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THE NEW ARTICLE 7 OF THE OECD MODEL TAX CONVENTION:

ILLUSION OR REVOLUTION?

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The New Article 7 of the OECD Model Tax Convention: Illusion or Revolution?

Abstract

This thesis intends to study the impact of the new version of Article 7 of the OECD Model Tax Convention on practical issues such as e-commerce. This will be undertaken through an analysis of the authorised OECD approach put forward in this article and the identification of the main issues that arise regarding its applicability to e-commerce. The analysis undertaken suggests that one of the main problems of applying the authorised OECD approach to e-commerce is that while the OECD approach is based on a significant people functions assessment, in the particular situation of e-commerce, there is usually no personnel attached to it. The thesis claims that the solution to this dilemma may rest on the fact that the OECD considers that the essential element of the analysis is not where these functions are performed but on whose behalf they are performed. The thesis argues that although this aspect is a breakthrough in relation to Article 7, there are still many questions left unopened namely in respect of the documentation burden applicable in e-commerce situations. In respect of this new version, the thesis concludes that the OECD is going the right way but that it still has a long road ahead before reaching the finishing line.

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Table of Abbreviations

CFA	Committee of Fiscal Affairs of the Organisation for Economic Co-operation and Development
Commentary	Organisation for Economic Co-operation and Development Model Tax Convention Commentary
MTC	Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
Report	2010 Report of the Organisation for Economic Co-operation and Development on the Attribution of Profits to Permanent Establishments issued on July 22, 2010
TAG	Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits
TP Guidelines	Organisation for Economic Co-operation and Development Transfer Guidelines for Multinational Enterprises and Tax Administrations issued on July 2010

Introduction

Roy Rohatgi defines International Tax Law as the set of "principles derived from public international law that deals with tax conflicts involving cross-border transactions"[1]. Whether International Tax Law is or not truly an international field of law is not consensual[2]. In very broad terms, International Tax Law refers to the domestic legislation of contracting states and provides a guidance by means of a model convention (generally implemented through the celebration of bilateral tax treaties) on how these conflicts may be solved. The divergences between contracting states are based in many aspects of tax law, namely in respect of the right to tax a certain amount of profit of an enterprise located in a given country.

However, with the impact of globalisation, the location of the enterprise has become less and less an essential element for attributing profit. Instead, attention is drawn to where the profit is actually generated and earned. This is possible through the concept of Permanent Establishment established by the OECD in the Model Tax Convention in Article 5 and the taxation of business profits found in Article 7. Although the combination of these two articles provides for a solution for certain issues arising out of globalisation, it leaves behind new problems as regards the advent of new technologies such as e-commerce.

This thesis intends to study the impact of the new version of Article 7 of the MTC on International Tax Law. This will be undertaken in three parts. The first part details the amendments of the new version of Article 7 of the MTC and explains the authorised OECD approach it implements. The second part applies the scheme of the authorised OECD approach to the practical case of e-commerce in order to identify the main issues which may arise in such context. Finally, the third part provides a response to our main question: the new Article 7 of the OECD Model Tax Convention: illusion or revolution? This thesis will generally follow the Vancouver system of citation.

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[1] See Rohatgi, R., *Basic International Taxation, Volume 1: Principles*, 2nd Edition (London: BNA International Inc., 2005), p. 14.

[2] See Avi-Yonah, Reuven S., "International Tax as International Law" 57, *Tax Law Review*, 4 (2004), p. 16. Available at SSRN: http://ssrn.com/abstract=700644. (The author, in contrast to some other authors, defends that "international tax law is part of international law, even if it differs in some of its details from generally applicable international law".)

I. A formal approach to the new Article 7 of the Model Tax Convention

A. The Recent Developments of the OECD

The concept of the Permanent Establishment (hereinafter "PE") as a separate and independent enterprise for business profits taxation purposes has come a long way before reaching its current structure. We believe that it is fundamental to retrace the main historical events in relation to this matter in order to contextualise the new version of Article 7 as well as to allow for a better understanding of the main issues that gave rise to its present wording. The table below presents, in a summary form, the main events that led to the currently applicable legal framework.

DATE	ENTITY	DOCUMENT	EVENT
1927	League of Nations	Draft Rule on the Attribution of Profits to Permanent Establishments	First appearance of the source apportionment method
1933	Fiscal Affairs Committee of the League of Nations	Draft Model of a Tax Convention on the Allocation of Business Profits	First appearance of the concept of the PE as a separate and independent enterprise
1943 – 1946	League of Nations	Mexico Draft and London Draft	Draft of a distributive rule based on source taxation whereby the separate and independent enterprise concept is maintained
1963	Organisation for European Economic Co-Operation	Draft Convention and Commentaries	First appearance of Article 7 as a distributive rule on business profits to the PE
2001 – 2004	OECD	Discussion Draft on the Attribution of Profits to Permanent Establishments	Establishment of a new approach for attributing profits: the working hypothesis (new authorised OECD

			approach) whereby in determining the PE as a separate and independent entity one must take into account the functions performed, assets owned and risks assumed
2006 – 2008	OECD	Report on the Attribution of Profits to Permanent Establishments	Establishment of a new version of the Commentary to Article 7 in accordance with the working hypothesis
2008 – 2010	OECD	2010 Update to the OECD Model Tax Convention	Establishment of a new version of Article 7 and its Commentary in accordance with the working hypothesis
2010	OECD	New Version of the Report on the Attribution of Profits to Permanent Establishments	Inclusion of the amendments foreseen in the new version of Article 7 and its Commentary

As clear in the table above, the OECD has been concerned with the issue of attribution of profits to a PE for a long time. These concerns gave rise in 2010 to three new documents which will be deepened in this first part: the OECD Report on the Attribution of Profits to Permanent Establishments, the new Article 7 and the Commentary to Article 7.

1. The OECD Report on the Attribution of Profits to Permanent Establishments

a) General considerations

The OECD Committee of Fiscal Affairs (hereinafter "CFA") approved on July 2008 the Report on the Attribution of Profits to Permanent Establishments (hereinafter "Report") which led to a two-track implementation strategy whereby the CFA decided, on a first phase, to prepare a revised Commentary on the current version of Article 7 and, on a second phase, to introduce a new version of Article 7 and its Commentary.

The Report was subject to an update in 2010 in order to incorporate the amendments foreseen in the new Article 7 and its Commentary, namely regarding the elimination of any references to the relevant business activity approach. In effect, in the latter version of the Report, the separate functionally entity approach is the sole authorised approach by the OECD. Hence, we call it the "authorised" OECD approach.

The Report is divided in four parts: Part I establishes general considerations on the attribution of profits to PEs; Part II focuses on PEs of Banks; Part III relates to PEs of enterprises carrying on global trading of financial instruments; and Part IV refers to PEs of insurance companies.

The first part of the Report, which is of our greater interest, establishes a two-step approach for attributing profits to PEs: the hypothesis of a separate entity and the determination of a price at arm's length. The first step is achieved through a significant people functions analysis and the second by an analogous comparability analysis and application of the transfer pricing methods. The issues arising out of the application of this approach will be developed under subparts B and C of this first part.

b) Step 1: Hypothesising the PE as a separate entity

Under this approach, a legal fiction is construed whereby the profits attributed to the PE are those which the PE would have earned had it been a separate legal entity.

However, the PE is not a separate legal entity and does not have a capacity to conclude agreements in its own name, thus making it difficult to determine the rights and obligations attributed to the PE. In order to overcome this issue, the OECD determined that the analysis should start by determining the functions performed by its personnel and assess which profits result from the performance of such functions.

The assessment of the amount of profits attributed to the functions performed by the personnel or the significant people functions will take into account the risks assumed by the PE, the assets owed by the PE and the capital allocated to the PE. As for the risk, it will be deduced from the conduct of the PE and the enterprise according to internal practices and internal data examination. In the matter of the identification of assets, it introduces the notion of economic ownership. Once the risk and assets have been identified, free capital, established in accordance with an authorised approach, must be attributed to the PE.

Before embarking upon the second step, it is vital to identify the nature of the dealings with the rest of the enterprise in order to undertake the comparability analysis. These dealings are

relevant for the purpose of attributing business profits in accordance with the functions performed by the personnel to the extent that they relate to a real and identifiable event which results in an economically significant transfer of risk, responsibilities and benefits according to a factual and functional analysis.

c) The comparability analysis

Under the second step, a comparison must be undertaken of the dealings between the PE and the enterprise and dealings between the enterprise and third parties, in order to determine the arm's length price. This process will follow the rules established in the Transfer Pricing Guidelines (hereinafter "TP Guidelines") as adapted by analogy to the specific circumstances of the PE since the same factors such as the contractual terms are not applicable.

As for the application of the transfer pricing methods, the OECD prescribes the use of the traditional methods which are based in the comparability of transactions as mentioned above. This analysis will be applied by analogy, whereby the concept of controlled transactions is replaced by the notion of dealings. In effect, one must assess if none of the differences between the dealing and the transaction between independent enterprises materially affects the amount of profit attributed to the PE at arm's length or if a reasonable adjustment can be made to correct such differences. In the latter situation, transfer pricing methods will apply to determine the amount of profit that should be attributed to the PE according to the arm's length principle.

