Transfer Pricing Aspects of Business Restructurings

Risk allocation as set out in Issues Notes 1 of the OECD Discussion Draft

Master thesis in Tax Law (Transfer Pricing)

Author: Forsberg Annelie
Tutor: Cottani Giammarco
Hallbäck Camilla
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Abstract

The purpose of this thesis is to analyze the notion of risk as set out in Issues Notes 1, in the document “Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment”. Furthermore, the approach of this draft is compared with the authorized OECD approach, established in the 2010 Report on the Attribution of Profits to Permanent Establishments. German law on transfer pricing provisions will also be examined to see whether domestic provisions could make a good example in allocating risks, as a supplement to the guidance from the OECD.

Issues Notes 1 has been subject for a debate as to how it should be interpreted and whether the provisions laid down in the document provide the tax authorities of contracting states too much room for subjectivity in determining whether risk allocation scenarios as set up by associated enterprises have economic substance. It has also been argued that Issues Notes 1 is an attempt by the OECD to align risk allocation under Article 9 of the OECD Model Convention with the authorized OECD approach, applicable to permanent establishments, because risk allocation under Article 7 is conducted by applying the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations by analogy. There are however crucial differences between associated enterprises and permanent establishments which makes this impossible.

The guidance under Issues Notes 1 is insufficient, why the OECD should seek to further clarify the concepts regarding business restructurings. The German way of implementing domestic provisions is incompatible with the provisions of the OECD and Article 9 and therefore violates most of its tax treaties.
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<td>Associated Enterprise</td>
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<td>AOA</td>
<td>Authorized OECD Approach</td>
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<td>BIAC</td>
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<td>ch.</td>
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<td>Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009</td>
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<td>EBIT</td>
<td>European Business Initiative on Taxation</td>
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<td>Guidelines</td>
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<td>IBFD</td>
<td>International Bureau of Fiscal Documentation</td>
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<td>IDIB</td>
<td>Institut für Deutsche und Internationale Besteuerung</td>
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<td>IFFS</td>
<td>Interdisziplinäres Zentrum für Internationales Finanz- und Steuerwesen</td>
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<td>MAP</td>
<td>Mutual Agreement Procedure</td>
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<td>MNE</td>
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1 Introduction

1.1 Background

“Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises”\(^1\).

Transfer pricing is a growing issue within international tax law. The globalization of world economy has led to structural changes in world trade. Multinational Enterprises (MNEs)\(^2\) play an important part in the globalized economy, as they account for an estimated 60% of world trade.\(^3\)

Individual companies within a corporate group are usually taxed as separate entities under domestic law. The system used by a country to determine a company’s tax base may differ from another country, thus leading to taxation of the same item in different states. Such economic double taxation may hinder transactions with goods and services and the movement of capital.\(^4\)

The separate entity approach, meaning that each individual group member is subject to tax on the income arising to it, is the standard chosen by the Organisation for Economic Cooperation and Development (OECD) countries to minimise economic double taxation.\(^5\) In applying the separate entity approach, the arm’s length principle constitutes an important mechanism, where associated enterprises\(^6\) in their intra group relations need to establish conditions as if they were independent parties, dealing at arm’s length.\(^7\)

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\(^1\) The Guidelines, Preface, para. 11.

\(^2\) According to the Guidelines, p. G-6, a MNE is defined as: A group of associated companies with business establishments in two or more countries.


\(^4\) The Guidelines, Preface, paras. 4-5.

\(^5\) Ibid., para. 5.

\(^6\) According to Article 9 1a) and 1b) of the OECD Model Tax Convention, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.

\(^7\) The Guidelines, Preface, para. 6.
These principles are incorporated in the OECD Model Tax Convention on Income and Capital (OECD Model Convention).\(^8\)

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (Guidelines), adopted in 1995, aim to provide guidance on the arm’s length principle and have been amended several times since. Member countries’ tax administrations are recommended by the OECD to use the assistance of the Guidelines when reviewing and adjusting transfer pricing between associated enterprises.\(^9\)

In order to establish a common view on transfer pricing consequences of business restructurings, the OECD released the “Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009” (Discussion Draft). This publication has been revised and now presents chapter IX of the Guidelines. The Discussion Draft covers transactions between related parties in the context of Art. 9 of the OECD Model Convention. It is composed of four Issues Notes: Issues Notes 1 provides general guidance on the allocation, Issues Notes 2 discusses the application of the arm’s length principle to restructurings, Issues Notes 3 examines the application of the arm’s length principle and the Guidelines to post-restructuring arrangements, and Issues Notes 4 addresses the non-recognition of transactions.\(^10\) The entrepreneurial risk allocation is what sets the basis for where return should be allocated. This is why it is of critical importance for tax administrations to assess the risk transfer of a business restructuring, a task which may be exhaustive.\(^11\)

