1. Theoretical Background

When talking about planning scenarios regarding the structuring of business units within in multinational enterprises (MNEs), one of the first questions to deal with is the question of whether the business activities of an MNE in a foreign country should be carried out via an associated enterprise or via a permanent establishment (PE) situated in that country.

In light of this strategic decision-making process, plenty of different aspects (like legal issues, labour law issues, customs, general business specific aspects, accounting, etc.) are to be contemplated; one of these aspects – which will be the focus of the given paper – is the issue of profit attribution. For purposes of this paper, the term 'profit attribution' is to be understood as an umbrella term that comprises both (i) the profit attribution between associated enterprises in light of Art 9 OECD Model 2017 and (ii) the profit attribution between a head office and its PEs in light of Art 7 OECD Model 2017.

In order to properly deal with the aspect of profit attribution within MNEs – irrespective of Art 7 or Art 9 OECD Model 2017 – two dogmatic questions have to be considered:

- The first question is a very intuitive one since it has to be analysed whether the profit attribution provision (i.e., Art 7 or Art 9) of the OECD Model 2017 are **applicable** at all for the case at hand (level of **applicability** of the principles of profit attribution)?
- Once it is safeguarded that the principles of profit attribution are actually applicable, the second question deals with the issue on how to technically apply those principles (level of **application** of the principles of profit attribution)?

Coming back to the initially mentioned tax planning exercise carried out in MNEs, another question arises. However, this question rather has more a tax policy background:

- Are there differences/should there be differences between the profit attribution among associated enterprises in light of Art 9 OECD Model 2017 and between the profit attribution among head office and its PEs in light of Art 7 OECD Model 2017?

1.1. Level of Applicability and Level of Application of the Principles of Profit Attribution

As shown above, the profit attribution within MNEs essentially has to deal with questions on different levels, namely, the level of **applicability** and the level of **application** of principles of profit attribution. If the steps to be taken are systematically analysed in order to properly derive the profits attributable to an asso-

ciated enterprise in light of Art 9 OECD Model 2017 or to a PE in light of Art 7 OECD Model 2017, it can be seen that those questions are very similar (nearly the same).

The following figure illustrates the systematic understanding of those questions:

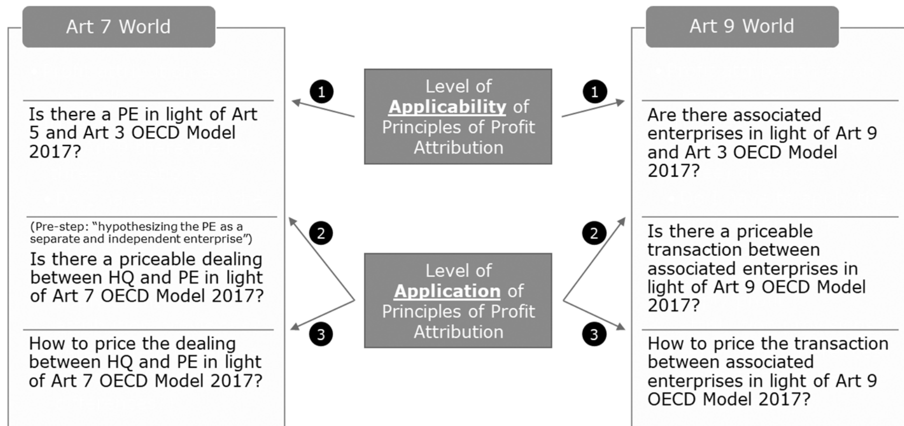

Figure 1: Relevant questions on the level of applicability and application of the principles of profit attribution

1.1.1. The Level of Applicability of the Principles of Profit Attribution

When dealing with the level of **applicability** of the principles of profit attribution, the questions are either:

- Is there a PE in light of Art 5 and Art 3 OECD Model 2017?
- Are there associated enterprises in light of Art 9 and Art 3 OECD Model 2017?

Analysing the rationale of these questions, it becomes evident that it is to be analysed whether or not the activities of an MNE in a certain country exceed a certain level/threshold that might eventually result in a (at least theoretical) taxing right of that country; accordingly, the questions deals with nexus or jurisdiction to tax.

