by an employee and the arm's length situation of a dependent agent PE established by a related or unrelated enterprise? In all these situations the agent is *not* independent within the meaning of article 5(6)[86] but, at the same time, *is* independent within the meaning of article 9 in terms of not being associated and/or being adequately rewarded for all functions performed, assets used and risks, if any, assumed in the source state. In all these situations the "single taxpayer" approach should thus apply, regardless of whether the dependent agent PE is established by an employee or by a related or unrelated enterprise[87] – or the "single taxpayer" approach should not apply at all.

In arguing for the "dual taxpayer" approach, the 2010 Report emphasizes that under article 7(2) "the same principles as used for other types of PEs" must be followed:[88]

> A functional and factual analysis determines the functions undertaken by the dependent agent […] both on its own account and on behalf of the non-resident enterprise [which is the principal]. On the one hand the dependent agent […] will be rewarded for the service it provides to the non-resident enterprise […]. On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent […] on behalf of the non-resident, together with sufficient "free" capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital.

In this context it is decisive that:[89]

> […] certain risks, for example, inventory and credit risks under a sales agency arrangement, belong not to the dependent agent […] but to the non-resident enterprise which is the principal. Although it is agreed that the risks are legally borne by the non-resident enterprise, […] under the "single taxpayer" approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the authorised OECD approach would attribute those risks to the dependent agent PE for tax purposes if, and only if, the dependent agent performed the significant people functions relevant to the assumption and/or subsequent management of those risks.

Conventions on Income and on Capital: Commentary on Article 5 para. 31 (11 Apr. 1977) and para. 32 (1 Sept. 1992-22 July 2010), Models IBFD ("dependent agents i.e. persons, whether employees or not, who are not independent agents").

85. *See also* Arnold, *supra* n. 5, at sec. 3. ("employees receive arm's length salaries"); similarly Fris, Llinares & Gonnet, *supra* n. 9, at sec. V. ("employees are third parties to the companies that employ them").
86. To be precise, according to the wording of article 5(6) the agent may even be independent but nevertheless establish a "dependent agent PE" under article 5(5) so far as he is not acting in the ordinary course of the business of a broker, general commission agent or any other agent of an independent status.
87. *See*, to that effect, Görl, *supra* n. 4, at pp. 122-123; Bendlinger, *supra* n. 4, at sec. 4.4.
88. Part I, para. 232 *2010 Report*; *see also* part I, para. 47.
89. Part I, para. 235 *2010 Report*.

This means that where the dependent agent enters into a typical sales agency agreement and warehouses a stock of goods belonging to the principal in order to fulfil the customer orders generated by the dependent agent's sales activities, the associated inventory risk (the risk of being unable to sell the goods or that its value will go down) is assumed by the principal. An arm's length agency fee to the dependent agent would therefore not include an element to reward the assumption of these risks since these risks are not borne by the dependent agent.[90] If, however, the dependent agent makes the active decisions related to inventory levels and therefore:[91]

> […] perform[s] the significant people functions relevant to the assumption and/or subsequent management of inventory risk and the significant people functions relevant to determining the economic ownership of the inventory […] on behalf of the non-resident enterprise […] the "economic ownership" of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach [together with a profit element] to the dependent agent PE.

Given that, conceptually, there should be no difference between the arm's length principles of articles 7(2) and 9, why should the inventory risk be attributed, under article 7(2), to the dependent agent PE based on the significant people functions performed by the dependent agent in the source state even though the same risk cannot be attributed, under article 9, to the dependent agent based on the *same* significant people functions performed by the dependent agent? Because the inventory risk does not *legally* belong to the dependent agent, as the 2010 Report seems to suggest?[92] Or if solely the legal arrangements are decisive for attributing the inventory risk to the principal, why should it not be possible to establish pro-forma contracts and hypothesize their legal relevance under article 7(2) in order *not* to attribute the inventory risk to the dependent agent PE?

Under article 9, the principal's assets and risks can be separated, at arm's length, from the functions performed by the dependent agent especially because the principal exercises control functions over the dependent agent's activities. Under article 7(2), the functions performed by the dependent agent thus cannot be decisive for the attribution of the principal's assets and risks to the dependent agent PE. Rather, the control functions which the principal exercises over the dependent agent's activities must be considered. As soon as those control functions can be attributed to the dependent agent PE, the principal's assets and risks related to those control functions can be attributed to the PE as well, together with profits which may exceed the arm's length compensation to the dependent agent.

If an entrepreneur who sells goods to customers decides to outsource functions including the reviewing of the customers' creditworthiness and generally the active decision-making that leads to the assumption of credit risk, i.e. whether or not, or under which conditions, to sell to a particular customer,[93] he might hire an employee or conclude a sales agency

90. Part I, para. 241 *2010 Report*.
91. Part I, para. 243 *2010 Report*.
92. Part I, paras. 235 *2010 Report* ("legally borne by") as well as 236-237 and 245 ("legally belong to"); *see also* part III, para. 281 ("the legal owner"), although para. 278 focuses on a functional analysis ("ability to assume the risks" based on the capital available). *See*, in addition, D. Oosterhoff, *The True Importance of Significant People Functions*, 15 Intl. Transfer Pricing J. 2, pp. 68-75, at sec. 6.2. (2008), Journals IBFD; J. Wittendorff, *Agency Permanent Establishments and the Zimmer Case*, 17 Intl. Transfer Pricing J. 5, pp. 358-364, at sec. 5. (2010), Journals IBFD ("under the AOA, profits may thus be allocated to an agency PE if the contractual and factual attribution of risks and intangibles diverge").
93. *See*, in this context, part I, paras. 24-25 *2010 Report*.