2. The new Article 7 and its Commentary

The 2010 Update to the Model Tax Convention is the result of several discussion drafts released between 2008 and 2010 and puts forward a new version of Article 7, and corresponding Commentary, whereby current paragraphs are altered or eliminated and new paragraphs are included. The text corresponding to the current paragraph 7 remains unaltered and reappears as the new paragraph 4. This section will be dedicated to analysing the nature and extent of such changes.

a) Changes to existing paragraphs

(i) Paragraph 1

The text of the new paragraph 1 is as follows:

"Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent

establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State."

In the first paragraph, the core of the text is maintained with one minor change, that is, the wording according to which the profits that are attributable to the PE may be taxed in the other state with the elimination of the expression "only so much of them". In fact, the reformulation of this article eliminates the potential for misinterpretation under which the enterprise as a whole would need to realise profits in order for the PE to be able to have taxable business profits[3]. In this regard, as Van Wanrooij states "there is no need for the profits of the PE to be traceable to the profits of the enterprise as a whole"[4]. Thus, with the new paragraph 1, the dependence of the PE with the enterprise is eliminated, therefore enabling a clearer interpretation and assessment of the PE as a separate and independent entity.

(ii) Paragraph 2

The text of the new paragraph 2 is as follows:

"For the purposes of this Article and Articles [23A] and [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 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 permanent establishment and through other parts of the enterprise."

The second paragraph is the main illustration of the authorised OECD approach since it puts an emphasis on the functionally separate entity approach by determining that the profits will be attributed taking into account the functions performed, the assets used and the risks undertaken. It also makes a particular reference to the dealings between the PE and the enterprise in order to ensure these are treated the same way as independent transactions with third parties. However, it should be noted that this reference does not limit the scope of the paragraph since it includes transactions between the enterprise and associated enterprises

[3] See Bennett M. and Russo R., "Discussion Draft of a New Art. 7 of the OECD Model Convention", 12 *International Transfer Pricing Journal March/April/*2 (2009), p. 75.
[4] See Van Wanrooij, J. S.A., "Comments on the Proposed Article 7 of the OECD Model Convention", 37 *International Tax Review* 5 (2009) p. 300.

which affect the determination of business profits to the PEs. Furthermore, as Van Wanrooij[5] notes, the attribution of profits should not be solely based on dealings but should take into account all the activities of the PE. This line of thought is in accordance with the scope of the article since it is not intended to be limited given that it merely provides a guidance on how profits should be attributed.

b) Elimination of paragraphs

The new version of Article 7 does not contain any mention to former paragraphs 3, 4, 5 and 6.

The third paragraph, which allowed a deduction of the expenses incurred for the purpose of the PE, was eliminated since the OECD considered these could be misinterpreted as limiting the deduction of expenses that indirectly benefited the PE to the actual amount of expenses[6]. The new version of paragraph 2 of Article 7 requires the deduction of an arm's length charge corresponding to an expense which would occur had the transaction been with independent parties.

The elimination of paragraph 4 comes as a consequence of the adoption of the primacy of the arm's length principle in the OECD Report since it established the customary apportionment method. Effectively, since there is no reference to the formulary apportionment method in the OECD Report, it can be safely assumed that the OECD considers the arm's length principle as the sole authorised approach for determining business profits. This argument is confirmed by the elimination of paragraph 6 which implied the existence of several methods for calculating business profits.

As for paragraph 5, the OECD[7] considered that the provision made sense in so far as the main activity of the PE consisted in the purchase of goods or merchandise. However, if it does not fall under the exception of subparagraph 4 d) of Article 5 of the MTC, the profits should be determined according to all functions performed by the PE, including the function of purchasing goods and merchandise. This paragraph was a mere reflection of Article 5 of the MTC and, thus, the OECD did not find essential to reaffirm its content.

c) The new paragraph 3: elimination of double taxation

The text of the new paragraph 3 is as follows:

[5] See Van Wanrooij, note 4, p. 301.
[6] See OECD Commentary on Article 7, Para. 38.
[7] See OECD Commentary on Article 7, Para. 43.

"Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting State shall if necessary consult each other."

Some aspects of the third paragraph come as a break-trough in International Taxation but we will not proceed to an extensive analysis since our thesis focuses primarily on the functionally separate entity approach put forward with the new version of Article 7. The new paragraph 3 is a development of the proposed paragraph 3 in the 2008 discussion draft which applied solely to free capital. The main innovation of this article is the inclusion of an adjustment requirement which can be subject to a time limit but this innovation also involves a concern in relation to the necessity of a consensus among the contracting states.

(i) The insertion of the adjustment requirement

The OECD took a step forward by including this provision in the new version of paragraph 3 of Article 7 whereby the other state is required to make a corresponding adjustment if it agrees that the latter leads to an arm's length result as regards the amount as well as the general principle. Effectively, one of the main sources for double taxation is the absence of an adjustment requirement in the cases where the tax administrations are reluctant to grant such relief.

The OECD qualifies this requirement as mandatory as seen in paragraph 69[8] but this characterisation is incorrect since the obligation is conditional upon the other state considering the adjustment to be made in accordance with the arm's length principle. Thus, it seems we are back to the initial problem since this will compulsorily lead to the mutual agreement procedure whereby there is no obligation on either party to resolve the issue but to endeavour their best efforts to do so.

However, we must applaud the OECD since it requires a consensus among contracting states in relation to the conformity with the arm's length principle and not with the amount *per se* thus making it easier to reach an agreement given that there are many ways to reach an arm's length amount within the authorised OECD approach.

[8] See OECD Commentary on Article 7, Para. 69.

(ii) The time limit option

The OECD puts at the disposal of the contracting states the option of including a time limit after the expiration of which the other state will no longer be obligated to make a corresponding adjustment[9].

On the one hand, it seems unreasonable that the tax administration of the other state should be committed to this obligation endlessly but on the other hand it does not seem fair to leave the enterprise unprotected and subject to double taxation, the elimination of which is a basic premise of the OECD Model Tax Convention.

In effect, as mentioned in the Commentary to Article 25 of the OECD Model Tax Convention[10], the time limit could be an option but it should respect certain requirements such as celerity in the process whereby the formalities should be kept to their strict minimum, flexibility in communicating with the other state and attribution of a right of hearing to the taxpayers.

(iii) The deadlock in the pursuit of an agreement

The inclusion of this paragraph in the new version of Article 7 presents several issues in relation to the lack of agreement between the parties therefore a solution must be set forward to prevent such a deadlock.

The remedy is surprisingly found in the OECD Commentary at paragraph 68 and 69[11] whereby it provides for an alternative provision which is in effect stronger than the one initially suggested. This may sound as contradictory given that the OECD refers that this alternative provision does not impose a mandatory requirement to proceed to the corresponding adjustment.

The provision is as follows:

"Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other Sate, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State;

[9] See OECD Commentary on Article 7, Para. 62.
[10] See OECD Commentary on Article 25, Para. 39 and 40.
[11] See OECD Commentary on Article 7, Para. 68 and 69.

if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement."

Effectively, it determines that, if the other party does not agree with the primary adjustment, the contracting states shall eliminate any double taxation through the mutual agreement procedure. In including the term "shall" it imposes a reciprocal obligation on both contracting states to eliminate double taxation by mutual agreement and not solely to endeavour their best efforts to do so as illustrated by Article 25 of the MTC.

We believe the alternative provision resolves both issues mentioned above since the reciprocal obligation has as an implicit element the mandatory adjustment requirement given that the mutual agreement will certainly result in a corresponding adjustment. Effectively, it is not as straight forward as the first provision, which makes it even easier for the contracting states to agree on the text when negotiating the double tax convention.

Following this analysis of the new wording of Article 7, the next section will be dedicated to an in-depth analysis of the relevant documents introduced up to this point. After this analysis, we will construe a scheme, based on the elements provided by these documents and according to the dominant literature, on the attribution of profits to the PE. This will culminate in a graph which will make it easier to understand Article 7 and apply it to a practical situation, namely to e-commerce. The scheme is divided in two steps as mentioned above, step one whereby the PE is hypothesised as a separate and independent entity and step two in which the arm's length remuneration is determined.

B. Step 1: Hypothesising the PE as a separate and independent entity

The new Article 7 prescribes that the PE should be attributed the profits it would have made had it been a separate and independent entity. This hypothesis embodies an analysis of the functions performed by the PE and how these are relevant for the ownership of assets and assumption of risks. Once this significant people functions analysis is done, one can attribute to the PE the free capital it needs to support the assets owned and risks assumed. Finally, before embarking upon the second step, the internal dealings will have to be identified in order to compare them with the transactions entered into with other enterprises.

Thus, the first step can be divided in three parts: the significant people functions analysis, the attribution of capital and the identification of dealings.