According to the prevailing opinion,[1] PEs in light of Art 5 and associated enterprises in light of Art 9 OECD Model 2017 have in common that there has to be a 'business' according to Art 3(1)(c) in combination with Art 3(1)(h) OECD Model 2017,[2] meaning that the MNE performs professional services and other activities

1 Cf *Dürrschmidt* in *Vogel/Lehner*, DBA[6] Art 3 mn 41a; *Ditz* in *Schönfeld/Ditz*, DBA Art 7 OECD MA 2008 mn 51 et seq; *Reimer* in *Reimer/Rust*, Klaus Vogel Commentary[4] Art 3 mn 38 et seq; *Waser* in *Aigner/Kofler/Tumpel*, DBA Art 7 Rz 14; *Plansky*, Gewinnzurechnung zu Betriebsstätten, pp 55 et seq.

2 According to Art 3(1)(c) OECD Model 2017, the term 'enterprise' applies to the carrying on of any business; what is more, according to Art 3(1)(h) OECD Model 2017, the term 'business' includes the performance of professional services and other activities of an independent character.

7[7], and 14[8] produced as part of that project. To *prevent the use of certain common tax avoidance strategies* that have been used to circumvent the traditional PE definition, BEPS Action 7 recommended changes to the PE-definition in Art 5 OECD Model which is widely used as the basis for negotiating tax treaties as a result of the work on BEPS Action 7.

2. Preparatory and Auxiliary Activities

2.1. Artificial Avoidance of PE Status through Art 5 (4) OECD Model

Art 5 (4) OECD Model lists a number of business activities (e.g. storage, display, delivery or purchasing of goods, collecting information) that are treated as exceptions to the general definition laid down in Art 5 (1) OECD Model which are not considered to constitute a PE even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, of a preparatory or auxiliary nature.[9] The OECD well recognized that such places of business may well contribute to the productivity of the enterprise. However it was considered that the activities listed in Art 5 (4) OECD Model are so remote from the actual realization of profits that it seemed to be difficult to allocate any profit to the fixed places of business in question.[10]

Due to new business models, the old-fashioned PE concept has been more and more scrutinized and questioned by tax authorities. It was concluded that the weakness of Art 5 OECD Model has opened opportunities for multinational enterprise (MNEs) to minimize their tax burden.[11] To tackle such practices, the OECD was commissioned by the G20 to develop an action plan that finally consisted of 15 actions. The definition of what should constitute a PE was seen as one of the areas used by enterprises to reduce their tax bill. To prevent such abuse, BEPS Action 7 was developed targeting the artificial avoidance of permanent establishment status (BEPS Action 7). This report proposed changes to the definition of a PE to prevent the artificial avoidance of PE status in relation to base erosion and profit shifting (BEPS) including with the use of the *specific activity's exemptions* provided for in Art 5 (4) OECD Model.

Under the wording of Art 5 (4), before the 2017 update of the OECD Model, the exemption should apply automatically when one of the activities listed in sub-

7 *OECD* (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD Publishing Paris.

8 *OECD* (2015), Making Dispute Resolution Mechanisms More Effective, Action 14 – 2015 Final Report, OECD Publishing Paris.

9 No 20 OECD Commentary on Art 5 OECD Model (as it read on 15 July 2014).

10 No 23 OECD Commentary on Art 5 OECD Model (as it read on 15 July 2014).

11 *Bendlinger*, Verhinderung künstlicher Betriebsstättenvermeidung durch spezifische Ausnahmen: Vorbereitende und Hilftätigkeiten, in *Bendlinger/Kofler/Lang/Schmidjell-Dommes*, Die österreichischen DBA nach BEPS, p 104 et seq. *Bendlinger*, Übernahme des BEPS-Betriebsstättenbegriffs in die österreichischen Doppelbesteuerungsabkommen, ÖStZ 2017, p 11.

This notion became the basis for the introduction of the *'authorized OECD approach'* in the course of the update in 2010 bringing a new Art 7 into the OECD Model which was based on a report developed by the OECD on the attribution of profits to PEs, the final version of which was released in 2010 (2010 Report[35]) which is deemed to be consistent with the OECD Transfer Pricing Guidelines. The 2010 Report, which was incorporated into the OECD Commentary, expresses the '*functionally separate entity approach*' as basic principle, assuming that the PE is an independent entity and profit allocation rules are based on a *two-step analysis*.

