Dependent Agents after BEPS
Especially with regard to commissionaire arrangements

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Abstract

The OECD estimates that every year between 100 and 240 billion US dollars of tax revenue is lost due to domestic tax base erosion and profit shifting resulting from the business practices used by multinational enterprises. In 2013, the BEPS Action Plan, encompassing 15 different actions, was sanctioned in response. In 2015, the Final Report on BEPS Action 7 was published. BEPS Action 7 targets the artificial avoidance of permanent establishment status by proposing changes to the wording of the articles of the OECD Model and its commentary. Commissionaire arrangements are common practice among certain multinational enterprises, whereby a non-resident enterprise enlists another entity to sell products owned by the non-resident. Under the proposals of BEPS Action 7, such an arrangement may result in the creation of a permanent establishment of the non-resident. This thesis examines the implications of the BEPS proposals by examining how the principles of attributing profits to permanent establishments is likely to impact commissionaire arrangements. The thesis also explores the conditions that motivated the proposals, and considers unintended consequences that may arise because of the proposals. The thesis concludes that under the Authorized OECD Approach, it is uncertain whether the new permanent establishments will contribute to a significant increase in the tax base of the host state. The thesis also concludes that it is perceivable that the uncertainty relating to the interpretation of the OECD Model provisions governing this area may persist after the implementation of the proposals.
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1. Introduction

1.1 Background

A decision facing all multinational enterprises is whether to organize their legal structure as parent-subsidiaries or branches with a head office, or to rely on separate local entities to carry out business activities. It is a multifaceted question, each facet having potential benefits and drawbacks. These must be evaluated and weighed before the enterprise decides. One such facet is taxation. An enterprise that chooses to organize its legal structure within the parent-subsidiary framework will establish several legal entities that may entail a complex ownership structure. As separate legal entities, each enterprise within the group is taxed in accordance with the residence and source principles, which are principles of international taxation.\(^1\) An enterprise who, on the other hand, chooses the branch structure will end up with a single legal entity and, likely, permanent establishments in the cross-border jurisdictions. As the principal purpose of double taxation conventions is to eliminate double taxation\(^2\), it is likely that such an entity will only be treated as a resident in one of the states, as opposed to the parent-subsidiary structure where the members of the group are residents in different states. The commonly used OECD Model Tax Convention (OECD Model) therefore contains provisions on how to define and to some extent attribute profits to permanent establishments.

The concept of permanent establishments can be traced to the source principle, which entails that since the entity has a continuous presence in the state it should also be taxed on any profits derived from that same state.\(^3\) It has long been held that doing business through an independent agent, such as a commissionaire, in another state than the residence state is not reason enough to subject the enterprise to taxation in that state. BEPS, a project of the OECD with the objective of countering base erosion of states’ tax bases and profit shifting, in 2015 submitted the Final Report on Action 7, an initiative to counter the avoidance of permanent

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\(^1\) Martin Berglund & Katia Cejie, *Basics of international taxation: From a methodological point of view* (Iustus 2014) 20-23

\(^2\) Michael Lang, *Introduction to the law of double taxation conventions* (2\(^{nd}\) edn, Linde Verlag GmbH 2014) 30

\(^3\) Martin Berglund & Katia Cejie, *Basics of international taxation: From a methodological point of view* (Iustus 2014) 25
establishment status in which they suggested various changes to the provisions governing the definition of a permanent establishment. In contrast to permanent establishments, setting up a subsidiary is often an active choice. This is because most states use the concepts of incorporation or place of effective management when determining the residency status of an enterprise.\textsuperscript{4} Permanent establishments may exist regardless of the intentions of the entity simply by interpretation of the provisions of the OECD Model. In its current form, the 2014 version, the OECD have argued that the wording of the OECD Model and the guidance offered by the commentary allows for the artificial avoidance of PE status. One of the suggestions put forward by BEPS Action 7 to mitigate this is expanding the dependent agent provision found in the OECD Model. In its current form, article 5(1) of the Model Convention stipulates the following:

“For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”\textsuperscript{5}

Besides those situations covered by the paragraph above, paragraph 5 of the same article stipulates that anyone acting on behalf of the enterprise, who is not an independent agent, and has and habitually exercises the authority to conclude contracts in the name of the enterprise; any activities undertaken by such a person is also considered part of a permanent establishment of the enterprise. This type of person is regularly referred to as a dependent agent. The next paragraph essentially stipulates that certain situations automatically qualifies as independent agencies; which do not constitute permanent establishment. This paragraph is regularly referred to as the independent agent test. The expansion of the dependent agent provision found in article 5(5) proposed by BEPS Action 7 means that the definition of a dependent agent would apply to anyone who “habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are

\textsuperscript{4} Martin Berglund & Katia Cejie, \textit{Basics of international taxation: From a methodological point of view} (Jüstus 2014) 23-24
\textsuperscript{5} Article 5(1) OECD Model
As can be inferred from the differences in the two definitions, the addition of the term “principal role” is prone of create problems of interpretation. Where the agent’s principal and the agent himself are both involved in the conclusion of a contract, the question of who plays the principal role arises. Moreover, the lowered threshold for qualifying as a dependent agent PE (DAPE) may mean that previously untested types of activities qualify, which poses new problems when attributing profits to those PEs in accordance with Article 7(1-2) and its interplay with Article 9.\(^7\) The OECD has argued against this, stating that the nature of a PE is intact even in the post-implementation version of the OECD Model, and as such no significant changes need to be made to the current framework of rules that govern the attribution of profits to PEs, they have conceded that new guidance may be needed however.\(^8\) Even though the broader scope of the proposed wording of Article 5(5) may lead to the creation of many new PEs, many of these will consist of dependent agents conducting solely limited commissionaire work, raising the question of what functions can be attributed to them.\(^9\) Noteworthy is also the fact that the Authorized OECD Approach of attributing profits to permanent establishments is not universally accepted and while this is a problem already in existence today, it could be expected to increase with the creation of new DAPEs. Lastly, it has been argued that the creation of these new PEs may lead to an unreasonable burden being placed on taxpayers and tax authorities in the form of compliance work.\(^10\)


\(^7\) Stef van Weeghel, ‘Discussion Draft: attribution of profits to permanent establishments’ (Comment, PwC 5 September 2016) 2

\(^8\) OECD, ‘Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments’ (OECD 2016) para 6

\(^9\) Stef van Weeghel, ‘Discussion Draft: attribution of profits to permanent establishments’ (Comment, PwC 5 September 2016) 1-2

\(^10\) Raffaele Petruzzi & Raphael Holzinger, ‘Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era’ (2017) 9 WTJ 263, 295
1.2 Objective

The objective of this thesis is to provide a critical examination of the proposals put forward through BEPS Action 7 regarding the artificial avoidance of PE status through commissionaire arrangements and similar strategies. Specifically, the thesis seeks to determine the effectiveness of the proposals in counteracting the tax base erosion perceived by BEPS to presently result from such arrangements. Additionally, the thesis seeks to examine whether unintended consequences can arise as a result of the proposed lowered threshold on qualifying as a DAPE under article 5(5) of the OECD Model.

1.3 Delimitations

BEPS Action 7 proposes additional changes to the definition of a permanent establishment in article 5, particularly expanding the condition of “preparatory or auxiliary work” to all the examples of activities not considered a PE that are listed in article 5(4). The implications of this change and other changes proposed by BEPS Action 7 will not be dealt with other than to the extent that they affect the definition of a DAPE or have implications for the attribution or profits to a DAPE.