contract with another related or unrelated enterprise, a sales agent. If the entrepreneur hires an employee, functions relevant to the assumption of the credit risk which the entrepreneur previously performed by himself will be performed by the employee. Nevertheless, the credit risk (the risk for default on payments in respect of the customer receivables) is not borne by the employee. Rather, the customer receivables and the associated credit risk belong to the entrepreneur, and the employee is not rewarded for the assumption of credit risk. With "outsourcing" functions and separating them from assets and risks, the entrepreneur created new functions, i.e. control functions (employer functions). By deciding to appoint the employee for that work, assigning the objectives to the employee, supervising the employee's activities, controlling the employee's performance as well as monitoring and assessing comprehensively and on a regular basis the outcome of the employee's activities, the entrepreneur exercises significant functions which, amongst other things, relate to the credit risk. If the entrepreneur decides to conclude a sales agency contract with another related or unrelated enterprise, a sales agent, again functions relevant to the assumption of the credit risk which the entrepreneur previously performed by himself will be performed by the sales agent. Nevertheless, under a typical sales agency agreement the credit risk is not borne by the sales agent. Rather, the customer receivables and the associated credit risk belong to the entrepreneur, and the sales agent is not rewarded for the assumption of credit risk. Yet again there are different functions, namely the functions which have been outsourced to the sales agent and the control functions which relate to the work of the sales agent and are exercised by the entrepreneur. Only so far as the latter functions can be attributed to a dependent agent PE which is established by the sales agent for the entrepreneur, there will be a profit attribution above (or, in cases of losses, below) zero.

Functions performed by a dependent agent may remain separated from the assets and risks belonging to the principal at arm's length under article 9 if they are substituted by appropriate control functions performed by the principal (assets and risks follow control functions). By outsourcing functions to the dependent agent, control functions emerge, and those control functions must be attributed to the dependent agent PE under article 7(2) in order to attribute to the PE the related assets and risks of the principal, including a profit element. It is therefore decisive whether or to which extent control functions, even though, in fact, exercised by the enterprise as a whole, can be attributed to the dependent agent PE. Would the PE, as a hypothetically separate and independent enterprise, exercise those control functions over the dependent agent's activities or would they rather be exercised by another part of the enterprise? Only so far as control functions can be attributed to the dependent agent PE, the related assets and risks can be attributed to the PE as well, including a profit element which may exceed the reward to the dependent agent. It therefore must be analysed how control functions as significant people functions can be attributed to a PE.

7. Attribution of People Functions to a Fixed Place of Business PE

Under the AOA, significant people functions must be performed "by people in the PE",[94] "by the personnel of the PE"[95] or "by employees of the PE"[96] in order to be attributable to the PE together with assets, risks, capital and thus profits. However, the 2010 Report does not spe-

94. Part I, para. 15 *2010 Report*.
95. Part I, para. 68 *2010 Report*.
96. Part I, para. 23 *2010 Report*.

cifically deal with the question as to what constitutes the personnel of the PE or when an employee may be regarded as belonging to the PE.[97] A solution for allocating personnel within an enterprise could lie in applying the arm's length principle of article 7(2) to specific control functions, namely employer functions. In arm's length situations between legally separate and independent enterprises, it can be determined who the employer of an employee actually is. In that regard, the contractual relationship between the employee and the legally separate and independent enterprise is not necessarily decisive. Who the employer is for tax treaty purposes rather depends on who mainly exercises the relevant employer functions.[98] An employee provides his employment services to his employer and thus is part of the personnel of his employer. As there cannot be an employer without an employee nor an employee without an employer, the functions performed by the employee must be performed on behalf of the person who mainly exercises the respective employer functions.

In this regard, i.e. in determining for whom the employee works, the functions performed by the employee and the functions performed by the employer must be considered together. In applying article 7(2), it could be determined whether an employee works for the hypothetically separate and independent PE, or for another part of the enterprise. Even though the employee has concluded his employment contract with the employer, who carries on the business of the whole enterprise, it could be determined which part of the enterprise, in fact, primarily exercises the rights and obligations in respect of the contract and the relevant employer functions. To the extent that the PE, being a separate and independent enterprise, would be the employer based on the employer functions attributable to and hypothetically exercised by it, the employee would provide his employment services to the PE and could be regarded as part of the personnel of the PE.[99] Initially, however, this approach has the drawback that employer functions such as supervision and control are also exercised by people and thus are also people functions. Again, employer functions must be performed "by people in the PE" or "by the personnel of the PE" in order to be attributable to the hypothetically separate and independent PE.

Similar to the proxy that the place of use of a tangible asset is decisive for its economic ownership (absent circumstances in a particular case that warrant a different view),[100] the AOA uses the place of performance as a proxy for attributing functions to a hypothetically separate and independent PE:[101]

> It has to be determined in what capacity functions are performed, i.e. as a service performed for another part of the enterprise or as a function of the PE on its own. Where the PE is created through a fixed place of business within the meaning of Article 5(1), the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the "fixed place" that constitutes the PE and the functions performed at that "fixed place".