According to Art 7 (2) in the version of the 2017 update of the OECD Model which is a result of the OECD's 2010 Report on the attribution of profits to a PE, the profits that are attributable to a PE

> […] are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

According to the version of Art 7 (2) OECD Model, before the update of 2017, which is still part of Austria's tax treaties,

> […] there shall in each Contracting State be attributed to the PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same and similar conditions and dealing wholly independently with the enterprise of which it is a PE.

Art 7 in the version after the update of 2017 of the OECD Model minimizes the gap between the principles of profits attribution under Art 7 OECD Model and Art 9 OECD Model. Whereas Art 7 (1) OECD Model 2017 is very similar to the version before the update, Art 7 (2) OECD Model 2017 requires that, for the purpose of Art 7 OECD Model 2017 and Art 23 A (exemption method) or Art 23 B OECD Model 2017 (credit method), the profits that are attributable to a PE should be

> the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

35 *OECD*, Report on Attribution of Profits to Permanent Establishments, OECD 2010.

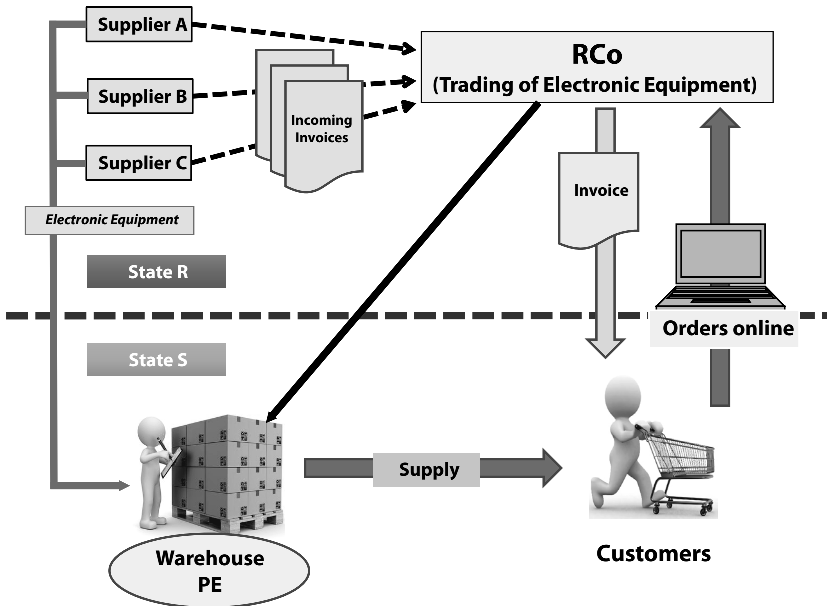

Figure 1: Facts of the case

State R and State S have signed a tax treaty that is in line with the OECD Model that prevents State S from taxing RCo's business profits unless RCo would carry on business in State S through a permanent establishment situated therein. The tax treaty includes the changes made in the update of 2017 of the OECD Model to Art 5 (4) OECD Model. In the subject case, State S is not willing to apply the exception for facilities solely for the purpose of storage, display, or delivery of goods or merchandise provided for in Art 5 (4) subparagraph a). Tax authorities of State S consider the functions done by the warehouse in the light of the overall business activities of the enterprise to exceed the scope of a preparatory or auxiliary character. The authorities determined the activities form an *essential and significant part of RCo's business activities* as a whole.[39] As the work done in the warehouse is considered *to be core* to the business activities of the enterprise as a whole, the warehouse cannot be exempt from the PE status. From an OECD perspective the storage and supply of goods for an enterprise engaged in online trading is considered to be an *essential entrepreneurial function.* The allocation rule for business profits as per the tax treaty between the States R and S is in line with Art 7 (2) OECD Model 2017 determining that the profits attributable to the warehouse PE are those that the PE might be expected to make particularly in its dealings with

39 No 60 OECD Commentary on Art 5 OECD Model (as it read on 21 November 2017). According to the wording of Art 5 OECD Model as it read on 15 July 2014, the warehouse operated by RCo in State S could be considered to be of an auxiliary nature and not deemed to constitute a PE.