By functioning as an economic unit, MNEs today, to a larger extent have the possibility to transfer e.g. labor and production factors, from high-cost countries to low-cost countries and thereby increase their revenue. By stripping one company, situated in “State A”, out of functions and risks and transferring them to another entity, situated in another country, the taxable base in “State A” will be reduced.\(^12\)

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\(^8\) The Guidelines, Preface, para. 8.

\(^9\) Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 51.

\(^10\) Discussion Draft, Preface.

\(^11\) Ibid., para. 19.

\(^12\) The Guidelines, Preface, para. 2.
1.2 Purpose
The purpose of this thesis is to analyze the transfer pricing aspects of risk allocation in a business restructuring as set out in Issues Notes No 1 of the Discussion Draft, now part I of chapter IX of the Guidelines. The three research questions to be answered are:

- Does Issues Notes 1 of the Discussion Draft provide satisfactory guidance on risk allocation for associated enterprises?

- Is the approach given in Issues Notes 1 similar to the approach for PEs as stated in the PE Report?

German domestic transfer pricing law is also studied and put in contrast to the OECD guidance, in order to see whether the German approach is efficient to avoid double taxation issues in business restructurings.

1.3 Method
In this thesis a traditional legal method is primarily used. This method examines and analyses legal sources hierarchically.\textsuperscript{13} By applying the traditional legal method, the legal basis for the transfer pricing issues in question will be determined.

A comparative method is used in order to provide more depth to the analysis. Risk allocation according to Art. 9 of the OECD Model Convention will be compared to risk allocation in an Art. 7 perspective. Since transfer pricing and the rules thereof are international to a large extent, transactions normally involve more than one country. German transfer pricing legislation will be examined and compared with previous findings. Due to the author’s insufficient knowledge of the German language, legal sources have to a large extent been found in secondary sources such as doctrine and academic articles. It should be noted that the author has no profound knowledge of the German jurisdiction.

A study of the German transfer pricing aspects of business restructuring regarding risk allocation gives the thesis a depth as it puts the OECD regulations from the viewpoint of a single jurisdiction. Germany is relevant to examine as it was one of the first countries to introduce transfer pricing regulations on business restructurings, and there has been a concern that these provisions are not in accordance with Art. 9 of the OECD Model

\textsuperscript{13} Lehrberg B, \textit{Praktisk juridisk metod}, p. 135.
Germany is also a member country of the OECD. This thesis results in a discussion of the problems which the concept of risk allocation as set by the OECD give rise to.

German tax treaties generally follow the OECD Model Convention, and the treaties prevail over domestic law. The legal status of the Guidelines in Germany is not clear, however the German tax authorities frequently cross-reference to them in their administrative principles. The Guidelines have also been approved by the German government, why one may assume that the Guidelines do have high legal priority.

The OECD Model Convention aims to remove the obstacle to international trade and economic relations between countries that international juridical double taxation creates. It has been used to a large extent in bilateral conventions, by OECD member countries as well as non-members. International organizations, such as the United Nations, working with related issues, use the convention as a basic reference.

The provision of each article of the convention is clarified by the OECD Commentary on the OECD Model Tax Convention on Income and Capital, 2010 (the Commentaries). The Commentaries are not meant to constitute a part of the bilateral conventions signed by member countries, and will therefore never constitute a legally binding instrument. They are, however, meant to serve as guidance in the application of the OECD Model Convention, and in particular in the settlement of any disputes. The result has also been that the Commentaries have been used to a large extent by tax administrations and tax officials of member countries. Courts are now using the Commentaries in reaching their decisions. As international economic integration increases, the

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14 Beck, K. *Business Restructuring in Germany*, p. 277-278.
15 See introduction to the OECD Model Convention.
16 Perdelwitz Andreas, *Germany – Corporate Taxation*, sec. 7.4.1.1.
17 Kroppen H, and Eigelshoven A. *Germany – Transfer Pricing*, sec. 2.4.
18 OECD Model Tax Convention, Introduction, para. 1
19 Ibid., Introduction, para. 14.
20 Ibid., Introduction, para. 28.
21 Ibid., Introduction, para. 29.
22 Ibid., Introduction, para. 29.1.
Commentaries are expected to play a larger role and receive even more widespread acceptance in the future.\textsuperscript{23} As for member countries, the articles become binding conventions when a double taxation agreement, following the OECD Model Convention, is conducted. Countries are encouraged to use the Commentaries by means of interpreting their bilateral conventions.\textsuperscript{24}