97. *See also*, critically, Kroppen, *Der „Authorized OECD Approach", supra* n. 4, at p. 1089.
98. *See*, with further references, K. Dziurdź, *Article 15 of the OECD Model: The 183-Day Rule and the Meaning of "Employer"*, 58 British Tax Review 1, pp. 95-108 (2013); and K. Dziurdź, *Kurzfristige Arbeitnehmerüberlassung im Internationalen Steuerrecht*, at sec. 4 (Vienna: Linde, 2013).
99. *See also*, in the context of article 15(2)(c), K. Dziurdź, *Article 15 of the OECD Model: The 183-Day Rule and the Meaning of "Borne by a Permanent Establishment"*, 67 Bull. Intl. Taxn. 3, pp. 122-127 (2013), Journals IBFD; and K. Dziurdź, *Dependent Agent PE Created by an Employee: Remuneration "Borne by" under Article 15(2)(c) of the OECD Model?*, in *Dependent Agents as Permanent Establishments* (M. Lang, P. Pistone, J. Schuch, C. Staringer & A. Storck eds., Vienna: Linde, forthcoming).
100. Part I, paras. 75 and 194 *2010 Report*.
101. Part I, para. 60 *2010 Report*.

It is thus necessary to consider the significant people functions "performed by the personnel of the PE at the PE's location."[102] Again and again the 2010 Report refers to the location "where the significant people functions […] are performed"[103] and to "the performance of the functions in the PE jurisdiction".[104] It suggests "looking at whether the people performing those [significant people] functions are located in the PE"[105] and after stating that key entrepreneurial risk-taking and any supporting functions are all "performed by personnel: 'people functions'",[106] again focuses on the location where those functions are performed and whether they are "performed partly in one jurisdiction and partly in another".[107] It therefore appears that under the AOA, the location where significant people functions are performed is decisive for attributing them to different parts of an enterprise.[108]

Such a proxy is reasonable from the perspective of article 5(1), which defines what a fixed place of business PE is. Without a PE, there is no need or possibility to attribute functions under article 7(2). Thus, the PE definition in article 5(1) and the real presence in the source state required for establishing a PE are the basis and benchmark for attributing people functions. When a fixed place of business establishes a PE under article 5(1), it can be assumed that functions involved in carrying on the business through the fixed place of business are attributable to the PE, and thus it must be determined, what is happening at the fixed place of business. Initially there is the presumption that the functions performed at the fixed place of business are also the functions attributable to the PE and performed by the personnel of the PE. In other words, the people working at the fixed place of business are supposed to be the personnel of the PE and to perform functions attributable to the PE. Therefore, the PE definition in article 5 lays the foundation for attributing people functions under article 7(2). As the PE definition in article 5(1) focuses on a certain location, that location and the people functions physically performed at that location are an important starting point.

As indicated, both employee and employer functions must be considered together in order to regard an employee as belonging to the personnel of a PE, and the PE as the hypothetically separate and independent "employer" of the employee. It cannot be assumed that there is an "employee PE" which hypothetically performs only such functions which the respective employees perform and for which they are already remunerated, at arm's length, with their salaries and wages,[109] or that there is an "employer PE" which hypothetically performs only employer functions without having any employees functionally belonging to it. Rather, every employee needs an employer, and vice versa, also hypothetically when article 7(2) is applied.

This means that to determine for which hypothesized part of the enterprise an employee works, the functions performed by the employee and the corresponding functions performed

102. Part I, para. 68 *2010 Report*.
103. Part I, para. 107 *2010 Report*.
104. Part I, para. 246, and part III, para. 285 *2010 Report*.
105. Part II, para. 64, and part III, para. 203 *2010 Report*.
106. Id.
107. Part II, paras. 70-71, 73-75 and 171, and part III, paras. 224-226 *2010 Report*.
108. *See also*, critically, T. Edgar & D. Holland, *Source Taxation and the OECD Project on Attribution of Profits to Permanent Establishments*, 37 Tax Notes Int. 6, pp. 525-539, especially at pp. 526 and 533 (7 Feb. 2005) ("a concept of the PE as a hypothesized separate entity that is defined simplistically on the basis of the geographic location of activities", "[…] that is apparently tantamount to the geographic location of […] functions"); Schön, *Attribution of Profits*, *supra* n. 9, at p. 1065.
109. For an additional argument based on the fact that article 7(2) hypothesizes a PE to be a separate and independent *enterprise*, *see*, in this article, section 8.

by the employer cannot be separated from each other. Thus, if the place of performance is used as a proxy for attributing functions under article 7(2), problems arise when employee and employer functions are exercised from different locations. Especially at a high strategic level, people functions performed by the senior management often relate to all parts of the enterprise and can be exercised from almost anywhere. In such cases it might be helpful to focus on the employee functions and to determine whether or not the employee (i.e. the person in control) physically performs functions primarily at the fixed place of business in the source state. On that basis, the corresponding employer functions could be attributed to the PE even if they are physically exercised outside of the source state's jurisdiction.

To the extent that the employee belongs to the personnel of the PE, the PE, being a separate and independent enterprise, would be the employer of the employee by exercising the corresponding employer functions. Where, for example, the employer supervises and controls from the residence state an employed manager who is predominantly present in the residence state (because he is responsible for the business carried on through the head office), and another employed manager who is predominantly present at a fixed place of business in the source state (because he is responsible for the business carried on through the PE), it could be concluded, based on the place of performance (but also based on a functional analysis), that the former manager belongs to the personnel of the head office while the latter manager belongs to the personnel of the PE. As a consequence, the PE, being a separate and independent enterprise, would be the employer of the latter manager even though the employer physically exercises the corresponding employer functions from the residence state.