Profit Attribution to PEs and PE Exemptions (Art 5 para 4) – Panel Discussion

Mario Riedl

Question 1

What has changed post-BEPS for PE exemptions under Art 5 (4) OECD-MC?

MNE: Going back to the beginning of the BEPS process, it might be clear that the BEPS process was about tax avoidance, especially double non-taxation. It was not about the allocation of taxing rights. The difficulty was that, when it came to Action 7, there was clearly a tension between those two things (tax avoidance and allocation). By lowering the threshold for PEs, you are reallocating taxing rights. The question now is how much? I think the politically motivated tension drove the result in a sense that the OECD did not deal with the allocation question but just dealt with a lower threshold. From a UK perspective, the BEPS process is an unfinished business, and this is why the OECD is moving on with the Secretariat Proposal for a 'Unified Approach' under Pillar One released on 9 November 2019. Equally, in that context, I would note that the United Kingdom did not adopt the qualification of these specific PE exemptions. Why did the United Kingdom not adopt it? Because it has its own bespoken diverted profits tax to deal with artificial avoidance of PEs. If the United Kingdom had adopted these changes in the PE exemptions, it would have come under pressure to eliminate those diverted profits tax provisions. As I said, from the UK perspective, this is unfinished business. Therefore, the United Kingdom will not be stopping here in the development.

In addition, I will make some comments with a distinction between doing business *with* a country and doing business *in* a country. If someone is doing business *with* a country, then you are essentially doing it from offshore to in-shore, and that is not taxable in the country. If you are doing business *in* the country, then you should be taxable there. If we take an example of 'old world' business: if a German car manufacturer wants to import into the United Kingdom, there has to be an importing activity and a transfer of title to solve the distribution and operations there. In the 'old world', that worked fine. The tax provisions designed to deal with allocating taxing rights in accordance with value creation ensured that profits attributable to the production activity in Germany were taxable in

3. Analysis of the Facts in the Additional OECD's Guidance

The Additional OECD's Guidance first assumes that the remuneration paid to SellCo by TradeCo is at arm's length. That is basically the only the analysis of the relationship between Articles 7 and 9 OECD in the example despite the fact that the DAPE (SellCo) is a subsidiary of TradeCo.

Then, the OECD explains how the profits should be attributed to the PE in Country S. Under step 1 of the AOA, the functional and factual analysis shows that TradeCo's personnel located in Country R deal with the purchasing of the widgets from third party suppliers, but the sales of the widgets to the final customers are concluded by personnel of SellCo on behalf of TradeCo in Country S (para 52). The functions relevant to inventory risk and disposition of inventory are performed by the personnel of SellCo on behalf of TradeCo in Country S so that the PE is the economic owner of the inventory and, therefore, assumes the inventory risks (para 53). From the facts, it is not clear whether SellCo controls the inventory as a service to TradeCo or as the 'economic owner' of the inventory. The analysis of the case seems to assume, without explaining why, that SellCo controls the inventory on behalf of TradeCo (para 53). The Additional OECD's Guidance also hypothesized, as an internal dealing, the sale of goods by the head office to the PE which suggests that at least the PE is the economic owner of the inventory. This hypothesis, as will be explained below, is also controversial and requires further elaboration.

Under step 2, the Additional OECD's Guidance assumes that the OECD Transfer Pricing Guidelines are applied to calculate the price of the internal 'sale' of goods by the head office (TradeCo) to the PE (SellCo acting as a DAPE). The 'price' of the goods is the one TradeCo would have received if had sold the goods to an unrelated party performing the same or similar functions under the same or similar conditions that SellCo performs on behalf of TradeCo, attributing to such party ownership of the assets of TradeCo related to such functions and assumption of the risks related to such functions (para 55). In the DAPE's tax computation, the 'price' of the hypothetical sale between TradeCo and SellCo would be a deductible expense ('cost of goods sold') as well as the remuneration paid to SellCo or other expenses wherever incurred for the purpose of the PE (para 56).

The Additional OECD's Guidance recommends that, for administrative convenience, the tax administration of Country S may choose to collect the tax only from SellCo even though the amount of tax is separately calculated by reference to the tax liability of SellCo and the PE (para 57).