1.4 Legal method

Of specific importance to this thesis is the comparative legal method. When dealing with sets of rules from different legal systems, it is important to provide an account of the value of those sets of rules in the context of the subject at hand. The comparative legal method, while controversial, has been pointed out to be of both theoretical and practical benefit. It enables the writer to widen his scope, thereby adding to the knowledge of his own legal system. At the same time, it also allows the writer to draw conclusions on the relationship different sets of rules have with each other.11 Samuel states that while it is indeed possible to give a definition of what constitutes the comparative legal method, one must appreciate that the terms in the definition are beset with vagueness. Samuel gives the definition as follows:

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“[… it can be defined as the comparing of legal rules (or norms), concepts, categories and (or) institutions in one system with those in another.”12

Comparative law does not consist only of accounting for the nature of certain legal systems. While it is true that such knowledge is of course important, it does not constitute comparative law on its own because in such a case no comparison is made. To arrive at a more specific definition, Samuel argues that it is useful to examine the meaning of the constituent words in the term. By looking at other sciences, one can see that making comparisons is fundamental to the advancement of knowledge. By probing the components of different objects and searching for shared traits or differences, one can deduce how similar they are. This deduction allows one to arrive at conclusions that would not have been possible had the objects been studied independently of each other. In the field of law, Samuel states that this approach would imply that comparative law entails studying multiple objects and viewing each of them in terms of the other. An object can be a certain source of law such as domestic law, which is then compared to another object such as foreign law. The discrepancies discovered between these objects lead to the advancement of knowledge. 13 The functional approach to comparative law is the most prevalent method for conducting the comparison between the objects. It stipulates that it is the function of the object in one system that determines which object in the other system it should be compared with. Legal systems may have different ways of addressing the same issue or need, and because of this the starting point according to the functional approach should be the function of the objects. When conducting a comparison in accordance with the functional approach, one can examine an issue in the case law of one state and then enquire about how the same issue would be resolved in another state.14

To accomplish its objective, the thesis begins with an account of the applicability of tax treaties by examining the framework in which they have developed, as well as the relationship between the provision of tax treaties and domestic law, as it is

12 Geoffrey Samuel, An Introduction to Comparative Law Theory and Method (Hart Publishing Ltd 2014) 10
13 ibid, 11
14 ibid, 65-67
necessary to have a firm understanding of this relationship to appreciate the implications of the proposals put forward in BEPS Action 7. The thesis then briefly accounts for the history of the PE concept, after which contention points are demonstrated by examining differences in the application of the PE concept through the case law of different states. The application of the PE concept in case law demonstrate the perceived need for the proposals put forward through BEPS Action 7. To determine the efficiency of the proposals, the thesis examines the principles of profit attribution to PEs. The subsequent discussion of the material examines whether discrepancies between the aim of the proposals and the effect the proposed changes will have can be established. In addition, it is discussed whether the new proposals could be accompanied by some of the same issues of interpretation that have been demonstrated to presently exist due to differences in domestic law. Unless otherwise stated, references to the articles and the commentary of the OECD Model refer to the 2014 version of the OECD Model Tax Convention and its commentary.

Due to its importance to this thesis, an account of the value of the OECD Model as a source of law is presented in sections 2.2 and 2.3 below.

2. Double Taxation Conventions

2.1 Tax liability
The right of states to levy taxes is based on their sovereignty. In the modern era, most states have adopted residence based taxation, meaning full tax liability is imposed on persons based on their residence. Some states have instead opted for citizenship or domicile as the factor that determines tax liability for individuals. Full tax liability entails the taxation of the worldwide income of the person, regardless of where that income has its source. The opposite of full tax liability is limited tax liability. For a person who has had that status conferred upon them, states will only levy taxes on the income that has its source in the state. For legal entities, residency is usually determined by the place of incorporation or the place of effective management. The connecting factors that determine the residence status of a person in a given state is determined by that state’s domestic law. Because international law does not meaningfully restrict the sovereignty of states, and
because states use different criteria when assigning residency status, a situation may arise where a person is deemed to have full tax liability in more than one state; giving rise to double taxation. A somewhat more common scenario, especially for legal entities, is being assigned full tax liability in one state and limited tax liability in another state. In this scenario, the other state will only seek to levy taxes on the income that has its source in that state. Because the first state will levy taxes on the person’s worldwide income, double taxation still arises. This type of double taxation is known as juridical double taxation, meaning the same person is taxed twice on an item of income. Conversely, the phenomenon where same income is taxed twice in the hands of different persons is known as economic double taxation.15

### 2.2 Tax treaties and model conventions

It is inherently in the interest of states to provide the conditions necessary to allow economic activity to thrive, since economic prosperity is the source of states tax bases. Because of the threat double taxation poses to cross-border economic activity, many states have concluded tax treaties with each other. At present the global tax treaty network comprises over 2 000 tax treaties. The principal purpose of tax treaties, as indicated by the alternative designation ‘double taxation conventions’ (DTC), is to alleviate double taxation. DTCs are almost always bilateral (A notable exception is the multilateral Nordic tax treaty.). DTCs function by serving as an instrument for the division of taxing rights between the contracting states. Tax treaties are international law, meaning the contracting states are obligated to follow the provisions of the treaty. In most cases, this will entail renouncing taxing rights already awarded under domestic law. How this is accomplished varies, but frequently international treaty obligations are directly applicable, with treaty provisions prevailing over domestic law.16

Even though most tax treaties are bilateral in nature, the clear majority of tax treaties bear a likeness to each other. The reason for this is that intergovernmental organizations have developed model conventions which the contracting states have

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16 ibid, 30-32
opted to use as a template in their negotiations. The DTC may deviate on certain provisions set out in the model convention, as deemed appropriate by the contracting states, but the overall structure is kept. Of these model conventions, the OECD’s is arguably the most successful. The OECD Model was first published in 1963. It has since been revised and updated multiple times.\(^1\) The most recent revision took place in 2014. The OECD Model is accompanied by a commentary, which can be viewed as guidelines on how to interpret the provisions in the OECD Model. The commentary is also regularly updated. The OECD Model and its commentary are held to be instrumental to the interpretation of DTC provisions based on the OECD Model. As pointed out by Lang, article 31(4) of the Vienna Convention on the Law of Treaties stipulates that a special meaning should be given to a term if the parties so intended. Adopting a provision of the OECD Model into a tax treaty can be argued to constitute intention in this regard.\(^2\) Because the commentary is subject to change, it has been debated which version of the commentary should be used when interpreting a tax treaty. One view is that because the contracting states didn’t have access to subsequent versions of the commentary at the time of conclusion of the tax treaty, the old version should be used to interpret treaty provisions. A similar view is that legislative bodies that might have approved the treaty on the domestic level have also only had the chance to consider the commentary as it existed at the time. A contrasting view is that if this approach is applied consistently, the commentary would stagnate and fail to achieve its purpose. Lang concludes that the arguments are stronger for the view that only the version of the commentary that existed at the time of conclusion of the tax treaty in question can be used for the interpretation of the treaty provisions.\(^3\)

### 2.3 The relationship to domestic law

As this thesis will demonstrate\(^4\), tax administrations and courts will on occasion consult the domestic law of the state they represent to find definitions of concepts not clearly explained within the OECD Model and its commentary. Therefore, it is

\(^{1}\) Michael Lang, Introduction to the law of double taxation conventions (2nd edn, Linde Verlag GmbH 2014) 32-34
\(^{2}\) ibid, 48
\(^{3}\) ibid, 50-51
\(^{4}\) See section 3.2
necessary to explore the relationship between tax treaties and domestic law. As was mentioned in the previous section, tax treaties are international law. More specifically, DTCs are held to be treaties in international law. Contracting states are thus required to abide by the provisions of the tax treaty in good faith\(^\text{21}\). How they achieve this is up to the individual states. It is important to note that the provisions of a tax treaty do not replace existing domestic law, rather, the provisions of the tax treaty are implemented alongside domestic law. The provisions of tax treaties and domestic law are regularly contradictory, so in such situations, one of them must take precedence. Tax treaty provisions are widely considered to be special rules under the *Lex specialis*-principle, which is legal doctrine that stipulates that when two rules govern the same situation, the more specific rule takes precedence. Consequently, tax treaty provisions take precedence if it applies to the same situation as the corresponding domestic law and stipulates something in addition.\(^\text{22}\)

As a starting point, DTCs should be viewed as independent from domestic law. Domestic law can be taken into account when interpreting treaty provisions, but only when all other options relating to the treaty provisions and the commentary are exhausted. Lang has stated that it is only very rarely that a solution cannot be found within the DTC itself.\(^\text{23}\) In certain cases, the OECD Model implicitly instruct the contracting states to consult domestic law, which is evident from the terminology of the OECD Model. Consider for example the term “person” or “asset”, both featured in the OECD Model. While “person” is partly defined in article 3(1)(a), both terms ultimately depend on the domestic law of the contracting states. Domestic law can thus be said to be of use when determining the factual situations to which the DTC applies.\(^\text{24}\)

\(^{21}\) 1969 Vienna Convention on the Law of Treaties articles 2(1)(a), 26

\(^{22}\) Michael Lang, *Introduction to the law of double taxation conventions* (2\(^{nd}\) edn, Linde Verlag GmbH 2014) 35-37