In other cases, where, for example, an employee is highly mobile and travels the world, it might be helpful to focus on the employer functions and to determine whether or not the employer, or a manager on the employer's behalf (i.e. the controlling person), physically performs employer functions primarily at the fixed place of business in the source state. However, it must be determined in which cases which approach to follow and, furthermore, situations remain where both employee and employer functions are exercised from numerous different locations. If it cannot be assumed that the employee is working for several hypothesized "employers", for each on a part-time basis or on a sequential full-time basis (e.g. full-time for several months for one "employer", then full-time for several months for another "employer"), the place of performance will often not be a conclusive proxy. Circumstances in a particular case, especially the functions performed, may also warrant the abandonment of the place of performance as a proxy. In such situations, in order to attribute employee and employer functions together to a particular part of the enterprise, a functional analysis is required under article 7(2), which is not limited by geographic borders.

In attributing significant people functions to a PE established under article 5(1), it is not singularly decisive at which place the functions are physically performed, or whether they are physically performed at the PE's premises. Needless to say, the personnel of the PE may leave the PE's premises in order to, for example, visit clients and customers, to collect information or to negotiate with suppliers. Nevertheless, those functions may be performed by the personnel of the PE and, to that extent, attributable to the PE. This is also true if the personnel of the PE travel abroad to another state and thus physically perform functions outside of the PE's state jurisdiction.[110] By using modern communication tools, people functions can be

110. *See*, for example, B.J. Arnold & J. Sasseville, *Source Rules for Taxing Business Profits Under Tax Treaties*, in *The Taxation of Business Profits Under Tax Treaties*, pp. 109-131, at p. 119 (B.J. Arnold, J. Sasseville & E.M.

exercised from almost anywhere. Thus, there might be functions not performed at the fixed place of business which are nevertheless attributable to the PE, and there might be functions performed at the fixed place of business which are nevertheless attributable to another part of the enterprise. If, for example, the PE provides services or goods to the head office and therefore sends employees to the head office, the employees may remain personnel of the PE, and if the head office provides services or goods to the PE and therefore sends employees to the PE, the employees may remain personnel of the head office.

Accordingly, the 2010 Report emphasizes that the functional and factual analysis under the AOA "should, to the extent relevant, consider the PE's activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE".[111] This means that the functional analysis must take into account all activities carried on both inside and outside of the source state's jurisdiction:[112]

> In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE's host country. […] However, it is important that the functional analysis include not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE by other parts of the enterprise and all activities performed by the PE on behalf of other parts of the enterprise.

In a similar way the 2010 Report states that "it may […] be necessary to determine whether some functions, although performed outside the PE, should nevertheless be taken into account when attributing profit to the PE as being related to, at least in part, the functions and characteristics of the PE."[113] For the purposes of attributing significant people functions to a PE, in an overall view it must be determined, what is happening at the fixed place of business, what is happening outside of the fixed place of business, which functions performed at the fixed place of business nevertheless relate more closely to another part of the enterprise, and which functions not performed at the fixed place of business nevertheless relate more closely to the work carried on at the fixed place of business.

In determining to which part of the enterprise certain functions relate more closely, it is necessary to take into account all other functions, assets and risks of the enterprise; by whom those other functions are performed; to which hypothesized parts of the enterprise those other assets and risks belong; and whether or how those other functions, assets and risks interact with each other and with the functions under scrutiny. Other functions, assets and risks can provide guidance for the functions under scrutiny only after they have been attributed to a particular part of the enterprise, and perhaps for that purpose the place of performance or the place of use[114] might be a useful and conclusive proxy, or not. As functions are interconnected, their attribution may influence the attribution of others. Performing a

Zolt eds., Toronto: Canadian Tax Foundation 2003); Plansky, *supra* n. 5, at p. 89; Wassermeyer, *supra* n. 5, 112th suppl., Art. 7 MA, mn. 172 (2010). *See also*, for example, para. 67 *OECD Model: Commentary on Article 24* (2010) ("when foreign income is included in the profits attributable to a permanent establishment, […]").

111. Part I, para. 10; part II, para. 62; part III, para. 201; and part IV, para. 92 *2010 Report*.
112. Part I, para. 65 *2010 Report*. *See also* Schön, *Attribution of Profits*, *supra* n. 9, at p. 1065; Fris, Llinares & Gonnet, *supra* n. 9, at sec. II.
113. Part III, para. 203 *2010 Report*; *see also* part II, para. 64.
114. *See supra* n. 100.

functional analysis may thus require reconsidering initial assumptions before definitively splitting up the enterprise into several hypothetically separate and independent parts.

8. Attribution of People Functions to a Dependent Agent PE

Not everything that a dependent agent does in the source state must be attributable to the dependent agent PE of the principal. Only what the dependent agent does on behalf of the hypothetically separate and independent PE established under article 5(5) – not for any other part of the enterprise – is attributable to the PE as agency services received. As article 5(5) focuses on certain activities and a certain presence in the source state, it must be determined what those activities are which establish the PE and what work is performed in the source state.