The Discussion Draft is not, nor are the Guidelines, a legally binding document for the member countries.\textsuperscript{25} The public was asked to give comments to the Discussion Draft before the final version was set in July 2010. The Discussion Draft presents relevant guidance on the OECD view on how to determine the interpretation of the application of the Guidelines. It is merely a draft, and has therefore no direct legal value. The Guidelines aim to create an international legal approach to the arm’s length principle. Although it is not a legally binding document, national courts use it in their interpretation of bilateral conventions containing provisions that correspond to Art. 9 of the OECD Model Convention.\textsuperscript{26} There is limited literature on the subject as these documents were recently published; therefore, additional information has mainly been found in academic articles.

In order to obtain OECD publications, such as the OECD Model Convention, the Guidelines and the PE Report, the OECD iLibrary is used. The Discussion Draft and public comments regarding the Discussion Draft are found on the OECD website. The public comments selected and presented in this thesis are the ones which provide for differentiated and thorough opinions on Issues Notes 1 of the Discussion Draft. A few other opinions are further briefly referred to, to give a better overview on the public opinions on the Discussion Draft. The source mainly used to obtain academic articles and other relevant information on the subject is the International Bureau of Fiscal Documentation (IBFD) database.

1.4 Delimitations

This thesis does not go beyond the scope of its purpose. The concept of risk allocation is examined from a perspective of Issues Notes 1 of the Discussion Draft. Other aspects of

\textsuperscript{23} OECD Model Tax Convention, Introduction, para. 29.3.

\textsuperscript{24} Ibid., Introduction, para. 3.

\textsuperscript{25} The Guidelines, Preface, para. 16.

business restructurings are not examined. It can be argued that German law is incompatible with EU-law. EU-law however will not be examined in the thesis.

The German regulations on business restructurings are not applicable to PEs.\textsuperscript{27} There is no domestic regulation on the allocation of income between a head office and its foreign PE. The German PE should be treated as an independent entity according to international principles; the OECD guidance is generally followed.\textsuperscript{28} Therefore, the PE issue under German regulations will not be considered.

1.5 Outline

Chapter 2 This chapter describes the main OECD regulations applicable to transfer pricing issues of business restructurings of associated enterprises. Applicable parts of the OECD Model Convention, the Guidelines and the Discussion Draft are examined. A comparison is made between Issues Notes 1 and chapter IX of the Guidelines.

Chapter 3 A description is given in this chapter regarding the applicable OECD regulations on transfer pricing issues of risk allocation in business restructurings to PEs. Art. 7 is examined as well as relevant parts of the PE Report.

Chapter 4 In this chapter the key concepts of risk allocation from an Art. 9 and an Art. 7 perspective, which are found in the previous chapters 2 and 3, are further examined. A discussion is also provided, which elaborates on whether the approaches of the two articles differ and what effects this may have on different risk allocation scenarios.

Chapter 5 German transfer pricing law is presented in this chapter. The German transfer pricing provisions in general will first be presented briefly. The business restructuring and risk allocation provisions are further presented, which apply to associated enterprises. Next, the German view of the PE risk allocation issue regarding business restructurings is

\textsuperscript{27} Beck, K. Business Restructuring in Germany p. 279

\textsuperscript{28} Perdelwitz, A. Germany – Corporate Taxation, sec. 7.2.1.2.
examined. Finally, a discussion is provided on whether German law is compatible with the OECD guidance.

Chapter 6 The final chapter of this thesis analyses the research questions. A conclusion and recommendation is lastly given where the respective answers of the research questions are given.
2 Associated Enterprises

2.1 Initial Remarks

This chapter deals with the transfer pricing consequences of associated enterprises when conducting business restructurings. Art. 9 sets the basis for this application, why this article is described first. The Guidelines and the Discussion Draft have no direct legal value however they provide well acknowledged guidance that most states follow in their application of Art. 9. Relevant parts thereof are therefore examined. Finally, Issues Notes 1 of the Discussion Draft is presented. Five case scenarios are given in order to clarify the intent of Issues Notes 1. The OECD Committee on Fiscal Affairs received several comments on the Discussion Draft. Subchapter 2.5 provides a review of some of the comments that the OECD received, regarding the notion of risk allocation. This chapter aims to give an understanding of the risk allocation approach that OECD recommends for associated enterprises.