\(^{23}\) ibid, 45

\(^{24}\) ibid, 46
3. Permanent Establishments

3.1 Background on the PE concept

The concept of the permanent establishment is dealt with in this thesis as a component of the OECD Model. The origins of the concept, however, precede the current version of the OECD Model, and even the model itself. Permanent establishments are mentioned in the first ever bilateral tax treaty concluded in 1899 between Prussia and the Austria-Hungary. It can thus be said that the concept is as old as DTCs themselves. Upon examination, we can see that the reason these concepts go hand in hand is quite clear. Tax treaties are concluded mainly to eliminate double taxation, although there are other justifications. The central idea is that double taxation leads to an unwillingness to pursue economic activity in multiple jurisdictions, since the enterprise will then be subject to economic double taxation. During the period following World War I, the prospect of double taxation threatened reconstruction efforts. In 1919, the International Chamber of Commerce was formed in response, and proceeded to lobby the League of Nations to take measures in response. The League of Nations assembled a committee consisting of economists to work towards a solution to the double taxation problem. The work of this committee resulted in several of today’s established concepts, such as origin of wealth (now most often referred to as source) and residence (where said wealth is spent). The committee further concluded that even though most countries would rather use source taxation as the basis for their claim of authority to levy taxes, residence was preferable because it was deemed more effective. Even though a state may rather wish to extract tax revenue from foreign entities, it may be logistically difficult and thus ineffective. In addition, it would discourage cross-border trade, and one of the committee’s main goals was to promote trade. 25 The work of the committee resulted in a model bilateral tax treaty based on their work, the 1928 League of Nations Tax Model. In this draft, they nevertheless included an instrument that would allow for the taxation of the profits of a foreign entity, the Permanent Establishment (PE). 26

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26 ibid, 122
The concept of PEs evolved in a time when there existed a significant correlation between economic activity and physical presence. Moving goods was difficult, shipping costs were high and long distance communication arduous. Due in large part to the automation of processes, the advent of telecommunications and the growth of the remote services industry, a physical presence may no longer be needed to participate in the economic activity of a geographic area such as a host state.27

3.2 PEs under the OECD Model Convention

Roughly coinciding with the reshaping of the League of Nations into the United Nations, the OECD assumed a leading role in shaping the features of bilateral tax treaties. The OECD’s importance in this area stem from the wide adoption of the OECD Model and its commentary. It is so successful that even though it is not binding for member states it is frequently used even between member states and non-member states.

Under the OECD Model, the definition of what constitutes a permanent establishment is found in article 5 of the model convention, while the provisions for allocating business profits are found in article 7. Article 5 allows us to deduce whether a state has taxing rights over the business profits of a resident of the other state, by determining whether or not a PE is deemed to exist. At this point in the methodology of applying a bilateral tax treaty to a given situation28, we have already established which state is the residence state and which is the other state or host state. Article 5(1) reads as follows:

“For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”29

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28 Martin Berglund & Katia Cezie, Basics of international taxation: From a methodological point of view (Iustus 2014) 50
29 Article 5(1) OECD Model
The word “fixed” is a temporal and geographic criterion, meaning that the place of business must exist as a physical place and with a degree of permanence. The phrase “place of business” refer to the premises the enterprise uses. The commentary tells us that the place of business must be at the disposal of the enterprise. With disposal comes some degree of decision making authority. However, this does not mean that it is necessary for the person to own the premises, borrowing someone else’s premises might suffice. In fact, the commentary mentions that a place of business can exist even if the premises are illegally occupied.\textsuperscript{30} The final criterion of this provision is that business of the non-resident enterprise must be carried out through the premises.\textsuperscript{31} The types of establishments that are considered PEs under article 5(1) are often referred to as fixed place of business PEs.

Article 5(2) provides a list of examples of what constitutes a permanent establishment. Article 5(3) deals with special requirements for construction sites, establishments considered PEs under this article are often referred to as construction PEs. Article 5(4) lists exceptions, entities that are not to be considered permanent establishments, although various changes have been proposed through the BEPS project to the wording in this paragraph.

The most relevant paragraphs of the article in the context of this thesis are articles 5(5) and 5(6). The former describes what is known as a dependent agent PE or agency PE. The paragraph reads as follows:

\textit{“Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business,}}

\textsuperscript{30} Commentary on article 5(5), paras 4, 4.1-4
\textsuperscript{31} ibid, para 2
would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

From this paragraph, we are able to deduce that if a person is acting on behalf of an enterprise and has the authority to conclude contracts in the name of the enterprise, that person is considered to constitute a PE of the enterprise and accordingly an extension of that legal entity. Even though the wording of the paragraph seem to apply only to contracts which are concluded in the name of the enterprise, the commentary makes clear that under certain circumstances the paragraph applies even where the contract is not in the name of the enterprise. The paragraph applies where the contract binds the enterprise, irrespective of the name on the contract. If the enterprise usually approves the contracts concluded with third parties by acting on them, it is regarded to suggest that the authority to conclude contracts has in fact been granted to the agent by the enterprise.

Article 5(6) deals with independent agents, those agents whose activities do not result in the creation of a PE. The current wording of article 5(6) is as follows:

“An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.”

The paragraph states that if the principal is conducting its business through an independent agent, it should not be considered to have a permanent establishment in that state. A difference between article 5(5) and article 5(6) is that the former identifies certain conditions that lead, automatically, to the creation of a permanent establishment through dependency. Article 5(6) contain no such conditions; however, guidance is offered in the commentary. In its current form, it identifies two conditions that must be met for the agent to qualify as an independent agent,

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32 Article 5(5) OECD Model  
33 Commentary on article 5(5), para 31.2  
34 Article 5(6) OECD Model
and thus not result in the creation of a PE. First, the person must be legally and economically independent of the enterprise on whose behalf he acts. Second, he acts in the ordinary course of his business when acting on behalf of the enterprise. \textsuperscript{35} The independence of the agent should be determined by examining how the obligations are divided in the relationship with the enterprise. If the agent is subject to “detailed instructions and comprehensive control” when it undertakes activities on behalf of the enterprise, it cannot be considered independent of the enterprise. \textsuperscript{36} As a rule, the commentary mentions that an independent agent normally bears responsibility for the result of his work, but is not subject to wide-ranging control with regards to the manner in which he accomplishes it. \textsuperscript{37} It can thus be inferred that freedom with regard to the principal is a central tenant of the dependency test. The commentary also mentions number of principals, an agent who has a multitude of principals is more likely to be independent than an agent who represent only one principal. \textsuperscript{38}

The term “general commission agent” is mentioned in the paragraph. No definition of the term is given in the OECD Model, but according to the Final Report on BEPS Action 7, a commissionaire arrangement can be loosely defined as “an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products”. \textsuperscript{39} The entity which sells the products cannot be taxed on the income it receives selling the products because it does not own them.

The fact that general commission agents, or commissionaires, do not constitute PEs only because of their activities as commissionaires has led to conflicting views on such arrangements.

The case law of recent years illustrates the divisive nature of commissionaire arrangements. Especially relevant in the European context are the French, Spanish and Norwegian examples accounted for in the section below.

\textsuperscript{35} Commentary on Article 5(6), para 37
\textsuperscript{36} ibid, para 38
\textsuperscript{37} ibid, para 38.3
\textsuperscript{38} ibid, para 38.6
\textsuperscript{39} BEPS Action 7 Final Report, para 5
3.2.1 Case Law
Zimmer v Ministre de l'Économie, des Finances et de l'Industries (the tax authorities) was a case that was ultimately tried in the Supreme Administrative Court of France. The tax authorities contended that Zimmer, a UK resident company, had a permanent establishment in the country in accordance with the provisions of article 4(4) of the UK-France tax treaty of 1968, the equivalent of article 5(5) of the OECD Model. Zimmer had concluded an agreement with Zimmer SAS, a French resident, whereby Zimmer SAS would sell goods owned by Zimmer and be remunerated with a commission on those sales. Zimmer disagreed with the assessment of the tax authorities and brought the case to court. The case was dismissed in the first instance, but Zimmer appealed. The appellate court, the Administrative Court of Appeal of Paris, reached a verdict where they concluded first that a fixed place of business PE could not be deemed to exist under the provisions of the tax treaty, which is comparable in this regard to the OECD Model. Next, the court examined the provisions of article 4(4) of the treaty, which is the equivalent of article 5(5) of the OECD Model. According to article 4(4) of the UK-France treaty of 1968, in order to be deemed a dependent on the enterprise, the court maintained that Zimmer SAS must have the authority and habitually exercise the right to conclude contracts on behalf of and in the name of the enterprise, subject to the exception of those entities deemed to be independent. The appellate court determined that Zimmer SAS had such authority and could accept orders and enter into contracts on behalf of the enterprise. The fact that Zimmer SAS acted in its own name and did not conclude contracts in the name of Zimmer was not relevant as it did not materially affect the commercial relationships of Zimmer. Additionally, Zimmer SAS could not be an independent agent, because it had only one principal and was subject to comprehensive control. The appellate court upheld the verdict. Zimmer appealed the verdict to the Supreme Administrative Court. The Supreme Administrative court in its verdict focused on the binding effect of the contracts entered into by Zimmer SAS. Concluding that commissionaire arrangements were in fact outside the scope of article 4(4) of the tax treaty because they act in their own name, lacking the authority of bind the principal. The only exception to this rule would be if it could be shown that Zimmer had in fact become bound by the contracts entered into by Zimmer SAS. Since no such evidence had been presented,
the court overturned the earlier verdict and concluded that Zimmer SAS did not constitute a PE of Zimmer.  