In this regard, the wording of article 5(5) is broad. It provides that the principal "shall be deemed to have a permanent establishment […] in respect of *any activities* which that person [the dependent agent] undertakes for the enterprise [the principal]"[115] unless the activities are limited to activities of a preparatory or auxiliary character. However, as article 5(5) also provides that a PE is established only if the dependent agent "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", there is no force of attraction.[116] There might be

115. Emphasis added.

116. In fact the term "in respect of any activities which that person undertakes for the enterprise" was added to the OECD Model with its 1977 revision. In this context, para. 34 *OECD Model: Commentary on Article 5* (2010) states that "where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person [dependent agent] acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise". However, this does not mean that all activities of the dependent agent exercised for the principal necessarily establish a PE in the source state and are attributable to that dependent agent PE under article 7(2). The dependent agent (who may be a resident of the residence state, the source state or a third state) may act on behalf of the principal and have, and habitually exercise, the authority to conclude contracts in the name of the principal both in the residence state and in the source state. It would be surprising if, in such a case, the activities which involve the principal only in the residence state would be covered by "any activities" of article 5(5), as well. After all, this would mean that the income from such activities could be attributable to the PE under article 7(2) and taxable in the source state, and, as a consequence, the residence state could be required to exempt that income or to give a corresponding tax credit under article 23, even though the underlying activities were not sourced and did not involve the principal in the source state. Rather, the historical materials reveal a different background of para. 34 *OECD Model: Commentary on Article 5* (2010). In the *Revised Report on Article 5 (Permanent Establishment)*, Working Group N° 1 of Working Party N° 1 of the Committee on Fiscal Affairs on Double Taxation explained a draft of that paragraph as follows: "It appears that the [redrafted] Commentary takes inconsistent positions on the question of whether a permanent establishment which engages in both taxable and exempted activities is entitled to avoid taxation on the income attributable to the exempted activities. Compare paragraphs 12 and 14 with the deleted portion of paragraph 20 (independent-dependent agent example) and paragraph 23 [as the author understands, the term 'exempted activities' thus refers to activities of a preparatory or auxiliary character]. We believe the intent of the Article is that the permanent establishment should be taxable on the income from both types of activities." *See* OECD, *Working Party N° 1 of the Committee on Fiscal Affairs on Double Taxation – Working Group N° 1 (Germany, United Kingdom) – Revised Report on Article 5 (Permanent Establishment)*, CFA/WP1(74)6, p. 23, handwritten remark (30 Aug. 1974). *See also* OECD, *Permanent Establishment – Second Report by Working Group N° 1 on Potential Amendments to Article 5 and to the Commentary Thereon (Germany – United Kingdom)*, DAF/CFA/2697, p. 24 (18 May 1973); OECD, *Summary of Discussions at the Fifteenth Meeting of Working Party No. 1 on Double Taxation (held from 4th to 7th March, 1975)*, DAF/CFA/WP1/75.8, p. 9 (26 Mar. 1975); OECD, *Summary of the Discussion at the 16th Meeting of Working Party N° 1 on Double Taxation (held on 13-16th May, 1975)*, DAF/CFA/WP1/75.11, p. 6 (21 July 1975); OECD, *Working Party N° 1 of the Committee on Fiscal Affairs on Double Taxation – Working Group N° 1 (Germany, United Kingdom) – Third Report on Article 5 (Permanent Establishment)*, CFA/WP1(75)6, pp. 3 and 21 (13 Oct. 1975).

functions performed by the dependent agent in the source state which are nevertheless attributable to another part of the enterprise, and there might be functions not performed in the source state which are nevertheless attributable to the dependent agent PE. If the dependent agent performs work in the source state which relates to contracts concluded in the name of the enterprise under an authority habitually exercised in the residence state, the dependent agent may to that extent provide his services on behalf of the head office, and if the dependent agent performs work in the residence state which relates to contracts concluded in the name of the enterprise under an authority habitually exercised in the source state, the dependent agent may to that extent provide his services on behalf of the PE. In an overall view it must be determined, what is happening in the source state, what is happening outside of the source state, which functions performed in the source state relate more closely to another part of the enterprise, and which functions not performed in the source state nevertheless relate more closely to the activities carried on in the source state that establish the dependent agent PE under article 5(5).

When determining which functions exercised by the dependent agent establish the PE for the principal under article 5(5) or functionally belong to that PE, it is also important to consider which control functions exercised by the principal outside of the source state's jurisdiction follow the dependent agent's functions to the PE and thus are attributable to the PE as well. If the dependent agent is an employee, it can be assumed that insofar he provides his employment services on behalf of the dependent agent PE and belongs to the personnel of the PE, and the respective employer functions are attributable to the PE as well, together with assets, risks and thus profits which may exceed the employee's remuneration. This means that the dependent agent PE, as a separate and independent enterprise, would to that extent be the employer of the employee,[117] and that is the reason why there may be profits attributable to the PE which exceed the employee's remuneration. Even if certain employer functions are physically exercised by the principal outside of the source state's jurisdiction, they may be attributable to the hypothetically separate and independent PE in the source state to the extent they concern activities performed by the employee that establish or functionally belong to the dependent agent PE. It is, however, unclear whether the same holds true for other control functions that are less intensive than employer functions, i.e. in cases where the dependent agent is not an employee but a related or unrelated enterprise. Only if such less intensive control functions are attributable to the dependent agent PE as well, it will again be possible to attribute net profits to the dependent agent PE above (or, in cases of losses, below) zero.