1. The significant people functions analysis

Before entering into our analysis it is important to specify what is understood by significant people functions and in order to do so we refer to the article of Nouel[12], where it determines that these functions are those which are performed by the personnel and are relevant to the economic ownership of assets and assumption of risk[13].

In indentifying them, it is important to assess the activities and responsibilities carried on by the personnel of the main enterprise at the PE, of personnel of other parts of the enterprise at the PE and whether these are performed on behalf of the main enterprise or on behalf of the PE and in what capacity. These different elements will be relevant in order to determine the significance of these functions in generating profits in the PE. One interest aspect in relation to this matter is that the personnel does not need to be located in the physical premises of the PE in order to perform significant people functions. In fact, the personnel of the main enterprise may carry on activities of the PE which will be relevant in the attribution of profits to the PE.

a) The attribution of economic ownership of assets

(i) General considerations

As mentioned before, the PE, contrary to the associated enterprise, does not enter into legal arrangements with the enterprise. Therefore the assets belong formally to the enterprise even though they are economically owned by the PE. The economic ownership of the asset, as defined above, will be determined according to a factual and functional analysis, and more specifically according to a significant people functions analysis. In this regard, a distinction must be established between tangible assets and intangible assets.

(ii) Tangible assets

As for tangible assets, as referred by the OECD[14] and confirmed by Nouel in his article[15], there are two methods to allocate profit to PEs which are the significant people functions and the place of use of the tangible asset. These methods should both arrive at similar results but

[12] See Nouel, L., "The New Article 7 of the OECD Model Tax Convention: The End of the Road", 65 *Bulletin for International Taxation* 2011/1 (2011), pp. 5 - 12.
[13] See Nouel, note 12, p.7.
[14] See OECD Report, Para. 75.
[15] See Nouel, note 12, p. 8.

the OECD considered that the place of use was easier to apply in practice where there is an "absence of circumstances in a particular case that warrant a different view". Nouel sets forth an example in his article[16] which warrants a different view given that it is an asset which is moved across several jurisdictions. Thus, we may infer that it is more likely that the place of use will apply in respect of immovable assets than as regards movable assets. In effect, Nouel seems to establish a parallel between the place of use and the location of the asset. However, given the intent of the OECD to apply this practical solution it does not seem correct that we should narrow it down to the location of the asset.

The problem which may arise with this practical solution is the definition of the term "use" since the OECD does not specify it in any way. But the problem may be the solution since the OECD allows for an open interpretation of the term "use" which can include the location as mentioned above as well as other criteria making it easier for the taxpayer to apply the definition of economic ownership. This open interpretation is adopted by the OECD in other parts of the Model Tax Convention such as in the case of the beneficial ownership concept in respect of interests and royalties. In effect, by broadening the scope of these concepts, the OECD widens the tax base of the contracting states, ultimately leading to the prevention of fiscal evasion which is one of the main premises of the Model Tax Convention.

(iii) Intangible assets

As for intangible assets, the discussion could be subject to a new independent thesis therefore we will only identify the main issues arising from its determination. The economic ownership of an intangible asset is much more difficult to assess than in respect of tangible assets since usually the costs attributed to its creation are not attributable to one specific part but to the enterprise as a whole. This is the position reflected in the current version of Article 7, whereby after allocating the costs to the whole enterprise these will be segregated into the different parts of the enterprise, thus configuring an apportionment method. The OECD distinguishes several cases, the internally developed tangible, the acquired tangible and the marketing tangible but this differentiation does not have any practical effect given that the main solution will be the same for all of them. Effectively, it puts forward a solution which departs from the risk attributed to the asset, namely the performance of functions related to the active decision-making with regards to the taking on and management of the risk. The

[16] See Nouel, note 12, p. 8.(The example is a drilling rig which is used in several locations within the enterprise including the PE thus in this case we must look at where the functions of the personnel allocated to the drilling rig are performed, namely where the main decisions are undertaken.)

OECD seems to merge the action of taking on with the action of management of the risk as one single action but, as mentioned below, it is important to segregate both activities since they can be attributed to different parts of the enterprise. In this case, the difficulty lies in segregating the profits which arise from one activity from the ones resulting of the other but the OECD does not deal with this matter. Instead, it refers to a case-by-case analysis which needs to be undertaken according to the specific facts and circumstances of the situation. Thus, in this particular case, it might be reasonable to ascertain in practice which part of the enterprise bears the risk in order to determine the functions performed in relation to the active decision-making.

b) The identification of the risk assumed by the Permanent Establishment

(i) General considerations

The functional and factual analysis will take into account the risks which are attributed to the PE in relation to the functions performed by its personnel. It is therefore imperative to determine how the attribution takes place since, as mentioned before, there are no contractual arrangements that allocate risks between the PE and the enterprise given that formally the risk is assumed by the enterprise as a whole. The Report establishes that the division of risk will be "deduced from their conduct and the economic principles that govern relationships between independent parties"[17]. It is surprising to find that the OECD, in the risk item, determined a method very similar to the apportionment method whereby the risk assumed by the whole enterprise is attributed to each part of the company according to the functions performed. Effectively, the inclusion of the expression "economic principles that govern the relationship between independent parties" does not seem to have any practical effect since the economic principles of these parties differ substantially from the ones applied between the PE and the main enterprise. Thus, we may infer that the OECD intended, by including this expression, to mitigate the rapprochement with the apportionment method and affirm once again the primacy of the arm's length principle.

(ii) The interrelation with other items

The OECD determines[18] that the items which form part of the functional and separate entity approach (functions, assets, risks and capital) are not prescriptive but interrelated since one

[17] See OECD Report, Para. 69.
[18] See OECD Commentary on Article 7, Para. 20.

item can determine the attribution of profit to the PE which will be subsequently transferred to another part of the enterprise by another item.

Of all the items contained in the functional separate entity approach, the risk assumed by the PE is the one which relates the most with the other items.

On the one hand, the risk item is connected to the asset item given that it can be related to the potential loss in value of assets attributed to the PE such as liability risks.

On the other hand, it will also be closely tied to the attribution of capital since as referred by the OECD "capital follows risk"[19] which, in other words, means that once the risks which are attributed to the PE have been identified, the allocation of the capital necessary to cover these risks will be possible.

Furthermore, the risks assumed by the PE will be relevant in the second step of the authorised OECD approach since this item will be decisive in selecting and applying the transfer pricing method.

We may conclude that this item has several functions in the authorised OECD approach since it acts as a bridge from the assets attributed to the PE to the capital necessary to support the risks inherent to the former but it will also be necessary to the determination of the adequate transfer pricing method. In this respect, the consideration of this item may lead to the selection of a transactional profit method rather than a traditional transaction method thus contradicting the foundation of the Report as discussed further below.

(iii) The difference between the assumption and management of risk

Besides the items referred above, the risks attributed to the PE are also intimately interrelated to the recognition of dealings since these may determine that a risk initially assumed by the PE or the management of the latter is subsequently transferred to another part of the enterprise. As for the nature of dealings which may lead to the transfer of risk, this issue will be dealt further below.

The OECD separates the taking on from the management of the risk in order to determine the relevance of each function to the attribution of profits but this segregation seems only possible in the situation where the initial assumption of risk remains in the PE and the management of the risk is transferred to another part of the enterprise. However, where there is a transfer of risk in the form of a dealing as evidenced by the relevant documentation, the other part of the

[19] See OECD Report, Para. 26.

enterprise will assume the risk in so far as it performs the function of managing the risk. The OECD adopts this position because it believes the other part of the enterprise "which has not initially assumed the risk cannot be deemed to have subsequently taken over the risk unless it is also managing the risk"[20]. This position which is stated as a general rule by the OECD is in consonance with the argument that the functional and factual analysis will always prevail over documentation. Effectively, in light of the difficulty to preserve transparency in the dealings between the PE and the other parts of the enterprise, the transfer of risk shall always be accompanied by the management of the risk in order to determine where such risk has been allocated.

2. The allocation of capital to the PE

Once the assets and risks attributed to the PE have been identified, a certain amount of free capital must be allocated to the PE according to the authorised OECD approach to support the functions performed, the assets economically owed and the risks assumed by the PE.

The OECD prescribes a two-step approach to attribute capital to the PE which is the measuring of risk and valuing of assets in order to, in a second step, determine the amount of free capital needed to support those items.

a) Measuring the risks and valuing the assets

Under the first step, one must determine the value of the assets and measure of the risk. In the first situation, which is the most common for non-financial enterprises, the value can be determined according to the book value of the asset, the market value of the asset and the original purchase price or cost of the asset. This last method is clearly the preferred method of the OECD which determines that it allows for consistency across jurisdictions and is less burdensome than the other methods[21]. However, it could lead to the attribution of different values to similar assets and, thus, it could damage the consistency advantage mentioned above. Effectively, the consistency is better achieved through the application of the market value which will be the same when similar assets are at stake.