Another similar case is that of Dell Products v Tax East (the tax authorities) tried in the Supreme Court of Norway. Dell, a resident of Ireland, had a commissionaire agreement with Dell AS, a resident of Norway. Norway and Ireland concluded a tax treaty based largely on the OECD Model in 2000. The tax authorities contended that a PE of Dell had been formed as a result of the activities undertaken by Dell AS, through the application of article 5(5) of the tax treaty. Dell disputed this assessment and brought the case to court. The first instance sided with the tax authorities and the verdict was subsequently appealed by Dell. Dell argued that two conditions must be met for the formation of a PE under article 5(5). First, contracts entered into by Dell AS must be legally binding on Dell. Second, Dell AS must not be an independent agent. In order for the first condition to be fulfilled, Dell contended that it must be shown that they are bound directly to the clients of Dell AS. Under the existing commissionaire agreement, no such obligations existed in their view. Dell also argued that Dell AS was independent, as Dell did not maintain control over them. The tax administration, conversely, argued that because both Dell and Dell AS used the same name and trademark on contract forms, the legal obligations of Dell AS extended to Dell. Also, the tax administration argued that Dell controlled the actions of Dell AS through instructions, and that any contracts entered into by Dell AS that deviated from normal practice would still be acted upon and thus not refused by Dell. As such, the agent could not be independent. The appellate court confirmed the verdict of the lower court, based on the reasoning that a functional rather than dogmatic approach should be taken with regard to the interpretation of the treaty provisions and in particular to the term “authority to conclude contracts in the name of”. The court referred to the commentary on the article, which states that article 5(5) can apply even if the contract is not entered into in the actual name of the principal. The court further determined that Dell AS was in fact dependent on Dell because of the reasons outlined by the tax authorities. Dell appealed to the Supreme Court. In its verdict, they concluded that relevance should indeed be given to the commentary as the wording of the article was identical.

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40 IBFD (ed), FR:CE [Supreme Administrative Court], 31 March 2010, 304715 and 308525, Tax Treaty Case Law IBFD
to that of the OECD Model. They however concluded that the commentary did not provide useful guidance on whether or not the contracts entered into by Dell AS with third parties are binding on Dell, and as such no PE could be formed. Relying on case law in the form of the Zimmer case, they reached the verdict that no PE was deemed to exist and therefore overturned the previous verdict.  

Spain is a jurisdiction which has taken a somewhat different approach than other European courts. Several cases are of importance to the understanding of it. One example also concerns Dell Products. In the case of Dell Products v Agencia Estatal de la Administración Tributaria (the tax authorities) tried in the Tribunal Económico Administrativo Central (TEAC), the verdict was reached that Dell Products did have a PE in the country based on the provisions of article 5(1) and 5(4) of the tax treaty between Spain and Ireland of 1994. Dell Products had a commissionaire agreement with Dell Spain by which Dell Spain sold goods owned by Dell Products. Dell Products had no employees or facilities in Spain. The court concluded, however, that whether or not Dell Products owned the facilities was irrelevant under the commentary to article 5(1), and that the facilities owned by Dell Spain was under their disposal, therefore resulting in the creation of a fixed place of business PE. With regard to the existence of a DAPE, the court concluded that Dell Spain had the authority to conclude contracts in the name of Dell Products even though the contracts were not concluded in the name of Dell Products. They concluded that these contracts should be considered to be legally binding. Additionally, Dell Spain was not an independent agent because Dell Products exercised comprehensive control of the activities of Dell Spain.

Another case of relevance to the Spanish approach is the one of Roche Vitamins. In that case, relying on the treaty between Spain and Switzerland of 1966, the court argued that although the OECD commentary does not provide much leeway when it comes to the interpretation of article 5(4) (corresponding to article 5(5) of the OECD Model), as it only considers DAPE to be formed only if the agent concludes contracts in the name of the principal, it nevertheless authorized considering other

41 IBFD (ed), NO: HR [Supreme Court], 2 December 2011, Dell Products v Tax East, Tax Treaty Case Law IBFD.
42 Jose M. Calderón (ed), ES:TEAC [Central Economic Administrative Tribunal], 12 March 2012, 00/2107/2007, Tax Treaty Case Law IBFD
activities as well, such as activities which could have been carried out by the principal through a fixed place of business.  

The court goes on to state that:

”[...] In short, the dependent agent clause works not only when the agent has authority to contract on behalf of the foreign principal, but also when, by the nature of its activity it is involved in the business activities of the domestic market.”

3.2.2 The semantics of Article 5(5)
As can be derived from the case law relevant to article 5(5) of the OECD Model, much emphasis is placed by the courts in the inherent meaning of certain phrases of article 5(5), some jurisdictions preferring a dogmatic approach where the words of the article and commentary are taken at face value and other jurisdictions opting for a functional approach, focusing on their interpretation of the purpose of the provision. The current article 5(5) requires that a person acts on behalf of an enterprise. A person is defined in article 3(1)(a) of the OECD Model as “an individual, a company and any other body”. Article 5(5) further provides that the person acts on behalf of an enterprise. The term “act” implies that an activity must be performed by the person. The commentary indicates that the activity should be related to the business activity of the principal, although no distinction is made between different types of business activities. What is excluded, however, is passive presences where nothing relating to the business activity of the principal takes place. Furthermore, the term “on behalf of” has been demonstrated to constitute a point of contention. Lang et al. argues that the general German translation of the OECD Model corresponds fairly well with the English wording, but in the official French version of the OECD Model the translation of “on behalf of” can also mean “for the account of”. They point out that “for the account of” indicates that the agent can act not only legally on behalf of the enterprise, but also economically. Consequently, an agent who concludes a contract in his own name that has economic significance for the principal it can in certain cases fulfill the requirement of “acting on behalf of” the principal. They further contend that it is

43 Monica Hernandez (ed), ES:TS [Supreme Court], 12 January 2012, 1626/200, Tax Treaty Case Law IBFD
44 ibid
45 Commentary on article 5(5), para 33
also possible to apply this interpretation to the English and German language versions of the OECD Model. Following this line of reasoning, it can be assumed that an agent who acts on behalf of its principal is also dependent to some degree on the principal, such as by repeatedly conducting the principal’s business in the host country. In order to be able to conduct the business the agent would be subject to instructions to a varying degree. Such an instruction could be to provide the principal with information about the business operations.\footnote{Michael Lang and others (eds), \textit{Dependent Agents as Permanent Establishments} (Linde Verlag GmbH 2014) 53-54} The commentary makes clear that providing the principal with general information about the business operation is not sufficient to qualify as a dependent agent and thus forming an agency PE, unless the information is provided in a business approval process, where the agent seeks permission of how to conduct its business.\footnote{Commentary on article 5(5), para 38.5}

As we are also provided with a more or less clear definition of independent agents in the OECD Model through article 5(6), the authors suggest it is useful to analyze the scope of that provision. The commentary to the article sets out two criterions that should be fulfilled in order for independence to be established. The agent must be (i) legally and economically independent of the enterprise and (ii) the agent acts in the ordinary course of his business when acting on behalf of the enterprise. Dependency status depends on the extent of the obligations the agent has vís-a-vís the principal. Furthermore, if the agent is subject to detailed instructions and control relating to the carrying out of commercial activities on behalf of the enterprise, the agent cannot be said to be independent.\footnote{Commentary on article 5(6), paras 37-38} Another way of putting it is that the agent should typically bear responsibility in front of the principal only for the result of his work, and while it is deemed acceptable to issue overarching instructions to the agent, the agent should not be bound by detailed instructions on how he should conduct his work, in order to qualify as independent of the principal. Conversely, where the agent is subject to detailed instructions and control of the work process, he is acting “on behalf of” the principal.\footnote{Michael Lang and others (eds), \textit{Dependent Agents as Permanent Establishments} (Linde Verlag GmbH 2014) 55} The fact that the commentary makes references to legal independence as a criterion for independent agencies has nothing
to do with the ownership structure of the relationship, which is also pointed out in the commentary. Rather, it has to do with the binding effect of contracts negotiated between the agent and its customers.