On the one hand, article 9 refers to the definition of the term "person" in article 3(1)(a),[118] and based on that meaning of "person" (an individual, a company and any other body of persons) it may be established which person exercises which functions. If functions are outsourced between separate and independent enterprises, for example, by a principal to an agent, new control functions emerge. This means that the control functions exercised by the

117. *See also* Dziurdź, *Dependent Agent PE Created by an Employee*, *supra* n. 99.

118. Article 9 uses the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State", which are defined in article 3(1)(d) as an enterprise carried on by a resident of a contracting state and an enterprise carried on by a resident of the other contracting state, respectively. Article 4(1) defines the term "resident of a Contracting State" as any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and thus refers to the definition of the term "person" in article 3(1)(a).

principal and the functions exercised by the agent are performed by different persons, both under article 3(1)(a) and article 9. On the other hand, article 7(2) hypothesizes separate "persons" by having a completely different reference point, namely the PE definition in article 5. Based on that PE definition, not just by referring to the arm's length principle in isolation, article 7(2) must decide which functions are exercised by the "person" referred to as the PE. While article 9 accepts that the person referred to as the principal exercises control functions and thus other functions than the person referred to as the agent, article 7(2) must still decide which control functions exercised by the principal can be attributed to the "person" referred to as the dependent agent PE. Only so far as functions exercised by different persons under article 3(1)(a) are also attributable to different "persons" under article 7(2), these functions are effectively "outsourced" and remain separated in a PE context as well.

Some functions, even though exercised by different persons, namely by an employee and his employer, must to a certain extent be attributed together under article 7(2) in order not to render the PE concept meaningless. Thus, functions exercised by an employee at a fixed place of business are attributed to the "person" referred to as the fixed place of business PE *together* with corresponding employer functions, in order to attribute any profits to the PE at all. Similarly, functions exercised by a dependent agent, where the agent is an employee, are attributed to the "person" referred to as the dependent agent PE *together* with corresponding employer functions exercised by the principal, again in order to attribute any profits to the PE at all. Insofar those functions cannot be "outsourced" or separated in a PE context. They remain together and must be considered together. If the agent, however, is not an employee and thus is less dependent than an employee, but still is not independent within the meaning of article 5(6), the decisive question is whether or to which extent corresponding control functions may be attributed to the dependent agent PE, or whether they may remain "outsourced" and separated as they already are under article 3(1)(a) and article 9.

Article 7(2) hypothesizes the "person" referred to as the PE to be a separate and independent *enterprise*, while article 3(1)(c) and (h) defines the term "enterprise" as carrying on of any business, which includes the performance of professional services and of other activities of an independent character. Accordingly, an enterprise under article 7 must carry on work independently, i.e. not in a dependency relationship within the meaning of article 15. If an employee establishes a dependent agent PE under article 5(5), it would, therefore, not be possible to hypothesize the dependent agent PE as carrying on only functions performed by the employee, because then the PE would not be sufficiently independent to be regarded as an enterprise. In other words, because an employee (article 15) is not an enterprise (article 7), and because article 7(2) requires the "person" referred to as the PE to be a hypothetically separate and independent *enterprise*, it is not possible to attribute only functions performed by an employee to the PE. Rather, control functions exercised by the principal, i.e. employer functions, must be attributed to the PE as well, at least so far as they would be necessary to make the dependent employee under article 15 become an independent enterprise under article 7, although still remaining dependent within the meaning of article 5(6). In contrast, if a related or unrelated *enterprise*, which is not dependent within the meaning of article 15, establishes a dependent agent PE for the principal, it could be argued that article 7(2) does not impose any requirements to attribute control functions to the PE. Accordingly, it would be possible to hypothesize the dependent agent PE as carrying on only such functions which the dependent agent actually performs, not less and not more. Thereby the requirement of article 7(2) to hypothesize the "person" referred to as the PE to be a separate and indepen-

dent enterprise would already be met. As a result, an agency contract between the "person" referred to as the head office and the "person" referred to as the dependent agent PE could by hypothesized as well. It would assign only such functions, assets, risks and thus profits to the PE which are already assigned under the agency contract between the principal and the dependent agent. No additional control functions would be attributable to the PE, and thus no additional profits.

However, the wording of article 5(5) does not indicate that the dependent agent PE definition should only be relevant for the allocation of taxing rights where employees are active in the source state. On the contrary, if that were the intention of article 5(5), the distinction between dependent and independent agents under article 5(6), or whether independent agents are acting in the ordinary course of their business, would be unnecessary; article 5(5) could simply refer to employees. Rather, a dependent agent, whether an employee or not, is regarded as carrying on the business of the principal because he is not independent within the meaning of article 5(6), and that is a reason why article 5(5) establishes a PE.[119] This implies that control functions that are responsible for the agent being dependent, including but not limited to employer functions, should be attributed to the hypothesized dependent agent PE without the possibility of establishing a different allocation of control functions. Put differently, to the extent that the agent's dependence is decisive for establishing a dependent agent PE under article 5(5) and that dependence also is a reason why the agent is regarded as carrying on the business of the principal, it can be assumed that the PE, as a separate and independent enterprise, would receive the agent's services and exercise the related control functions. This means that insofar the hypothesized dependent agent PE would own or use assets and bear risks which relate to those control functions, together with a profit element which may exceed the reward to the dependent agent, regardless of whether the dependent agent is an employee or a related or unrelated enterprise. Even if those control functions are physically exercised by the principal outside of the source state's jurisdiction, they may be attributable to the hypothetically separate and independent PE in the source state so far as they make the agent dependent and, therefore, are responsible for establishing the dependent agent PE under article 5(5).