Where there is no asset at stake, the activity engaged in developing the asset should also be taken into account in order to measure the risk and the attribution of capital. As for risk *per se* the method of attribution is not clearly defined given that it is different according to the market and business where it has its activity. The OECD determines that one can look at the

[20] See OECD Report, Para. 70.
[21] See OECD Report, Para. 110.

measuring tools used by the enterprise but this should be seen as a starting point otherwise there would be a wide manoeuvre to determine its own risk and consequent attribution of capital.

b) Attribution of free capital

Under the second step, the OECD introduces[22] several methods to allocate such capital but the OECD only recognises two authorised approaches which lead to an arm's length result in respect of non-financial businesses. These consist in the capital allocation approach and the thin capitalisation approach. The first approach is based on the actual proportion of assets owned and risks assumed while the latter determines that the free capital will be allocated according to the amount usually attributed to an independent enterprise. The last method seems to be in consonance with the arm's length principle but the OECD does not prescribe it as the preferred method.

Both methods have imperfections such as the different ways of valuating similar assets within the enterprise in the first approach or the disparity between the free capital attributed to the PE and the one attributed to the enterprise in the second method. According to some states, this may lead to an inadequacy of the methods in relation to particular businesses ultimately resulting in the application of different methods by the residence and the PE state leading in turn to double taxation.

3. The recognition and characterisation of dealings

a) General considerations

The recognition of dealings is construed as a bridge between the first step and the second step whereby these dealings will be compared to dealings between independent parties, which can affect the attribution of assets and risks and consequently the allocation of capital.

The dealing must relate to a real and identifiable event according to a functional and factual analysis which will determine its economic significance as an internal dealing. Since there are no contractual arrangements, attention must be drawn to the accounting records and contemporaneous documentation which illustrate the intention to transfer risks, responsibilities and benefits from one part of the enterprise to another. But most of all, the

[22] See OECD Report, Para. 115 - 149.

OECD is of the opinion that the conduct of the parties will be decisive to determine the allocation of risk as illustrated in the TP Guidelines[23].

b) Accounting records and contemporaneous documentation

The OECD puts forward several requirements which consist in a threshold for a dealing to be considered as equivalent to a transaction that would take place between independent parties.

The requirements are as follows:

(i) consistency of the documentation with the economic substance of the activities taking place within the enterprise;

(ii) comparability of arrangements with those that would have been engaged by comparable independent parties acting in a commercially rational manner or, if they do so differ, possibility of the tax administration to apply an appropriate transfer price; and

(iii) compliance with the principles of the authorised OECD approach.

The third requirement does not seem to present any difficulty but the same cannot be said of the first two. As for the first, the OECD lacks in defining what is understood by economic substance of the activities of the enterprise. We believe this term is in consonance with the doctrine of economic substance found in the United States of America's tax law which is based on commercial considerations as defined by Rohatgi[24]. There has been a discussion about the prevalence of form or substance on tax issues, namely at the 2003 International Fiscal Association Congress in Sidney, and as illustrated by Rohatgi, in many countries the tendency is to move away from a literal interpretation. However, there is no reference to the prevalence between economic and legal substance. In most civil law countries one tends to look at the legal substance according to legal instruments such as "*abus de droit*" or fraud but it is only in the United States of America that we have found the importance of the economic substance doctrine which is isolated as well from the rest of the common law countries. The adoption of this term is in consonance with the 2010 TP Guidelines[25] which determine that, in the particular field of business restructurings, there must be an accord between the form and the economic substance of the transaction (dealing in the PE context). It further determines[26] that the economic substance will be assessed according to economic and commercial facts

[23] See TP Guidelines, Para. 1.48.
[24] See Rohatgi, R., *Basic International Taxation, Volume 2: Practice*, 2nd Edition (London: BNA International Inc., 2007), p. 143 - 148.
[25] See TP Guidelines, Chapter IX.
[26] See TP Guidelines, Para. 9.170.

surrounding the transaction, the object and effect under a practical and business point of view and the conduct of the parties.

As for the second requirement, we also refer to the 2010 TP Guidelines since the expression "commercially rational" is used in the mentioned document. In effect, the 2010 TP Guidelines determine that, in the business restructuring context, one should determine if the outcome is in consonance with the result achieved with a commercial rational behaviour. One option would be to assess if there is an attractive alternative offered to the parties[27] but this is not a general rule since one must look at the specificities of the case to determine if the alternative solution can be adopted. In either case, the OECD determines[28] in the same document that only in exceptional circumstances would tax administrations be able to disregard the transaction (dealing in the PE context). In fact, if there is reliable comparable documentation which confirms the existence of a transaction (dealing in the PE context) at an arm's length price then the parties will be recognised as behaving in a commercially rational manner[29].

We have applied by analogy some of the arguments referred in the TP Guidelines according to the reasoning followed in most of the OECD Report as illustrated below.

c) The parties' conduct

The contemporaneous documentation and accounting records are a useful starting point but the decisive element will be the parties' conduct as illustrated above as regards the difference between the transfer and management of risk.

In effect, the TP Guidelines[30] determine that, in the absence of written arrangements, the contractual relationship will be determined according to the parties' conduct and the economic principles that govern the relationship between the parties. In the Report, the OECD establishes that this reasoning is applicable by analogy to the PE since there are no agreements entered into with the enterprise.[31]

In effect, the reference to contractual terms shall be substituted by the reference to dealings whereby one must assess the conformity of the conduct of the parties to the terms of the dealings or whether the conduct demonstrates that the terms of the dealing are a sham or a cover-up. In this respect, the terms of the dealings are not contractually binding thus one must

[27] See TP Guidelines, Para. 9.59.
[28] See TP Guidelines, Para 9.171.
[29] See TP Guidelines, Para. 9.172.
[30] See TP Guidelines, Para. 1.52.
[31] See OECD Report, Para 178.

look at the different sources such as the contemporaneous documentation and accounting records in order to determine what they are. Therefore, the documentation has a much more important role than what one would expect given that although not a decisive element it could be used as a tool in determining the terms of the agreement and comparing those with the parties' conduct.

C. Step two: the determination of an arm's length remuneration

1. The comparability analysis

On a first hand, the internal dealings which have been recognised under the functional and factual analysis will have to be compared with the transactions with independent parties. In other words, it means that "none of the differences between the dealing and the transaction with independent parties materially affects the measure used to attribute profits to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences"[32].

In doing so, several elements will have to be taken into account as illustrated by the OECD Report[33]. These consist in the characteristics of property or services, functional analysis, economic circumstances, business strategies and contractual terms. The contractual terms will have to be replaced by the terms of the dealing which will generally be found in the contemporaneous documentation and accounting records as mentioned above.

As for the first element, one must look at their specific characteristics as defined in the TP Guidelines such as the physical features, quality, reliability and the availability of the supply in respect of tangible property; the form of transaction, the type of property and degree of protection as well as its anticipated benefits in the case of intangible property and the nature and extent of services in the case the latter is at stake. The OECD addresses the issue[34] where there are similar functions performed in relation to certain products which have distinct properties which can be taken into consideration for comparability purposes. Thus, the scope of the analysis could be widened to include these cases.

This conclusion seems in line with the analogous application of the TP Guidelines to the authorised OECD approach given that primacy is given to a functional analysis under which the functions performed by the personnel are the thread of the first step of the approach and should continue to be under this second step. Thus, this element should not be seen as another

[32] See OECD Report, Para. 183.
[33] See OECD Report, Para. 190.
[34] See TP Guidelines, Para. 1.41.

additional element but as the base for the analysis of all the other elements. The functional analysis in this case resembles the one undertaken under the first step given that one needs to take into account the assets used, risks assumed and capital attributed to the PE.

As for the last two elements, economic circumstances and business strategies, the former refers to the general external conditions such as geography, size and level of competition in the market where the PE operates whereby the latter tends to look at the internal conditions of the company.

2. The application of transfer pricing methods

After the comparability analysis has been undertaken, the transfer pricing methods will apply. There are two types of methods foreseen in the TP Guidelines which are the traditional transactional methods and the transactional profit methods. The first group is identified as the preferred set of methods by the OECD.

However, from the combination of what is prescribed in the TP Guidelines and in the Report, we arrive at the conclusion that in most cases the transactional profit methods will be more appropriate in attributing profits to the PE. Effectively, in the TP Guidelines, the OECD determines that the methods based on gross or net profit "put more emphasis in the function similarities than in the product similarities"[35]. This lets us assume that in the PE context, given the importance of the functions performed by the PE, the transactional profit methods are much more suitable to the specificities of Article 7.

[35] See TP Guidelines, Para. 1.41.

II. The application of Article 7 to specific situations: E-commerce

With the advent of new technologies, the content of the PE concept has been progressively rendered as inadequate since it does not take into consideration the evolving realities which affect International Tax Law. This issue can be found in many domains such as in intangibles but in our thesis we decided to focus our attention on one particular area which is e-commerce. There has been an extensive study by academics and International Tax Law experts as to the applicability of the definition of the PE and, although less developed, the attribution of profits in the referred situation. We believe that it is crucial to determine how the new version of Article 7 will affect the attribution of profits to PEs which are involved in electronic commerce transactions.