Moreover, the Additional OECD's Guidance points out that the analysis would be the same if SellCo does not conclude sales but rather performs activities in

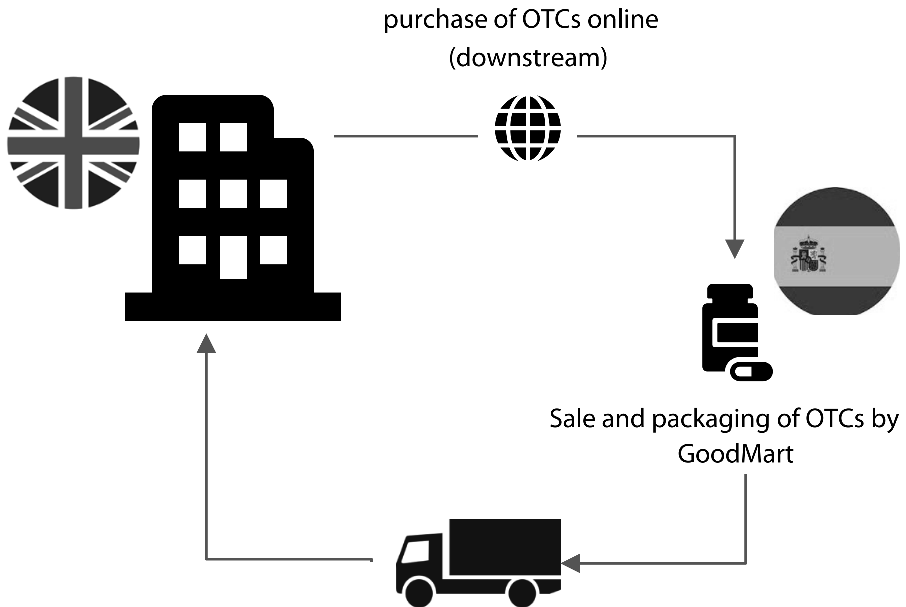

Figure 1: Case Study 1 – Transaction Flowchart

3.1.1. Possible Implications of the Case Study from SEP Perspective

Considering the case study from the perspective of a 'SEP' approach, assuming that any de minimis thresholds are passed, a fractional apportionment method should be considered that consists of three successive steps according to the OECD Work Programme:

- definition of the tax base to be divided;
- determination of the allocation keys to divide the tax base (e.g. sales, assets, employees or, when relevant, users); and
- weighting of these allocation keys.[15]

In this example, some downstream allocation can be seen when Alejandro opts for purchasing OTCs from the GoodMart store in Spain. Nevertheless, in real life, in light of the quantities purchased, it is rather doubtful that the tax base of Good-Mart would be divided according to the suggested allocation keys as Alejandro merely purchased some OTC products via an online shop (a website) thus no SEP (or unified approach) implications would likely arise. In other words, it will be very unlikely that the threshold for establishing a significant economic presence or taxable nexus in the United Kingdom would be passed.

15 Base Erosion and Profit Shifting Project Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy, 13 February – 6 March 2019.

3.2.1. Possible Implications of the Case Study from 'SEP' Perspective

Considering the case study from the perspective of a 'SEP', a fractional apportionment method should be considered, for example, as described by the OECD in the Work Programme, which consists of three successive steps:

- definition of the tax base to be divided (e.g. MNE global net income multiplied by local sales);
- determination of the allocation keys to divide the tax base (e.g. sales, assets, employees or, where relevant, users); and
- weighting of these allocation keys.

When applying the aforementioned steps to the financial data of the SuperDrug Company, the fractional apportionment could be determined in the way as presented in Figure 4:

Digital Signifcant Economic Presence Proposal				
Allocation key	**Country**	**Taxable base to be divided (MNE global net income multiplied by local sales) (CHF)**	**Weight of the Allocation Key**	**attributable SEP to a country (CHF)**
Sales	Switzerland	1151,91	45 %	518,36022
	Austria	164,56		74,05146
	Belgium	1316,47		592,41168
	Bulgaria	123,42		55,538595
	Croatia	82,28		37,02573
	Cyprus	24,68		11,107719
	Czechia	329,12		148,10292
	Denmark	822,79		370,2573
	Estonia	164,56		74,05146
	Finland	822,79		370,2573
	France	1481,03		666,46314
	Germany	1974,71		888,61752
	Greece	329,12		148,10292
	Hungary	658,24		296,20584
	Ireland	1151,91		518,36022
	Italy	1810,15		814,56606
	Latvia	82,28		37,02573
	Lithuania	164,56		74,05146
	Luxembourg	164,56		74,05146
	Malta	123,42		55,538595
	Netherlands	822,79		370,2573
	Poland	493,68		222,15438