Article 5(5) also mandates that the person has, and habitually exercises, the authority to conclude contracts in the name of the enterprise. Regarding the nature of those contracts, a point of contention has been whether any contract qualifies or just some. Consider for example where an unrelated entity with many principals increasingly does business with just one of them, and eventually it has only one principal. Such an entity would likely not have the authority to conclude contracts with third parties, and as such the contracts would not relate to the business proper of the enterprise. Any contracts concluded would probably relate to the internal operations of the group. Therefore, such an agent could not be deemed to constitute an agency PE and inversely a requirement for the formation of an agency PE is that the agent has the authority to conclude contracts with third parties.50

3.3 The attribution of profit to PEs

As has been established, one of the main reason for the development of the concept of permanent establishments is protecting the taxing rights of the jurisdiction where wealth is created. Article 7 of the OECD Model contains the provisions on the taxation of business profits. Article 7(1) reads:

“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.”51

According to the provision cited above, the profits of an enterprise should be taxed in the state in which the enterprise is a resident, unless the enterprise also conducts

50 Michael Lang and others (eds), Dependent Agents as Permanent Establishments (Linde Verlag GmbH 2014) 57-58
51 Article 7(1) OECD Model
business in the other state through a PE in accordance with the provisions in article 5, in which case the profits that can be attributed to the PE can also be taxed in the other state.

The wording of article 7(1) contains the words “may” and “attributable”, which deserve special attention. “May” in this context means that the state in which the permanent establishment is located is entitled to tax the profits attributable to the PE, but it doesn’t preclude the residence state from also taxing them, thus creating a risk of double taxation. That risk is alleviated through articles 23 A or B; the exemption and credit method. “Attributable” in this context has historically and continues to be a point of contention. Article 7(1) concludes by stating that the provisions of article 7(2) should be used to determine what profits are attributable to the PE. Article 7(2) tells us that “attributable” in the case of permanent establishments, should be interpreted as the profits it would make if it were an entirely separate entity, in particular with respect to internal transactions between different divisions of the enterprise. This is known as the separate entities approach. One must also consider the functions performed, risks assumed and the assets used by the PE; what is commonly referred to as a functional and factual analysis. The commentary on Article 7(2) makes clear that the purpose of this article is not to allocate the overall profits of a successful, and therefore desirable for tax administrations, enterprise between the contracting states. Rather, it seeks to ensure that whatever the profits may be, they are allocated based on the separate entities approach in accordance with the principles of residence and source taxation.

4. Base Erosion and Profit Shifting

4.1 Introduction to the BEPS project

The OECD estimates that every year 100 to 240 billion US dollars of tax revenue are lost due to aggressive tax planning resulting in tax base erosion and profit shifting. Therefore, in 2013 the largest 20 economies in the world (known as the G20 group) and the OECD member states jointly agreed to develop a package of measures to be proposed in reports on 15 different actions. Together, these reports

52 Commentary on article 7(2), paras 21-22
53 ibid, para 17
are the result of the work of the BEPS working groups. The measures are designed to be implemented either by domestic legislation or through tax treaty provisions in a coordinated manner. Of the 15 actions proposed by BEPS, Action 7 is the one most relevant for this thesis. The proposals in Action 7 aim to counteract the artificial avoidance of PE status by imposing changes to the articles and commentary of the OECD Model.

4.2 Permanent Establishments after BEPS

BEPS addressed concerns over the relevance of the PE concept in the modern era through BEPS Action 1, titled “Addressing the Tax Challenges of the Digital Economy”. In the Final Report on BEPS Action 1, it is questioned whether the expansion of the dependent agent provision of article 5(5) of the model convention, which will be discussed in length, will adequately address the relevance of the questions posed regarding the relevance of the concept of PEs, because the conclusion of contracts is today increasingly done remotely without any involvement of a physical presence or intermediate in the form of an agent. To counteract the perceived limitations of applying the PE concept to solve these challenges, the Final Report on BEPS Action 1 puts forward other proposals, which were however not recommended at that time because of the impact the BEPS project is nevertheless likely to have in this area. These are the taxation of a nexus that lead to significant economic presence, withholding taxes on digital transactions, and an equalization levy. The nexus proposal intends to cover those instances in which an entity uses technological tools to establish themselves in the economic activity of a state without having a physical presence.

4.2.1 Action 7 - Artificial avoidance of PE Status

Although the term artificial is given no specific definition in the Final Report on Action 7, the report elaborates on the different ways of avoiding PE status it wishes to address with its proposals. They are:

A) Artificial avoidance of PE status through commissionaire arrangements and similar strategies

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54 OECD, ‘Background Brief – Inclusive Framework on BEPS’ (OECD 2017) 9
56 ibid, paras 277-278
B) Artificial avoidance of PE status through the specific activity exemptions
C) Other strategies for the artificial avoidance of PE status

As mentioned in the previous section, a commissionaire arrangement is where a party agrees to sell goods on behalf of another party, the principal, and where the principal is the owner of those same goods. The seller of the goods receives remuneration in the form of a commission on the products sold. As the report on Action 7 explains, the seller cannot be taxed on the profit attributable to the sale of the goods because he does not own the products in the first place.\footnote{BEPS Action 7 Final Report, 9} Similar strategies also addressed under the umbrella of commissionaire agreements in the report include those where a person who habitually concludes contracts in the name of the principal qualifies as an independent agent under article 5(6), and consequently is not considered to constitute a permanent establishment. The OECD considers, through the report, many commissionaire arrangements to have been set up with the primary intention of eroding the tax base of the country where the goods are sold.\footnote{ibid, 15-25} The activity exemptions are the provisions laid out in article 5(4) of the model convention. The article contains specific exemptions, the activities contained therein are never considered permanent establishments under the current wording of the OECD Model.

The commentary to the current version of the OECD Model mentions that the common denominator shared by the activities of this list is that they are, in general, preparatory or auxiliary in nature.\footnote{Commentary on article 5(4), para 21} The criteria, however, apply only to two subparagraphs in the list. For this reason, the final report on Action 7 has opted to include the criteria of “preparatory or auxiliary in character” in each subparagraph of article 5(4).\footnote{BEPS Action 7 Final Report, 28-29}

Finally, the report mentions other strategies for artificially avoiding PE status. These are the splitting up of contracts, and strategies of selling insurance without having a PE in the country. The former involves abusing the temporal threshold for
qualifying as a PE by splitting a contract into several parts. As both methods fall outside the scope of this thesis, they will not be discussed further.

**4.2.2 Proposed articles 5(5) and 5(6)**

As we explored in the previous section, BEPS Action 7 expresses the opinion that a high proportion of commissionaire arrangements are entered into solely for the purpose of tax avoidance through base erosion. In accordance, they have proposed changes to the wording article 5(5) and article 5(6). The wording of article 5(5) after applying the proposed changes is as follows:

“Notwithstanding the provisions of paragraph 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) in the name of the enterprise, or

b) for the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

The changes to paragraph 5 focus on ensuring that PE status is not avoided when the terms of a contract is negotiated in the agency state, but officially concluded without major modification in the principal’s state. The proposed changes to the commentary elaborates, mentioning three conditions that should be met in order to be deemed a dependent agent of the enterprise. First, a person acts on behalf of an enterprise in one of the contracting states. Second, that the person either concludes contracts or plays the principal role leading to the conclusion of contracts by the

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61 BEPS Action 7 Final Report, 16
enterprise without material modification. Third, the contracts are in the name of the enterprise or cover the transfer of ownership of property belonging to the enterprise, or for procurement of services offered by the enterprise.\textsuperscript{62}

The changes to paragraph 6 are comprehensive. Two subparagraphs replace the current wording of the paragraph. The proposed subparagraph A read as follows:

\begin{quote}
\textquote{a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.}\textsuperscript{63}
\end{quote}

Subparagraph A makes clear that independent agents shall not constitute a permanent establishment, and imposes a restriction by saying that if an agent acts exclusively, or almost exclusively, on behalf of his principal, then the agent is not independent. The ambiguity of the term “almost exclusively” is cleared up in the proposed commentary. There it is stated that when an agent acts for both closely related companies and not closely related companies, a 10 per cent threshold shall apply. That is, if less than 10 per cent of the sales generated by the agent comes from not closely related companies it is unlikely that the agent is independent.\textsuperscript{64}

The proposed subparagraph B reads as follows:

\begin{quote}
\textquote{b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to}
\end{quote}

\textsuperscript{62} BEPS Action 7 Final Report, 18. Proposed commentary on article 5(5), para 31.2
\textsuperscript{63} ibid, 16
\textsuperscript{64} ibid, 26. Proposed commentary on article 5(6), para 38.8
be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise.”