In order to proceed to this analysis it follows as logical to determine how e-commerce falls under the definition of the PE and how the profits are attributed to the latter. In this process, we will apply the two-step scheme brought forward under the fist part in order to apply it to e-commerce and identify the main issues. Finally, this part will end with an analysis of the main alternative solution put forward by International Tax Law specialists: the relevant business activity approach.

A. The server as a Permanent Establishment

1. Server vs. Website

In the current version of the Commentary to Article 5 of the MTC, the OECD establishes a distinction between the server which involves a physical facility namely where the electronic equipment is located and the data and software which is used and stored by such equipment i.e. the website. In other words, one must distinguish between tangible and intangible property or hardware and software, whereby the former constitutes a fixed place of business through which business is carried through for the purposes of Article 5 as demonstrated by the OECD[36].

In order for the server to constitute a PE it will need to be fixed for a certain period of time, usually superior to twelve months and it must be considered at the disposal of the PE. In relation to the latter, an issue may arise since the PE will never be the legal owner of the hardware given that the legal title belongs to the enterprise. However, as mentioned in the

[36] See OECD Commentary on Article 5, Para. 42.1 – 42.10.

Commentary[37], no formal legal right to use is required in order for the space to be considered at the disposal of the PE.

2. The functions performed by the server

The server will be considered a PE if it respects the requisites mentioned above and if, additionally, the functions it performs are not considered as preparatory or auxiliary. In effect, these need to consist in an essential and significant part of the business activity of the enterprise in accordance with the nature of each particular business.

In this specific situation, the present requirement will mean that the main business activity of the enterprise will be channelled through the server thus taking place in the location where it is fixed.

As demonstrated by the OECD, there is no need for a presence of the personnel in the PE in order for it to be considered as such. However, in the absence of personnel, the control and ongoing monitoring will be undertaken by the head office and in this case, the server can be considered as a mere instrument necessary to perform the functions of the head office personnel. In consequence, the activities it performs may be considered as auxiliary or preparatory, as argued by Parrilli[38].

3. The attribution of profits to the PE

The Report deals briefly with the attribution of profits to a server when considered as a PE and it determines that the functionally separate entity approach will apply according to the functions associated with the server hardware. Subsequently, it determines that, in this situation, no or little profit will be attributed to the PE since it does not carry any significant people functions.

The OECD in an attempt to solve the issue took us back to the beginning since it substituted the personnel with the server hardware under Article 5 but did not follow the same reasoning in the application of the significant people functions analysis under Article 7. In effect, if there is no personnel the significant people functions analysis will have no relevance. Thus, an alternative solution must be found in order to meet the specificities of e-commerce since there will be situations in which profits are attributed to the PE even though no personnel is physically present, as demonstrated below.

[37] See OECD Commentary on Article 7, Para. 4.1.
[38] See Parrilli, D. M., "E-commerce and Transfer Pricing: Some Selected Issues", *Masaryk University Journal of Law and Technology*, 1/2008, (2007). Available at SSRN: http://ssrn.com/abstract=1270569.

B. Application of the authorised OECD approach to e-commerce: main issues

The development of e-commerce has been one of the main concerns of the OECD given that nowadays most businesses are carried through an electronic equipment and it seems unreasonable to not attribute profits to the server on the sole ground that it cannot carry significant people functions.

In this part, we are going to apply the scheme configured under the first part in order to identify the main issues that arise in respect of each step. This will be undertaken through the analysis of further bibliography and, namely, two documents which are the Business Profits Technical Advisory Group (hereinafter "TAG") discussion draft[39] and the TAG Final Report[40]. The TAG was set up by the CFA on January 1999 with the intent to assess the application of current treaty rules in the context of electronic commerce and to put forward proposals for alternative rules. The TAG Final Report gave rise in 2005 to a condensed document on e-commerce issues in respect of transfer pricing and business profits taxation[41].

1. The significant people functions

a) The economic ownership of assets in e-commerce

As put forward by the TAG in their discussion paper, there are several variations in the e-commerce scenario according to which the economic ownership will differ.

(i) The server itself constitutes a PE

In this scenario, the head office intends to develop its activity trough a server therefore establishing it in another state without any personnel allocated to it. It can transfer the assets, whether tangible or intangible, to the PE under the independent service provider model or retain control and responsibility over them according to the contract service provider configuration. In both cases, the attribution of profits will be insignificant according to the Business Profits TAG[42] since the arm's length charge for the transfer will attribute all profits to the head office and in the second scenario, no profit at all can be attributed to the PE given that it does not have economic ownership and thus no risk assumption results from it.

[39] See TAG, "Attribution of Profit to a Permanent Establishment involved in Electronic Commerce Transactions" Discussion Draft (2001). Available at: http://www.oecd.org/dataoecd/46/25/1923312.pdf.
[40] See TAG "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?" (2004) Final Report. Available at: http://www.oecd.org/dataoecd/58/53/35869032.pdf.
[41] See OECD "E-commerce: Transfer Pricing and Business Profits Taxation" *Tax Policies Studies,* 10 (2005).
[42] See TAG, note 39, Para. 140.

Under the independent service provider model, the Business Profits TAG allocates the right to use the software to the PE but it determines that it does not have the right to resell or modify the software. If we follow this reasoning, then the PE is the economic owner of the software, since, as mentioned above, the use of a right will be the decisive element to determine the economic ownership of an asset[43]. We believe that the right of use of the software confers the economic ownership to the PE which embodies the right to resell or modify. The Business Profits TAG affirms that the right to resell or modify can only be allocated to a PE if it contains personnel but we may conceive a situation where the decision to resell or modify is not taken by the PE but in its sole interest and for its benefit by personnel located in the head office. In effect, the sole fact that the personnel is present at the head office does not infer that the functions are not performed at the PE level. Effectively, as argued by the OECD in the Report[44], one must look as well at the activities performed on behalf of the PE by other parts of the enterprise since these can be decisive in the attribution of profits.

As for intangibles, the analysis will be different since it is the head office which will ultimately benefit from its exploitation given that it will usually undertakes the active decision-making in relation to the taking on and management of the risk. In this respect we refer to II. B. 1. b) below.

(ii) The server is a part of an existing PE

In this situation, the PE will have personnel allocated to it. Thus, the relevance of the economic ownership of assets in this case is determinant since the functional separate entity approach may be applicable in whole.

However, the economic ownership analysis *per se* will not be sufficient since it is imperative to assess the functions performed by the personnel given that if they correspond to technical and support staff functions, the profits will be allocated according to the risk associated with those functions but the exploitation of the assets will remain with the head office. In the opposite situation where the PE owns the assets and fully develops them, it will be entitled to the profits arising from them.

It seems that in this situation, the functional separate entity approach is more prominent than in any other since it attaches inherently the economic ownership to the functions performed by the personnel of the PE. But, as mentioned before, as regards to this aspect, the physical

[43] See OECD Report, Para 75.
[44] See OECD Report, Para. 65.

presence of the personnel will not be relevant. Indeed, what is relevant is where the functions are performed in practice. In this situation, the assessment will be much easier given that the personnel will be present in the PE making it easier to determine where the profits will be attributed.

(iii) Is economic ownership an appropriate item in respect of e-commerce?

As for tangible assets, the Business Profits TAG in their discussion paper took, in our opinion, the wrong direction given that they focused their attention on the assets owned by the company and the PE, in respect of the personnel attached to it. However, we believe that in the specific case of e-commerce, the physical presence of personnel aspect is inadequate given that in most cases, the server will have no or little personnel in order to determine the relevance of the functions performed.

In effect, we believe that the economic ownership must be assessed jointly with the functions performed by the server but the physical presence of the personnel will not be crucial in determining the functions it performs. Instead, one has to look at where these are actually performed irrespective of where the personnel is located.

Therefore, the economic ownership in respect of tangible assets is an adequate item although the emphasis on the functions performed is stronger and the one on personnel is lighter thus making it imperative to proceed to an adjustment.

As for intangible assets, as mentioned before, the economic ownership is very difficult to assess since it has to take into account the functions regarding the active decision-making in relation to the taking on and management of the risk. In effect, the OECD seems to skip the step of the economic ownership consideration and go directly to the assumption of the risk. Thus, the question which arises is whether the presence of personnel is necessary in order to allocate the risk to the PE, in other words, whether the server itself is capable of supporting those risks. As expressed by the Business Profits TAG, the following question "can risk be assumed by the actions of a computer or is human intervention required?"[45] is left opened for discussion. It seems that if we follow the reasoning of the OECD the function of decision-making will always have to depend on human intervention.

b) The allocation of risk in respect of e-commerce

(i) General considerations

[45] See TAG, note 39, Para.55

The allocation of risk will depend on the type of structure, as illustrated above, that is adopted by the PE given that if there is a transfer of assets, the risk associated to those depends on whether the main office has retained control over them.

In effect, there are several types of risk which are those directly associated to the assets such as credit risk or market risk and the risks resulting from the ongoing operation of the hardware and software which is embodied in the technological risk. The attribution of profits will depend on the assets owned and risk assumed based on the functions performed by the PE and the allocation of the credit and market risk to the PE will determine a higher rate of profit attributable to the PE.