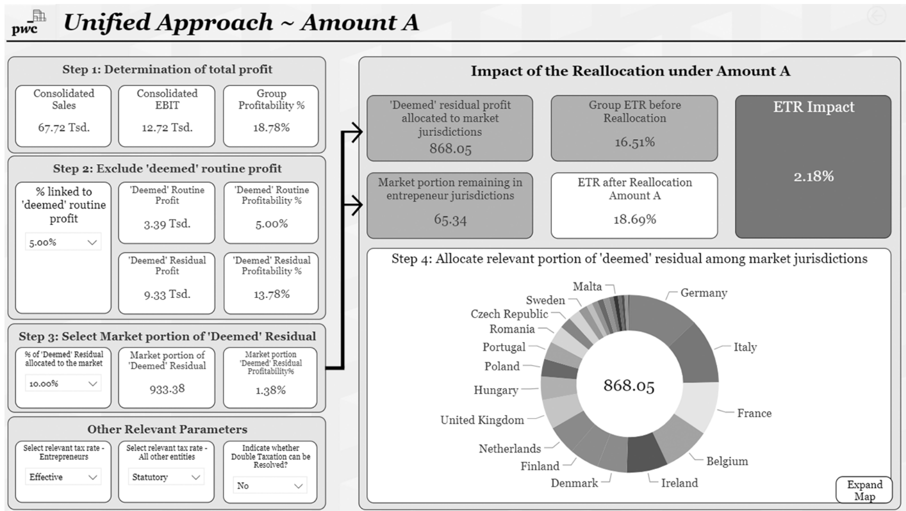

Figure 7B: Amount A – SuperDrug company Unified Approach Perspective Impact Assessment based on the Market Taxation Analyser Tool developed by PwC Business Advisory Services cvba/scrl

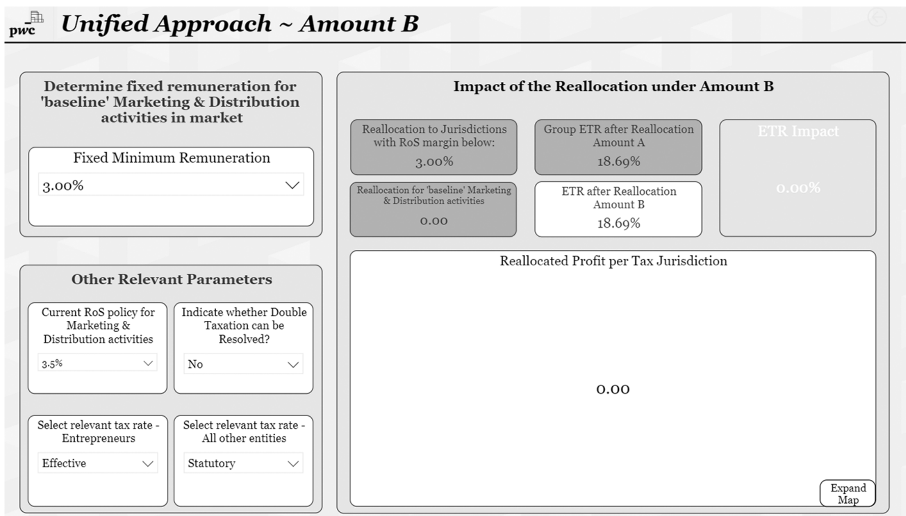

Figure 7C: Amount B – SuperDrug Company Unified Approach Perspective Impact Assessment based on the Market Taxation Analyser Tool developed by PwC Business Advisory Services cvba/scrl

As depicted in Figure 7B above, the 'deemed' residual profit allocated to market jurisdictions amounts to CHF 868,05 mln affecting ETR by 2,18 % while assessing Amount A. Thus, the initial ETR of 16.51 % increases to 18,69 % after calculating Amount A. Furthermore, the biggest reallocation of profit during the calculation