Subparagraph B defines what constitutes a closely related enterprise, setting the threshold at 50 per cent of the vote and value. In such an event, the agent would consequently not be able to qualify as an independent agent if he only, or almost only, acts on behalf of the enterprise. In relation to these articles, the proposed commentary also states that clearly it is entirely possible for a subsidiary to constitute a PE of its parent company. Just because the proposed articles effectively eliminate the possibility to use the independent agent provision to escape the formation of a PE, it does not mean that such an ownership structure override the provisions of article 5; those still need to be fulfilled in order to establish a PE.  

The proposals put forward by the OECD through the BEPS project is projected, for the reasons outlined, to result in a wider application of the PE concept and thus the creation of many new PEs, especially when it comes to commissionaire agreements where the party in the host country enters into contracts with third parties in his own name rather than the enterprises. As these arrangements have often been entered into, according to BEPS, solely for tax purposes, taking advantage of the provisions in article 5(5), the proposed measures would appear to successfully target these instances. It has also been pointed out that besides commissionaire arrangements, the proposed measures might result in the creation of PEs in other business arrangements, such as marketing support service providers.

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65 BEPS Action 7 Final Report, 16-17
66 ibid, 26-27. Proposed commentary on article 5(6) para 38.12
67 Dinis Tracana 'The Effect of the OECD/G20 BEPS Initiative on the Attribution of Profits to Permanent Establishments: The Special Case of Agency Permanent Establishments’ (2017) 71 BIT 214, 215
4.4 Attribution of profits under BEPS

Many different conditions can result in the establishment of a DAPE. Tracana identifies three situations in particular under the present version of the OECD Model, these are:

1. Employees of an enterprise are located in the host country and are vested with the authority to conclude contract, that they use on a regular basis.
2. Associated enterprises with the same authority.
3. Independent enterprises who are nevertheless deemed to be dependent agents because of their economic ties to the enterprise and the tasks delegated to them. ⁶⁸

The proposed changes to the wording of article 5(5) of the OECD Model entails that situations where no authority to conclude contracts is vested in employees, associated enterprises or agents can also lead to the establishment of the PE, if they habitually negotiate the contracts, and no significant change is made to the contracts by the enterprise. As this represents a significant change because actors with new functions may now constitute a permanent establishment, this has consequences for the attribution of profits to the permanent establishment because an integral part of profit attribution is based on the functions performed by it. ⁶⁹

Profit attribution to permanent establishments is governed by the provisions of article 7. Article 7(1) states that if there is a PE, the profits of it should be taxed in accordance with paragraph 2. Paragraph 2 goes on to state that the profits of the PE should be calculated using the separate entities approach. That is, the profits it would be expected to make if it and the enterprise were independent of each other, taking into account the functions performed, the risks assumed and the assets used by the PE and the enterprise. Neither the article, nor the commentary or the proposals by BEPS Action 7 make any distinction between different types of permanent establishments, meaning the same attribution provisions govern all PEs.

Because agency PEs are by definition not legally independent, that is to say their own legal person with the ability to conclude contracts in their own name while

⁶⁸ Dinis Tracana ‘The Effect of the OECD/G20 BEPS Initiative on the Attribution of Profits to Permanent Establishments: The Special Case of Agency Permanent Establishments’ (2017) 71 BIT 214, 215
⁶⁹ ibid
acting as PEs, some problems relating to the applicability of the separate entities approach have arisen. Namely, some transactions between a PE and the enterprise had to be priced differently than transactions made between legally independent enterprises such as a subsidiary and its parent company. In several areas, such as services rendered between a PE and its main office, contrasting interpretations of the commentary by the member states led the OECD to develop a comprehensive framework for the attribution of profits to permanent establishments, labelled the Authorized OECD Approach (AOA). It has been pointed out, however, that the authorized approach is far from universally accepted.\textsuperscript{70}

The 2010 update of the model convention and its commentary incorporated the recommendations of the OECD on the attribution of profits to permanent establishments first released in 2008 to clarify these issues. Its applicability in all situations is limited by the fact that a tax treaty may have been signed before the 2010 update, thus relying on the earlier wording of article 7 and its commentary. It’s also limited by reservations countries may have made to the update or because the countries have passed domestic laws that differ from the provisions of the model convention and its commentary. Also, while states that are not members of the OECD sometimes utilize the OECD Model, that does not mean they will also follow the AOA. Lastly, the binding effect of reports and the commentary of the model convention is debated, even among OECD member states. \textsuperscript{71}

The AOA has adopted the functionally separate entities approach, which stands in contrast to the relevant business activities approach. The latter entails sharing the profit of business activities that occur between the enterprise and other independent parties, meaning that no transactions between the enterprise and the permanent establishment are considered to take place. The AOA considers PEs to be an independent party for the purposes of profit attribution. Transactions between them are thus to be priced in accordance with the arm’s length principle. Instead of counting the profits of the enterprise and then dividing them between the constituent taxpayers, often referred to as “force of attraction”, the permanent establishment

\textsuperscript{70} Jérôme Monsenego, \textit{Introduction to Transfer Pricing} (Kluwer Law International 2015) 128-131
\textsuperscript{71} ibid
has its own profitability statement as if it was a separate legal entity; in which profits and losses incurred by doing business with the other parts of the enterprise are included. The difference being that in the latter case, it is the actual activities performed by the PE that is responsible for any additional profits being allocated to it rather than its mere existence.\textsuperscript{72}

The arm’s length principle is included in the OECD Model through article 9, titled Associated Enterprises. Article 9(1) begins by listing the criteria that must be fulfilled for two enterprises to be considered associated. If either one of the enterprises participates in the management, capital, or control of the other, they are considered associated under the article. If by being associated enterprises, commercial or financial circumstances arise between them that would not have arisen had they not been associated, then any profit they would have made had they not been associated may be added and taxed by the contracting states.

While at first glance Article 7 and 9 seem to advocate the same thing, namely the treatment of the dependent agent as independent through the application of the arm’s length principle, depending on which article is applied the result can vary. Consider an enterprise that has an associated enterprise, according to article 9, which is also deemed a dependent agent according to article 5. Such an entity is simultaneously an associated enterprise and a PE, which raises the question of the interplay between the two provisions.

4.4.1 The single and the dual taxpayer approach
The AOA recognizes that when a dependent agent PE is formed in accordance with the provisions of article 5(5), the host state will exercise taxing rights over two entities: the DAPE and the dependent agent enterprise, which is an associated enterprise under article 9. With respect to transactions between the associated enterprises, the AOA stipulates that article 9 should be used to determine if the transactions are priced in accordance with the arm’s length principle.\textsuperscript{73} The objective with respect to the DAPE is to determine how much of the profits of the

\textsuperscript{72} Jérôme Monsenego, \textit{Introduction to Transfer Pricing} (Kluwer Law International 2015) 131-133

\textsuperscript{73} OECD, ‘2010 Report on the Attribution of Profits to Permanent Establishments’ (OECD 2010) para 230
non-resident enterprise is attributable to the DAPE. The AOA stresses that in these cases, one should follow the same approach as with fixed place of business PEs, as anything else would be inconsistent with regard to article 7. The AOA outlines the steps necessary to attribute profits to the DAPE. The first step involved a functional and factual analysis of the activities performed by the associated enterprise in the host state. The associated enterprise should be remunerated in accordance with activities performed taking into account its assets and risk. Simultaneously, some of the risks and assets of the non-resident enterprise is attributed to the DAPE, depending on the functions it performs on behalf of the non-resident enterprise. Capital is also attributed, based on the risks and assets previously attributed. Because of this, it is necessary to examine the nature of the functions performed by the DAPE, to establish if it fulfills the criteria required for the assumption of risk and ownership of assets. Here, a concept known as significant people functions comes in. An analysis is made of the skills of the people working for the DAPE (via their employment by the associated enterprise). If it is determined that the significant people functions exist for the assumption of risk or ownership of assets, the profits associated with those functions should be attributed to the DAPE, and thus contribute to the tax base of the host state. Thus, the DAPE and the associated enterprise are treated as two separate taxpayers, even though the functions performed by the associated enterprise heavily influence the profits that are ultimately attributable to the DAPE. Also, it is necessary to deduct the arm’s length remuneration received by the associated enterprise from the non-resident enterprise for the services it provides for the non-resident enterprise, from the profits attributable from the DAPE.