The assessment will be based on the analysis of the conduct of the parties and the economic principles that govern the relationship in order to determine which functions are performed by the PE and, consequently, which risks are allocated to it.

(ii) The conduct of the parties as a decisive element in attributing risk to the PE in the context of e-commerce

The consideration of the conduct of the parties comes as a corollary of the conclusion of part I since we may have to look at different aspects in order to determine the profits attributed to the PE and not only at the economic ownership of assets.

As mentioned earlier, we consider that the conduct can be a decisive element in determining the allocation of risk and in e-commerce this is most definitely the case. This may come as a contradictory conclusion given that the PE may not contain any personnel but we are of the opinion that in this situation we should regard the conduct of the personnel of the head office or other parts of the enterprise combined with the functions performed by the server. In other words, the head office may decide to allocate the risk of the ongoing operation to the PE while the latter assumes the functions that relate to such risk. In fact, if the PE performs such function and the head office decides to allocate the respective capital, there is no objection in determining that the capital supports the risk resulting from the performance of the ongoing operation function.

However, the question arises as to whether the PE is capable of assuming such risk where no personnel is present but as illustrated by the Business Profits TAG, the OECD "links the assumption of risk with the carrying out of functions"[46] and makes no reference to the

[46] See TAG, note 39, Para. 55

personnel so it would be indifferent to whether the function leading to the assumption of risk was carried out, with or without, human intervention[47].

(iii) The eclectic nature of e-commerce in relation to the allocation of risk

The basic premise of business profits of a PE is that the latter should have sufficient activity to be considered as such under Article 5 and profits arising from such activity should be attributed to it as illustrated in Article 7. In effect, if according to the first mentioned article the server is considered as a PE, it means its activity is an essential part of the business activity of the main enterprise and thus, that it contributes actively for the generation of business profits.

Under this statement, it does not seem reasonable to allocate the business profits of the PE to the head office on the sole ground that the server has no personnel and therefore cannot assume any risks. Effectively this goes against the very nature of the PE as described in the OECD Model Tax Convention whereby one needs to look at the different sources of business profits being the PE one of them.

The solution is therefore eclectic because one needs to look at the proposed scheme of the authorised OECD approach and adapt it to e-commerce. This is undertaken by looking at the functions performed by the server and at the conduct of the head office in order to determine the risks which will arise from the performance of such functions. We believe that in this case what is relevant is not where the decision-making function is undertaken but where it has the most impact. In other words, the mere fact that the personnel is present in the head office does not mean that it is not entirely at the disposal of the PE since with the advent of new technologies one does not need to be in the PE state to undertake the functions necessary for it to operate. In fact, if the functions performed by this personnel solely affect the activity of the PE it seems fair that the risk allocated to such performance is assumed by the PE, irrespective of the physical location of the personnel. This argument is reinforced by the OECD in the Report[48] which, as mentioned above, states that the assessment must take into account the activities performed by other parts of the enterprise on behalf of the PE. In other words, as argued by Cockfield[49], the "physical presence test has been replaced by an economic presence test that looks at the activities taking place at the location".

[47] See TAG, note 39, Para. 55.
[48] See OECD Report, Para. 65.
[49] See Cockfield, A. J., "Through the Looking Glass: Computer Servers and E-commerce Profit Attribution", 25 *Tax Notes International* 3 (2002), p. 269 - 275.

With e-commerce, and, in particular, in respect of the allocation of risk, the problem that arises is the attempt to force the analogy with a PE without looking at the specificities of the case. In effect, the basic rule of the PE in this situation does not apply since there are no physical premises. Thus, the adjustment needs to base itself around this new element otherwise all rules will be inadequate. In fact with e-commerce we can affirm there is a segregation of the personnel from the function whereby the latter assumes the outmost importance.

2. The recognition of dealings

a) General considerations

The recognition of a dealing between the PE and the enterprise can be demonstrated through the presentation of contemporaneous documentation and accounting records and taking into account the conduct of the parties. In relation to the latter, we refer to II. B. 1. b) above.

In the specific case of e-commerce, it will be very difficult to arrange such documentation given its inherent virtual characteristic, namely when the server itself constitutes a PE. In the case where there is personnel present in the PE there will compulsorily be an organisation of the transactions and capital flows in documents or in computers.

We believe that the situation that can pose a more serious problem is where there is no personnel attached to the PE and therefore we must determine how these dealings will be documented. Shall we solely look at the documentation and accounting records of the head office or is there a way to involve the PE as well?

As a matter of fact, the OECD prescribes, in the Commentary, that the documentation requirement under Article 7 is not meant to be more burdensome than the one imposed under Article 9 of the MTC. However, in many situations, such as e-commerce, this is the case. This may result in adverse reactions by many actors operating in the market influenced by such a provision.[50]

b) Contemporaneous documentation and accounting records of the head office

One solution to the problem referred to above would be to look at the documentation of the head office which would demonstrate the transfer of assets and flows of capital. This

[50] See Letter sent by R. S. Collier from PriceWaterhouseCoopers LLP to Jeffrey Owens, Director of the OECD Centre for Tax Policy and Administration on January 21, 2010 in reference to the Revised OECD Discussion Draft of a New Article 7 (Business Profits) of the Model Tax Convention and related Commentary changes. Available at: http://www.oecd.org/dataoecd/25/29/44461105.pdf.

alternative could be accepted given that the opposite solution would impose costs and burdens on taxpayers disproportionate to the circumstance as argued by the OECD in the new version of the Commentary[51].

However, in this circumstance, the threshold test found in the new version of the Commentary will not easily be passed since the documentation must demonstrate the compliance with the arm's length principle. In this case, the documentation will be incomplete since it will show only one side of the transaction or one direction of flows without illustrating the correspondent return.

Therefore, it will be very difficult to demonstrate that the price of the transaction is at arm's length under a transfer pricing method if the documentation does not show any record of the price itself. Even if the head office documents a certain price that is shown to be at arm's length, it should not be relied upon given the lack of correspondent documentation of the PE for the purpose of avoiding tax evasion.

c) An alternative to the documentation: registered information of the server

One could think that the server as an electronic equipment would have no record of its activity. We note, however, that every action of the server is usually saved in a hard disk drive which can be put at the disposal of the tax administration.

Nonetheless, some requirements must be imposed by the tax administration to ensure the security of such information in order for it to be reliable. For instance, this can be achieved through data recovery plans whereby back ups of data are undertaken in order to ensure these do not get lost. In fact these are addressed by Greenstein and Feinman in their book[52] which is of the greatest interest to our thesis since it focuses, among others, on security applications for accounting purposes.

These considerations impose on tax administrations the task to establish requirements in order for it to be able to analyse the data recorded by the server for arm's length purposes. The downside is that in applying the threshold test, it will be very difficult to find documents that will provide evidence of transactions undertaken between independent enterprises behaving in a commercially rational manner. In effect, since it will be a fairly new way of recognising dealings, there will not be sufficient material to compare for years to come which makes it impossible to determine what is then considered as commercially rational. Thus, we believe

[51] See OECD Commentary on Article 7, Para. 26.
[52] See Greenstein, M. and Feinman T., *Electronic Commerce – Security, Risk Management and Control* (Boston: Irwin/McGram-Hill, 2002).

that the OECD needs to proceed to a revaluation of paragraph 26 of the new version of the Commentary in order for it to embrace the challenges of new technologies, namely e-commerce.

C. An alternative solution: the relevant business activity approach

1. The alternative under the new Article 7

a) General description of the alternative

Many countries have come to interpret the wording of Article 7; 1 of the MTC found in its previous version as an expression of the relevant business activity approach namely by determining that the expression "profits of the enterprise" refers to the profits of the business activity in which the PE has a participation.

This approach focuses on profits derived by the enterprise as a whole from the function or activity performed by the PE while taking into account real transactions with third parties and not fictional dealings with the enterprise.

Therefore, the overall profit of the main enterprise will be allocated according to the functions performed by the different parts of the company resulting in a method quite similar to the functional separate entity approach.

The main difference arises in the fact that the functional analysis is not based in a significant people functions but in the performance of certain activities which contribute to the overall profit of the company.

This approach allows for greater flexibility since the definition of the term relevant business activity approach is left opened for member states to define. However, the amount of profit will vary on the wideness or narrowness of the definition of the relevant business activity since countries will have different views on what this term may enclose.

The downside will be that with flexibility comes uncertainty thus increasing the risk of arbitrariness by the tax administrations but we believe that the functionally separate entity approach does not provide for much certainty either given the wide scope of the arm's length principle.

b) The implications of the new version of Article 7, Commentary and Report

As mentioned before, the OECD in its new version, Commentary and Report eliminated all traces of the formulary apportionment method of which the relevant business activity approach is a corollary.