Concluding Example

XCo, a company resident of State X, is the parent company of YCo, a company resident of State Y. Moreover, XCo employs Ms Y and thus is her employer. Both Ms Y and YCo sell in the name of XCo goods to customers in State Y, although independently from each other and in different regions. For that purposes Ms Y and YCo, through its personnel, review the customers' creditworthiness and generally decide on their own, though by considering the general parameters for credit risks defined by XCo, whether a particular customer has a satisfactory credit rating and whether or not, or under which conditions, to sell to a particular customer. Seldom do Ms Y and YCo's personnel consult with XCo's managers who then ultimately make the decision of whether or not, or under which conditions, to sell. Ms Y and YCo's personnel review the credit rating electronically based on a database provided by a credit reporting agency and, where relevant, based on the previous payment behaviour of

119. *See supra* n. 84. *See also* para. 10 *OECD Model: Commentary on Article 5* (2010): "The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (*e.g.* dependent agents)."

a particular customer. Since Ms Y and YCo's personnel are very experienced, XCo's managers usually do not give detailed instructions regarding the manner in which the work has to be performed and, therefore, they only rarely need to be present in State Y. However, XCo's managers monitor and assess comprehensively and on a regular basis the outcome of the sales activities of Ms Y and YCo, in particular the payment behaviour of the customers, and whether Ms Y and YCo are able to satisfy the high expectations of the customers. Only so far as the outcome of their activities is unsatisfactory, XCo's managers discuss with Ms Y or YCo's personnel possible reasons for that outcome and finally give detailed instructions as to the conduct of the work in order to improve the outcome.

Since Ms Y is acting on behalf of her employer and has, and habitually exercises, in State Y an authority to conclude contracts in the name of her employer, she establishes a dependent agent PE for her employer under article 5(5) in State Y. Moreover, since YCo is also acting on behalf of XCo and has, and habitually exercises, in State Y an authority to conclude contracts in the name of XCo, YCo also establishes a dependent agent PE for XCo under article 5(5) in State Y, provided that YCo is not an agent of an independent status under article 5(6).[120] Even though Ms Y and YCo perform significant functions relevant to the assumption of the credit risk, under the employment contract and under the sales agency agreement the customer receivables and the associated credit risk belong to XCo. Ms Y's remuneration and YCo's compensation for agency services do not reward Ms Y and YCo, respectively, for the credit risk.[121]

Solution under the "single taxpayer" approach

According to the "single taxpayer" approach, the compensation to Ms Y for her employment services (including her agency services) and the compensation to YCo, if arm's length under article 9, are considered to adequately reward Ms Y and YCo for their functions performed, assets used and risks, if any, assumed. They thus reward Ms Y and YCo for all the significant functions they perform in State Y on behalf of XCo. Since there are no other functions performed, assets used and risks assumed in State Y, there can be no further profits to attribute to the dependent agent PEs.[122]

Regardless of whether the dependent agent is an employee (Ms Y) or a related or unrelated enterprise (YCo), the agent is *not* independent within the meaning of article 5(6) but, at the same time, *is* independent within the meaning of article 9 in terms of not being associated and/or being adequately rewarded for all functions performed, assets used and risks, if any, assumed in State Y. As a result, there can never be a profit attribution to the dependent agent PE, and article 5(5) is rendered meaningless under the "single taxpayer" approach.[123]

120. *See* paras. 38 and 38.3 *OECD Model: Commentary on Article 5* (2010): "Where the person's [agent's] commercial activities for the enterprise [the principal] are subject to detailed instructions *or* [emphasis added] to comprehensive control by it, such person cannot be regarded as independent of the enterprise." It therefore appears that where an agent is subject to significant control with respect to the manner in which the work is carried out, such agent cannot be regarded as independent within the meaning of article 5(6), regardless of whether the agent's commercial activities for the enterprise are subject to detailed instructions by it.
121. While there may be many different functions, assets and risks which could be attributable to XCo's dependent agent PEs in State Y, in the following solutions only the credit risk is considered in detail.
122. Many authors, however, argue that where an employee of the principal establishes a dependent agent PE, it is possible to attribute to the PE profits which exceed the compensation to the dependent agent, i.e. the respective remuneration of the employee. *See supra* n. 83.
123. Id.

Solution under the "dual taxpayer" approach (OECD's view)

According to the OECD's view on the "dual taxpayer" approach, Ms Y and YCo perform in State Y significant functions relevant to the assumption of the credit risk on behalf of XCo (by reviewing the customers' creditworthiness and generally making the active decisions that lead to the assumption of the credit risk, i.e. whether or not, or under which conditions, to sell to a particular customer). Accordingly, the credit risk belonging to XCo is attributable, together with a profit element, to the dependent agent PEs.[124] As a result, there might be profits attributable to the respective PE in State Y which exceed the compensation to the dependent agent, i.e. the part of the remuneration for employment that rewards Ms Y for her agency services, or the compensation to YCo.