According to what is known as the single taxpayer approach, which is not endorsed by the AOA, under article 9 the arm’s length remuneration such an entity receives should fully compensate the PE (after deductions), because a functional analysis taking into account the distribution of functions, risks and assets has determined the size of the remuneration in the first place. In view of the fact that the PE has been adequately compensated according to the arm’s length principle, there can be no

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reason to attribute any further profits according to article 7(2).\textsuperscript{75} Under the dual taxpayer approach, the arm’s length remuneration granted to the associated enterprise does not always fully compensate the PE, if it performs the significant people functions required for the assumption of risk legally borne by the non-resident enterprise.\textsuperscript{76}

4.4.2 The arm’s length principle under Article 7 and 9
A clear difference in the application of articles 7 and 9 when it comes to the attribution of profits through the attribution of functions, risks and assets is that article 9 must only deal with two entities, the non-resident enterprise, and the associated enterprise. When the permanent establishment is a DAPE, article 7 must consider three entities under the AOA: the resident enterprise, the associated enterprise and the DAPE. Associated enterprises and DAPEs are different in nature, DAPEs are not legal entities while associated enterprises are. Legal entities can technically enter into a multitude of arrangements with each other, while a PE and the resident enterprise naturally cannot. However, since article 7(2) instructs the parties to create a fiction where the PE and the associated enterprise are legally independent enterprises, it is necessary to search for the boundaries of the fiction. The OECD through the AOA advocates a strong separation between the PE and the enterprise.\textsuperscript{77}

The AOA mandates a two-step analysis when attributing profits to a PE.

1. Functional and factual analysis

This step entails entertaining the fiction that the PE and the resident enterprise as if they were separate entities that enter dealing, performs different functions and holds assets. As such, these functions, assets and the risks should be distributed between the PE and the enterprise. Risks and assets must be distributed according with the significant people functions, meaning an analysis

\textsuperscript{75} Raffaele Petruzzi & Raphael Holzinger, ‘Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era’ (2017) 9 WTJ 263, 295
\textsuperscript{76} OECD, ‘2010 Report on the Attribution of Profits to Permanent Establishments’ (OECD 2010) para 235
\textsuperscript{77} Kasper Dziurdź, 'Attribution of Functions and Profits to a Dependent Agent PE: Different Arm's length Principles under Articles 7(2) and 9?' (2014) 6 WTJ 135, 139
of the roles of the employees of the enterprise has to be done to determine where the roles necessary for risk and asset attribution exist, at the PE or at the main office. Capital should be attributed based on the attribution of risk and assets.  

2. Determination of remuneration

The second step has to do with pricing, it is determined by analogy using the provisions of article 9 – which in turn lead to the application of the OECD Transfer Pricing Guidelines.

4.4.3 OECD Discussion Draft on BEPS Action 7

The argument that the widened scope of Article 5 may create an unnecessary compliance burden placed on both tax administrations and enterprises is strengthened by the discussion draft on additional guidance on the attribution of profits to PEs circulated by OECD following the publication of the Final Report on BEPS Action 7. Included in the discussion draft are several examples addressing the attribution of profits to permanent establishments. One of these examples concerns Company A, resident in state X. Company A enlists Company B, an associated enterprise in state Y, to sell the products manufactured by Company A. Additionally, Company B is a dependent agent of Company A, giving rise to an agency permanent establishment or DAPE. No employees of Company A are based in Country B. We are shown in this example that, because no employees of Company A are based in Country B, the significant people functions are instead provided by Company B. Thus, no significant people functions are performed by the permanent establishment. Because of this, no risks or assets can be allocated to the DAPE. For this reason, no profits can be attributed to the DAPE, as there are none left to distribute.

78 Raffaele Petruzzi & Raphael Holzinger, ‘Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era’ (2017) 9 WTJ 263, 274
79 ibid, 275
80 OECD, ‘Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments’ (OECD 2016) paras 21-39
4.5 Implementation

The measures proposed by BEPS are intended to be implemented by amending domestic legislation as well as through amendments to the model convention’s provisions and updates to tax treaties themselves. As has been discussed, tax treaty provisions are, generally, to be interpreted with guidance from the commentary as it existed at the time when the treaty was concluded. Therefore, individual treaties would normally have to be renegotiated. Because of the sheer number of bilateral tax treaties in existence, individually renegotiating all of them would be a cumbersome process likely to drag on for quite some time. Therefore, one of the Actions of BEPS has been the development of a multilateral instrument aimed at modifying bilateral tax treaties, enabling the quick adoption of the measures in the BEPS package. Action 15, following the endorsement of the finance ministers of the G20 countries and the approval OECD committee for fiscal affairs, resulted in the creation of a group whose purpose was to develop the multilateral instrument and that the group be open to participation to all interested countries. In the end, 99 countries participated, along with several organizations. The finalized instrument, dubbed the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS”, covers the tax treaty related BEPS actions, of which Action 7 is one. The multilateral convention is not intended to amend existing treaty provisions directly, but instead it will be applied alongside them and in this way, modify their application in a way which is compliant with the BEPS measures. Parties to the convention are given leeway in various ways, for instance, a tax treaty may already have been renegotiated to implement BEPS measures directly, in which case the multilateral convention provision concerning the measures in question may be opted out of.  

In June 2017, a signing ceremony of the multilateral convention will be held, after which the OECD will support countries in the ratification and implementation process.  

81 OECD, ’Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting’ (OECD 2016) 1-3  
82 OECD, ’Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system’ (OECD 21 November 2016)
5. Discussion

5.1 Introduction

As BEPS Action 7 is titled “Preventing the Artificial Avoidance of Permanent Establishment Status” it is useful to contemplate what exactly the authors mean by the term “artificial”. The Final Report on BEPS Action 7 does not elaborate on the meaning of the word. However, as pointed out by Pleijsier, the term has been used in a court ruling by the European Court of Justice. Although the case itself dealt with controlled foreign corporations, the court determined that in order for an arrangement to be found to be artificial, there must be objective evidence that the controlled foreign corporation is not genuinely carrying out economic activity. Particular indicators for economic activity include premises, staff and equipment. This definition of “artificial” does not go hand in hand with what we have learned so far of commissionaire arrangements, the commissionaire in many cases certainly carry out economic activity. This leads the author to question whether the authors of BEPS view all such arrangements in a negative manner. It is a fair question, and one that is highlighted by the fact that the Final Report on Action 7 states that in many cases the intent of setting up commissionaire arrangements is to erode the tax bases of states.

5.2 Commissionaire arrangements in light of BEPS

As pointed out by Pleijsier, the new version of article 5 omits the terms broker and general commission agent previously found in article 5(6). That might be because these terms are not defined within the OECD Model and have different definitions in domestic law, as has been demonstrated in case law. Another interesting fact is that the BEPS project chose to forego the chance of explicitly defining the term “independent” within the article itself, which could have been accomplished by focusing on economic and legal independence mentioned in the commentary.

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84 Case C-196/04 Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue [2006] ECR I-7995
85 See section 3.2.1-3
86 BEPS Action 7 Final Report, 15
87 ibid
One focal point of the amendments to article 5(5) is that the agent is no longer required to conclude contracts in the name of the enterprise in order to be classified as dependent on the enterprise. It is enough that he plays the principal role leading up to the conclusion of contracts. As has been shown, it can be argued that sales agents always play the principal role in these cases; it is simply their job to find customers and promote the products or services the enterprise is looking to sell. While material modification may be intended to address cases where the sales agent is so dependent on the enterprise that he is using standardized price quotes or contract forms issued by the enterprise, it has likewise been pointed out that it punishes agents who perform well by correctly surmising the terms acceptable to the enterprise, since then no material modification would be needed.\(^{88}\) If this is the case, it would imply that the authors of the report only address a certain type of commissionaire arrangements, namely those in sectors where prices are uniform and a high degree of standardization is possible. The current trend of customization in the services industry consequently means that unforeseen consequences are likely if those sectors are impacted as well. Another problem, related to the name of the enterprise rather than the conclusion of the contract, is that contract conclusion in the name of the enterprise is no longer required. Ceteris paribus, it is enough that the agent concludes a contract with a third party for the sale of goods belonging to the enterprise for the agent to constitute a permanent establishment of the enterprise. This might cause interpretive challenges since domestic contract law often governs these types of situations.