In effect, the term "profits of the enterprise" in the previous version of Article 7; 1 was seen by many academics as the profits of the business activity of the enterprise in which the PE participated[53] thus leading to the adoption in many countries of the relevant business activity approach. Furthermore, the expression "only so much of them" of Article 7; 1 could be interpreted as a requirement that the enterprise made profits in an overall position in order for profits to be attributed to the PE.

With the proposed new wording of Article 7, these two expressions were eliminated as well as the previous number 4 which allowed for a customary formulary apportionment method.

The question which arises is whether contracting states by adopting this new version will still be able to adopt the formulary apportionment method. In paragraph 41[54] of the new Commentary, the OECD justifies the elimination of Article 7; 4 with the argument that the application of the method had become exceptional and that the result would not be consistent with the arm's length principle. Although we might agree with the latter argument, the same cannot be said of the former, since many countries apply the formulary apportionment method and more specifically the relevant business activity approach.

Although all traces of the relevant business activity approach have been erased, the OECD will have a much more difficult task in fading the countries' practices since these will be used to applying that method. Thus, we are going to study in the next two sections the advantages and disadvantages in applying this alternative solution in order to determine if it will be resistant for years to come.

2. Advantages in the e-commerce perspective

a) Flexible approach

The relevant business activity concept is left purposely undefined in order to attribute discretion to the contracting states to define it in whatever way they may find adequate.

This characteristic transforms this concept into a dynamic approach whereby it can be adapted to the constant evolutions experienced in International Tax Law, namely as regards e-commerce. Effectively, if a wide interpretation is adopted, the activities performed by the

[53] See 2008 OECD Report, Para. 62.
[54] See OECD Commentary, Para. 41.

server as a PE can be considered as a part of the relevant business activity of the main enterprise.

However, the downside is that it can lead to double taxation provided that not all countries would want to adopt a broad definition. The solution is found in the common agreement between contracting states which is very difficult to attain in practice. On the other hand, if we restrain the applicability of this approach to the case where a server constitutes a PE, a compromise would be easily achieved and there would be no issue in distinguishing income from e-commerce and non e-commerce as put forward by the Business Profits TAG.[55]

The advantage in having a tailor made e-commerce relevant business activity approach would be that the functional and analytical basis on which the profits would be attributed to the PE could take into account the specific nature of the server such as the fact that it has no personnel and cannot make any relevant decisions in order to perform certain functions.

Although we believe an agreement on this point between countries could be easily reached, it could also face certain adversities given that the residence state would not want to abdicate its right to tax. What should be borne in mind is that the profit allocated to the PE is not necessarily allocated to the main enterprise, thus incurring the risk of leaving untaxed a certain amount of profit. If a common agreement is reached, it would avoid tax evasion which should be in the best interest of each and every country, irrespective of whether it is a residence or a source state.

b) Functional approach

The relevant business activity approach is similar to the functionally separate entity approach in that it is based on the functions performed by the PE, although it does not require a fiction of a separate entity approach which will have a major impact on the attribution of profits in respect of e-commerce.

Effectively, the fictional segregation of the PE impedes us from determining that the functions may be performed at a different level from the one of the PE and might still result in the attribution of profits to the latter. Since there is no reference to the physical presence of personnel in the PE, the focus is drawn to the activity performed by it irrespective of where the personnel is located. In the scenario where the server constitutes a PE, there will be no difficulty in attributing profits to it given that it performs a certain activity which will contribute to a certain amount of profits.

[55] See TAG, note 40, Para. 298.

This solution is in consonance with the principle of non-discrimination in International Tax Law since it allows for the taxation of e-commerce as well as non e-commerce operations. Therefore we believe that it would not be in contradiction of the Ottawa Taxation Framework Conditions as argued by the Business Profits TAG[56]. In effect, if e-commerce operations are left untaxed, the PE which undertakes non e-commerce operations would be subject to more burdensome requirements as illustrated by Article 25 of the MTC.

c) Lighter approach

One of the main disadvantages of the functionally separate entity approach in respect of e-commerce is the compliance requirement whereby the main enterprise and the PE need to provide evidence, by means of documentation, that the threshold test as defined above is passed, namely as far as the compliance with the arm's length principle is concerned.

Effectively, given the lack of documentation in respect of the server it would be very difficult to exceed the threshold thus turning the relevant business activity approach into a much more attractive method. The latter would have reduced costs of compliance and administration since the contemporaneous documentation and accounting records of the main enterprise would be sufficient to determine if a PE exists and what are the activities it performs.

In this case, the enterprise and the PE do not need to provide evidence that they are proceeding in consonance with the arm's length principle since what is valued is the actual amount of profit made and the participation that is attributed to the PE. The tax administrations will be solely interested in the amount of profits that are allocated to the PE in order to apply the corresponding tax rate which can be found in the documentation of the main enterprise.

The alternative approach, opposite to the fiction of the functionally separate entity approach, is based on the accounting reality of the enterprise. This method tends to be preferred by economists since it reflects the reality that the whole is more than the sum of its parts.

3. Disadvantages in the e-commerce perspective

a) Flexibility

Although we determined that this characteristic was an advantage, it can also be a disadvantage where countries adopt a narrow interpretation of the relevant business activity approach since they may intend to leave out the activity developed by a server. Effectively,

[56] See TAG, note 40, Para. 298.

we mentioned that the focus is drawn to the activity performed by the PE, irrespective of the physical presence of personnel. However, countries may interpret this approach as requiring that the activities are performed by personnel which is present in the PE.

This is why we reiterate that a tailor made e-commerce relevant business activity approach would be the best solution since countries would be less reluctant to apply a wider definition in light of the specific circumstances of e-commerce and the prosecution of the avoidance of tax evasion.

However, this could trigger a dangerous consequence which is the constitution of a tailor made relevant business activity approach for every innovative aspect in International Tax Law. Although the latter needs to be dynamic it cannot be unstable otherwise it won't provide a system based on legal certainty. In this situation, the best solution would be to adopt a general common base taxation based on a formula which implies several factors and is broad enough to cover these situations and narrow enough to provide certainty[57].

b) The elimination of the PE nexus risk

The main advantage of the functionally separate entity approach is that it goes hand in hand with Article 5 of the MTC. The same cannot be said in relation to the relevant business activity approach since the PE under Article 5 will no longer constitute a sufficient threshold in order to attribute the right to tax to the source country.

This statement could lead to a revolution in International Tax Law given that the PE concept is an institution of this field of law and neither the OECD nor contracting states are willing to give it away thus making it difficult to reach an understanding between source and residence states.

However, the Business Profits TAG[58] suggests that source states may be able to continue to use the PE threshold subject to the presence of two conditions, namely, the existence of sufficient revenue to justify the compliance costs and the determination of whether the rule is administrable. Thus, since the threshold under Article 5 will no longer be sufficient, the applicable formula will deviate from the ratio of the PE concept by adding these two elements. We note, however, that it does not seem evident that the OECD and the contracting

[57] In respect of transfer pricing, the European Union has undertaken an attempt to introduce a set of rules whereby enterprises could calculate their profits within the European Union by a common standard of taxable profits and then allocate their consolidated profits by formulas between the countries in which they operate. This Common Consolidated Tax Base would be based in factors such as turnover, salaries and assets in each country.
[58] See TAG, note 40, Para. 298.

states will agree on a deviation of the PE concept especially when it provides for a stricter application thus leading to a potential decrease in the contracting state's tax base.

III. The new Article 7 of the OECD Model Tax Convention: Illusion or Revolution?

A. The revolution

1. The significant people functions analysis

The significant people functions analysis is the main breakthrough of the new Article 7, as illustrated by Nouel in its article, which determines that in identifying the PE as a separate and independent enterprise one must take into account the functions performed by the personnel relevant to the ownership of assets and the assumption of risks.

Effectively, with the insertion of this new functional element, there is a clear deviation from the fictional separate and independent entity approach towards a real separate and independent entity approach. One does not need to look at fictional elements but at real and identifiable events to determine the business profits of the PE thus taking into account the business and accounting reality of the enterprise which is one of the main critics formulated against this method.

Furthermore, this is reinforced by the deviation from a theoretical approach by taking into account practical elements such as the place of use in relation to the economic ownership of assets and the parties' conduct in respect of the assumption of risk. In relation to the first it determines that the significant people functions analysis can be inadequate in respect of assets thus leaving the place for the location where the assets are used. As for the risk assumed, it refers to the TP Guidelines which clearly invoke the parties' conduct to replace the contractual terms when these are not clearly available, as is the case of the PE.

However, one should not forget that this approach is still a fiction since it cannot, in any case, result in the creation of notional income for the main enterprise taxable by the other contracting state[59]. This is confirmed by the inclusion in paragraph 2 of Article 7 of the expression "for the purposes of this Article and Article 23A and 23B".

2. The importance of the parties' conduct

As mentioned above, the new Article 7 and its Commentary introduced the concept of parties' conduct by making an analogous reference to the TP Guidelines. This factor is found in two moments of the first step of the authorised OECD approach: the assumption of risks and the recognition of dealings.

[59] See OECD Commentary on Article 7, Para. 28.