It appears that the OECD's approach follows the legal arrangements when determining to whom the credit risk belongs under article 9, while it follows the dependent agent's functions when attributing the principal's credit risk under article 7(2). It thus presupposes that there are different arm's length principles under articles 7(2) and 9 (contractual arrangements versus functions), because otherwise it would remain unclear why the credit risk should not belong to the dependent agent instead of the principal also under article 9 (risks follow functions), or why it should not be possible to hypothesize legal arrangements under article 7(2) which would assign, at arm's length, the credit risk to the head office (risks follow contractual arrangements).

Solution under the "dual taxpayer" approach (author's view)

According to the author's view on the "dual taxpayer" approach, it is essential that XCo, as a person under article 3(1)(a), exercises relevant control functions (including employer functions) and thus controls the activities of Ms Y and YCo (especially by deciding to hire, and not to terminate the employment contract with Ms Y and to appoint Ms Y as an agent, by deciding to outsource functions to YCo as well and not to terminate the agency contract with YCo, by specifying the authority of Ms Y and YCo to conclude contracts and defining general parameters for credit risks, by monitoring and assessing comprehensively and on a regular basis the outcome of Ms Y's and YCo's activities, which requires Ms Y and YCo to regularly report back to XCo, and by giving Ms Y and YCo's personnel detailed instructions as to the conduct of the work so far as the outcome of the activities is unsatisfactory). This is also a key factor why the credit risk belongs to XCo, and not to YCo, at arm's length under article 9. In order to attribute the credit risk to XCo's dependent agent PEs under article 7(2), it is necessary to attribute the related control functions to the PEs (risks follow control functions), which in the case of an employment include employer functions. For that purposes the PE definition in article 5(5) is the relevant benchmark and reference point. So far as control functions related to the credit risk are a reason why the credit risk is not borne by Ms Y and YCo, and so far as they are, at the same time, a reason why Ms Y and YCo are regarded as being dependent within the meaning of article 5(6) and thus establishing a PE under article 5(5), it can be assumed that the respective PE in State Y, as a separate and independent enterprise, would exercise those control functions vis-à-vis Ms Y and YCo. This means that the credit risk is attributable to the PE as well, together with a profit element which may exceed the reward to Ms Y and YCo. Of course, if Ms Y and YCo's personnel

124. Part I, paras. 24-25 and 245 *2010 Report*.

do not, for example, make any decisions related to inventory levels, neither any functions related to inventory levels nor any control functions nor the inventory risk of XCo can be attributed to a dependent agent PE in State Y.

9. Conclusions

Hypothesizing a PE as a separate and independent enterprise for purposes of attributing profits under article 7(2) is especially difficult where the PE is established under article 5(5) by a dependent agent. However, the dependent agent PE is not more or less fictitious than a fixed place of business PE, it just requires a different type of presence for its legal existence. If the dependent agent is an employee, there might be assets and risks which belong to the principal (employer) but which nevertheless relate to the functions performed by the employee in the source state. They belong to the principal at arm's length especially because the principal exercises control functions (employer functions) over the work of the employee. So far as those control functions are attributable to the hypothetically separate and independent PE, the employee performs his work on behalf of the hypothesized PE and the related assets and risks of the principal are attributable, together with a profit element, to the PE as well. In that case the profits attributable to the dependent agent PE may exceed the compensation to the dependent agent, i.e. the part of the remuneration for employment which rewards the employee for his agency services.

If the dependent agent is a related or unrelated enterprise, the same principles apply as with an employee. Under article 9, functions can be separated from assets and risks if they are substituted by appropriate control functions. If an associated enterprise (principal) outsources functions to another associated enterprise (dependent agent), the related assets and risks might still belong to the principal especially since they follow, at arm's length, the control functions exercised by the principal. Moreover, those control functions might be attributable to the hypothetically separate and independent PE established by the dependent agent under article 5(5). While article 9 refers to functions exercised by persons as defined in article 3(1)(a), article 7(2) determines which functions are exercised by "persons" referred to as the PE or head office, and thus takes the PE definition in article 5(5) as a reference point. So far as those functions are attributed to and thus hypothetically exercised by the dependent agent PE, related assets and risks of the principal are attributable to the PE as well, together with a profit element which may exceed the reward to the dependent agent. In that case there may be a net profit attribution to the dependent agent PE above (or, in cases of losses, below) zero.

Since control functions are exercised by people, they must be attributed to the PE in a similar way as other people functions. For that purposes the PE definition in article 5 is the basis and benchmark for further considerations. While physical presence may be used as an indicator or proxy for attributing people functions to a PE, it is not alone decisive. Rather, employer functions may be attributed to a PE even if they are exercised outside of the source state's jurisdiction in order to attribute any profits at all, both under article 5(1) and article 5(5). It cannot be assumed that there is an "employee PE" which hypothetically performs only such functions which the respective employees perform, or that there is an "employer PE" which hypothetically performs only employer functions without having any employees and thus personnel functionally belonging to it.

The wording of article 5(5) does not indicate that the dependent agent PE definition should only be relevant for the allocation of taxing rights where employees are active in the source state. Therefore, also control functions that are less intensive than employer functions may be attributed to the PE. To the extent that the agent's dependence is decisive for establishing a dependent agent PE under article 5(5) and that dependence also is a reason why the agent is regarded as carrying on the business of the principal, the dependent agent PE, as a separate and independent enterprise, would receive the agent's services and exercise the related control functions. This means that insofar the hypothesized dependent agent PE would own or use assets and bear risks which relate to those control functions, together with a profit element which may exceed the reward to the dependent agent, regardless of whether the dependent agent is an employee or a related or unrelated enterprise.