Commissionaire arrangements lack a clear definition in the OECD Model. Instead, tax administrations and courts have relied on domestic legislation to determine what a commissionaire is. This is explicitly acknowledged in the Final Report on BEPS Action 7, where a loose definition is given as “a person [who] sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products”.\(^{89}\) More specifically, the discussion has been centered on whether “on behalf of” binds the principal to the obligations of the contract entered into by the

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\(^{89}\) BEPS Action 7 Final Report, 15
agent.\textsuperscript{90} By scrapping the term “general commission agent” in article 5(6), BEPS attempts to alleviate the unintended weight given to domestic law in deciding the outcome of these cases. The remedy for this, in the form of the proposed new wording of article 5(6) instead focuses on control through ownership. If the entities are deemed closely related because of the combined ownership structure and voting power, the agent cannot be independent if it acts only or almost exclusively on behalf of the principal. This approach is intended to make the independent agent provision less unclear and alleviate the perceived dependence on domestic law demonstrated by case law. Some however, argue that the threshold of 10 per cent of sales required to be on behalf of someone else than the closely related entity, set out in the proposed commentary to the new article 5(6), is subjective and that ultimate authority will lie with tax administrations who will determine on a case by case basis whether the entity is closely related or not.\textsuperscript{91} This may be because like commissionaire, the definition of closely related entities are also often defined in domestic law. Following the principle of the primacy of tax treaties over domestic law, an advantage of tax treaties in terms of its usefulness, is that the point of contention has largely been over the interpretation of the commentary rather than article 5(6) itself.\textsuperscript{92} Conversely, the proposed BEPS changes to article 5(6) make perfectly clear the requirements that need to be fulfilled in order to qualify as an independent agent without the use of divisive terms. The fact that the new wording is contrarian to many states’ domestic law is not unusual, rather, it is common that the provisions of tax treaties are in direct conflict with the domestic law of the contracting states.\textsuperscript{93}

Because of the widespread use of the commissionaire arrangements, many multinational enterprises will have to decide whether to continue with their current practices or consider alternatives. Arguable, tax administrations will face an increased burden, in the form of having to determine whether commissionaire arrangements warrant the formation of a PE. In many cases, however, parent-subsidiary structures in which remuneration is priced at arm’s length will not result

\textsuperscript{90} See section 3.2.2
\textsuperscript{92} See section 3.2.1
\textsuperscript{93} See section 2.2-3
in any additional profits being allocated to the new DAPE. Therefore, one can question the effectiveness of the BEPS proposals.

5.3 Revisiting the single taxpayer approach

Petruzzi and Holzinger identify some reasons why the AOA has adopted the dual rather than the single taxpayer approach. Firstly, the single taxpayer approach would be unfair to host countries because the contributions to its tax base would not become significant. Secondly, the single taxpayer approach would lead to a difference in treatment of different types of PEs. Thirdly, it is advocated that on a higher note, tax treaties would not be entered into that purposely includes articles that become insignificant once another article is activated. The single taxpayer approach voids article 5(5) in the case of dependent agent PEs, as it would be irrelevant whether a PE was deemed to exist. Also, it is mentioned that a proper understanding of the arm’s length principle entails that different facts and circumstances should lead to different results in terms of profit attribution. With the single taxpayer approach, DAPEs always end up with zero profit attribution, regardless of the circumstances.

The same authors point out that in the post-BEPS era, a significant compliance burden might be placed on the taxpayer and the tax administration just to establish whether the PE exists in the first place. They note that the establishment of the PE does not in itself guarantee any revenues for the host states. Rather, all it does is grant the right to the host state to tax profits that might not exist, especially considering transactions between the associated enterprise dependent agent and the principal should already be treated at arm’s length. This sentiment has also been echoed by multiple commentators who responded to the OECD Discussion Draft on BEPS Action 7. Thus, they conclude that the underlying motives for adopting the dual taxpayer approach have been weakened after the BEPS proposals. This can be seen directly by examining the examples provided by the BEPS Discussion Draft on BEPS Action 7 especially through example 1. In it, it is necessary to go through the entire process of establishing whether or not there is a PE present, even

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94 Raffaele Petruzzi & Raphael Holzinger, ‘Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era’ (2017) 9 WTJ 263, 277
95 ibid, 295
though ultimately no extra profit is allocated towards it and thus is does not contribute to the tax base of the host state, beyond the contribution of the subsidiary. It should be noted that it is likely that the compliance burden stems mainly from the creation of many new agency PEs and not from any significant changes to the concept of agency PEs itself.

On the other hand, some argue something that is overlooked by proponents of the single taxpayer approach, is that the purpose of article 5(5) has never been to provide a complete picture of the functions that may be performed by a dependent agent. Rather, it is intended only to set minimum standards for the formation of a DAPE and that therefore it would be wrong to base any argument on the attribution of profits to PEs based on those minimum standards. Instead, one should apply article 7(2) and apply the functional and factual analysis in ordinary fashion regardless if the results of that analysis indicates that some of the functions performed are not in complete harmony with the wording of article 5(5). This line of reasoning leads to the conclusion that it, under the AOA, the significant people functions performed can lead to residual profit being attributed to the DAPE even after the associated enterprise has been remunerated. The single taxpayer approach can be viewed as the expression of the opinion that the DAPE and the associated enterprise always perform the same functions, are attributed ownership of the same assets and assumes the same risks, or alternatively that the DAPE should only be remunerated for the activities it performs rather than based on the functions, risks and assets. A somewhat contrarian view is that residual profits attributable to the DAPE after the remuneration of the associated enterprise reveal inconsistencies in the application of the arm’s length principle under article 7 and 9, the latter being based to a larger extent on contractual arrangements while the former utilizes significant people functions. These inconsistencies can themselves

96 Dinis Tracana ‘The Effect of the OECD/G20 BEPS Initiative on the Attribution of Profits to Permanent Establishments: The Special Case of Agency Permanent Establishments’ (2017) 71 BIT 214, 216-217
97 ibid, 217
lead to unintended consequences such as tax planning and work is needed to ensure that the same outcome is achieved in the application of the two articles.\textsuperscript{98}

The authors of the BEPS Final Report on Action 7 concede that while the provisions of article 7 should still apply mostly unchanged, additional guidance might be needed on the attribution of profits to PEs arising from the proposals. What is somewhat worrisome is that the examples provided through the BEPS Public Discussion Draft illustrates the weaknesses of applying article 7 to the new PEs that arise.\textsuperscript{99}

\textsuperscript{98} Raffaele Petruzzi & Raphael Holzinger, ‘Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era’ (2017) 9 WTJ 263, 295

6. Conclusion

With Action 7, the BEPS authors have taken an aggressive approach that targets commissionaire arrangements. It can reasonably be assumed that, if adopted, the measures will result in the creation of many new PEs. For multinational enterprises business models will have to be reconsidered. While the measures appear to adequately target the sometimes-questionable practices of some large multinationals, the broad stroke with which the authors paint will also target smaller businesses, which can have an adverse effect on small businesses who nevertheless sell goods in different jurisdictions.

If the purpose of the BEPS project was to provide clarity, the endeavor only partly succeeded. While the removal of the explicit reference to general commission agents from article 5(5) is likely to vastly increase the reach of tax administrations, it is far from certain to generate a substantial increase in taxable profits in the host state. In order to determine the actual usefulness and whether the proposed changes are in line, more than superficially, with the stated purpose of BEPS of combating tax base erosion, an assessment of how many commissionaire arrangements are set up in a way that allows the attribution of profits to the DAPE after the associated enterprise has been correctly remunerated is required. In any case, the BEPS Action 7 working group has already concluded that action is warranted. Because on this, it is perhaps more useful to address issues rising from the application of the proposals rather than the motivations of the proposals themselves. As discussed, the interplay between articles 7 and 9 specifically is subject to contrarian opinions. First, there is the issue of the dual and single taxpayer approach. It has been pointed out that the primacy of the dual taxpayer approach under the AOA should be reconsidered in light of the BEPS proposals, because there would be no reason to analyze whether a DAPE exists at all if it is certain that it would not be attributed any profits.

Next, there is the issue of the arm’s length principle and whether it can result in different outcomes under article 7 and article 9. This is highlighted by the significant people functions concept developed for the attribution of profits to permanent establishments and the question of whether a DAPE, through the application of article 7, can assume risks or assets that an associated enterprise cannot based on its contractual arrangements with the non-resident principal. It
remains to be seen how tax administrations will interpret the proposals, one factor that could point to leniency regarding the closely related entities criterion of the proposed article 5(6) is that the strength of any measures undertaken is likely to be reciprocated by other states. Whether disputes between businesses and tax administrations are common or not is also likely to be influenced by how quickly businesses adapt and change their business models.
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