This comes as a truly revolutionary element in respect of the recognition of dealings since it is considered as the decisive element by the OECD[60]. Furthermore the OECD considers the documentation as a mere starting point[61] to identify the dealings which will then be confirmed by the conduct of the parties. Such conclusion is important since it does not impose on taxpayers an unjustified burden given that the main element will always be the conduct of the parties. This is in line with the argument of the OECD that there cannot be more burdensome documentation requirements than in relation to transactions between associated enterprises.

However, the tax administrations will always be akin on the presentation of documentation evidencing the terms of the dealing. Thus, one must not disregard this element even in relation to the PE. This follows as logical in light of the prevention of tax evasion since the parties' conduct will not be a sufficient evidence that the price of the dealing is at arm's length.

3. The adjustment requirement

Another break-through of the new version of Article 7 is the corresponding adjustment requirement in order to eliminate double taxation, which is the basic premise of the Model Tax Convention.

In the new version, there is no true mandatory requirement since the other contracting state shall proceed to such adjustment in so far as it agrees that the latter is in accordance with the arm's length principle. However, as mentioned above, if the alternative solution is adopted, this provision becomes stronger since it imposes the obligation on the contracting states to solve the issue through the mutual agreement procedure. This may set a precedent in relation to other articles of the Model Tax Convention such as Article 25, as mentioned by Antoine Glaize in his letter to the OECD[62].

Furthermore, the OECD grants discretion to contracting states in relation to the method by which the corresponding adjustment will be made. It can base itself in the methods for eliminating double taxation foreseen in Articles 23A and 23B of the MTC, respectively exemption and credit method or it can simply determine the taxable amount in accordance with the adjustment to be made. The freedom of choice gives flexibility to the application of

[60] See OECD Report, Para. 179.
[61] See OECD Report, Para. 177.
[62] See Letter sent by Antoine Glaize, Head of Taxand Global Transfer Pricing, to Jeffrey Owens, Director of the OECD Director of the OECD Centre for Tax Policy and Administration on January 21, 2010 in reference to the revised Draft of the new Article 7 of the OECD Model Tax Convention and related Commentaries changes issued on November 24, 2009. Available at: http://www.oecd.org/dataoecd/21/55/44469670.pdf.

this provision which will ultimately make it easier for contracting states to agree on such provision.

B. The illusion

1. The physical presence requirement in the PE

As we mentioned before, there is a tight connection between Article 5 of the MTC, which establishes the PE concept, and Article 7, which establishes the rule on how to attribute profits to the PE. However, there are some contradictions between these two articles.

The main contradiction is the one which states that the PE does not need to have personnel attached to it in order for the PE to be considered as such under Article 5[63] while Article 7 implicitly requires the presence of personnel due to the functional and factual analysis inherent to it. This is confirmed by the OECD in the Report[64] where it states that where no personnel is attached to the PE, as in e-commerce, it will not perform any significant people functions and, thus, no or little profit will be attributed to it.

However, again as mentioned by the OECD in the Report[65], the mere fact that the personnel is not physically located in the PE does not mean that there is no personnel attached to it since there may be personnel located elsewhere in the enterprise acting on behalf of the PE. In effect, as reinforced by Cockfield[66], the physical presence test is being replaced by an economic presence test which takes into account the activities taking place in the PE, irrespective of where the personnel is located.

Hence, the intrinsic relation between Article 5 and 7 is making way for a gap since Article 7 introduces a new element to the definition of the PE concept which is the economic presence of the PE in a contracting state. In this sense, Article 7 is evolving much quicker than Article 5 but leaves behind a certain coherence between both articles that is essential for their application.

2. The documentation burden

As mentioned above, the OECD is starting to attribute more importance to the parties' conduct in respect of the recognition of dealings but the documentation element remains an important requirement given that it provides for the best evidence of the pricing of a dealing.

[63] See OECD Commentary on Article 5, Para. 10.
[64] See OECD Report, Para. 66.
[65] See OECD Report., Para. 65.
[66] See Cockfield, note 49.

This formal requirement can become very burdensome. Indeed, since the PE does not enter into contractual arrangements with the main enterprise, one must look at the contemporaneous documentation and accounting records. The problem arises in the fact that not all enterprises have specific accounting records in respect of their PEs, especially in the e-commerce context.

Price Waterhouse Coopers[67] has raised this concern in a letter sent to the OECD whereby it suggests that this element should be reviewed in order to apply in practice the rationale of the OECD which states that the application of this requirement should not be more burdensome than when applied to transactions between associated enterprises. Although we concur with the OECD on the fact that this requirement should not impose too much of a burden on the taxpayer, we believe that Price Waterhouse Coopers' concern is grounded since the documentation burden in relation to the PE is not the same as in relation to associated enterprises. In effect, the latter will enter into contractual arrangements with the main enterprise. That is, they are separate and independent enterprises thus, their activity will be organised in accounting records. The same cannot be said of the PE. Hence, we believe that this analogy is not adequate in the PE context given that what is required for the associated enterprises might still be too burdensome.

Therefore, as argued by Price Waterhouse Coopers, paragraph 26 of the OECD Commentary should be subject to a revision in order to accommodate the concerns faced by the taxpayers in the PE context.

3. The elimination of formulary apportionment traces

The new version of Article 7 and its Commentary as well as the OECD Report eliminated all traces of the formulary apportionment method in light of the primacy of the arm's length principle in respect of this article and other articles of the OECD Model Tax Convention.

Thus, if this new version of the article is adopted, the contracting states are not given any option in respect of the methods of attribution of business profits. The sole accepted method will be the authorised OECD approach which is considered by the latter as the most suitable method which, in addition, is in accordance with Article 9 of the MTC.

However, in adopting this position, the OECD disregards the practices of many countries which apply a formulary apportionment method such as the relevant business activity approach described above. This drastic approach does not benefit the OECD since it will make it harder for contracting states to adopt the new version of Article 7 given that they do

[67] See PriceWaterhouseCoopers, note 50.

not want to brutally abandon their tax usages. We understand the intent of the OECD which focuses on the elimination of double taxation that may arise when more than one method is applied in respect of a single matter but we believe this could be done through a step by step approach without rushing straight away to the finishing line.

C. More than an illusion but less than a revolution: the evolution

The new Article 7 and its Commentary have come as a revolution in many aspects and, as mentioned by Antoine Glaize in his letter to the OECD, they "ensure better certainty for taxpayers as they clarify some of the issues" such as the provision of relief for double taxation. However, many aspects mentioned above still remain in the illusion that the authorised OECD approach is the most adequate method for the attribution of profits to the PE, such as the documentation burden.

Thus, Article 7 is evolving in the right path but has still a long road before achieving the goal it is aiming at which is the adoption by all contracting states of the authorised OECD approach and, consequently, the abandonment of the formulary apportionment method.

Following the analysis undertaken in this thesis, we believe that this goal is not an illusion since, although there are adjustments to be made, the authorised OECD approach remains the best of the existing methods. It is true that it is based on a fiction but, as mentioned above, this fiction is closer to becoming a reality with this new version of Article 7. Furthermore, the alternative provision, the relevant business activity approach, has many advantages but it has the main disadvantage of all which is the difficulty of reaching a common understanding as how this method will apply. In fact, since the common agreement is the foundation for International Tax Law[68], - the rules are mostly established by means of double tax conventions entered into between contracting states – it is imperative that the method provides for a common understanding among them. Although this new version of Article 7 may also put the common agreement of contracting states at risk, the fact that there is a Model Tax Convention and guidance by the OECD makes it easier for contracting states to follow it.

Therefore, we must applaud the OECD in this new version of Article 7 and its Commentary for taking a stand and determining what is the most appropriate method for attributing profits for the PE instead of providing an eclectic solution between two methods which would have certainly led to double taxation. However, in taking a stand, it should have taken into account the main concerns of the taxpayers and not only those of the tax administrations. We expect

[68] See Rohatgi, note 1, p. 13.

this is not the end but a story to be continued where these issues will be the object of a new version of Article 7 and its Commentary.

Conclusion

The new Article 7 of the MTC is innovative in many aspects of International Tax Law, namely as regards the improvement of the PE concept for the purposes of business profits taxation, the importance attributed to the parties' conduct and the adjustment requirement in order to prevent double taxation. However, there are many issues still arising namely as regards the documentation burden which seems more and more inadequate in light of new technologies. Thus, the discussion on this article will most likely still linger for some time.

In our opinion, in general terms, the main breakthrough is that the OECD finally took a stand in adopting a position which it believes is the best for attributing profits and disregarding any other. This is very important because, as mentioned above, International Tax Law does not impose any mandatory rules on contracting states. In effect, the OECD provides for a mere guidance included in the Model Tax Convention but, as seen with this new wording, it is pending towards a stricter interpretation of these articles. This will ultimately lead to the avoidance of double taxation given that most contracting states tend to follow the guidance provided in the Model Tax Convention. Thus, we remain with one important question: is the OECD abandoning its consulting status to make way to a more imposing and regulatory body?

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