2.2 Art. 9 of the OECD Model Convention

2.2.1 General

Art. 9 of the OECD Model Convention deals with adjustments to profits where transactions between associated enterprises are not at arm’s length. The first paragraph of the article provides the definition of the arm’s length principle, and states that when:

“Conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”

Therefore, where associated enterprises’ dealings are not at arm’s length, profits may be included in the enterprise as if the dealings had been at arm’s length and taxed accordingly. Pursuant to the second paragraph of the article, the other State involved should make an appropriate adjustment. In this way the article is relevant to avoid economic double taxation:

“Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Con-
tracting State has been charged to in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits.”

In making an adjustment “due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other”\textsuperscript{30}. This relief is only necessary if the state agrees with the initial adjustment as representing arm’s length. In determining such adjustment, other articles of the Convention shall be considered and the competent authorities of the contracting states shall consult each other, if it is necessary.\textsuperscript{31} That is, the States need to agree on the correct profit at arm’s length, otherwise economic double taxation might occur.

\textbf{2.2.2 Interpretation of the Article According to the Commentaries}

The tax authority of a contracting state has, according to Art. 9(1), been given a right to re-write the accounts of an enterprise when the enterprise has dealt with its associated enterprises in other ways than at arm’s length, which has lead to a different taxable profit in that State had it dealt at arm’s length.\textsuperscript{32} Disputes shall be dealt with by a mutual agreement procedure (MAP).\textsuperscript{33}

\textbf{2.3 The Guidelines}

\textbf{2.3.1 General}

The Preface to the Guidelines state that international taxation principles chosen by the OECD member countries provide a consensus on international taxation principles. It is further stated that consensus among nations is critical for the principles to have the

\textsuperscript{29} OECD Model Tax Convention, Art. 9(2).

\textsuperscript{30} Ibid.

\textsuperscript{31} Ibid.

\textsuperscript{32} The Commentaries, Art. 9, para. 2.

\textsuperscript{33} Ibid., Art. 9, para. 11.
sought effect, namely securing the appropriate tax base for each jurisdiction and thereby avoid double taxation.\textsuperscript{34}

The first chapter of the Guidelines provides a discussion on the arm’s length principle. This principle enables countries to make adjustments for tax purposes when transfer prices between associated enterprises are not at arm’s length; the conditions of the commercial and financial relations shall be established as if they had been between independent enterprises. Thereafter an appropriate adjustment can be established.\textsuperscript{35} The arm’s length principle has been criticized as the separate entity approach does not take into account economies of scale or interrelation of diverse activities of MNEs. No objective and widely accepted criteria for allocating these benefits between associated enterprises exist.\textsuperscript{36} In situations where it might be hard, or sometimes impossible, to find an appropriate transfer price, the Guidelines state that “transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer”\textsuperscript{37}, \textsuperscript{38}

A functional analysis needs to include a risk assessment where each party’s assumed material risk is considered; the allocation of risk usually infers with the conditions of the transactions between associated enterprises. Increased risk, normally, needs to be compensated by a higher expected return at the company which assumes it.\textsuperscript{39}

\textbf{2.3.2 Economic Substance and Contractual Terms}

The economic substance of a transaction is important to consider. The parties conduct should generally be taken as the best evidence concerning the true allocation of risk. Tax administrations may challenge the purported allocation of risk when the contractual terms are not in accordance with the economic substance, to which the parties’ conduct is generally taken as the best evidence.\textsuperscript{40} The Guidelines exemplify a transaction where

\begin{itemize}
  \item \textsuperscript{34} The Guidelines, Preface, paras. 6–7, 12.
  \item \textsuperscript{35} Ibid., para. 1.3.
  \item \textsuperscript{36} Ibid., para. 1.10.
  \item \textsuperscript{37} Ibid., para. 1.13.
  \item \textsuperscript{38} Ibid., para. 1.13.
  \item \textsuperscript{39} Ibid., para. 1.45.
  \item \textsuperscript{40} Ibid., para. 1.48.
\end{itemize}
Company A produce and ships goods to Company B, who decides on the level of shipment of goods. In this scenario, it is unlikely that Company A would assume substantial inventory risk since it has no control over the inventory level. Risks such as general business cycle risks, over which neither party has control, cannot be allocated to either party.\(^{41}\)

Contractual terms generally define how risks are allocated between the parties, however evidence may also be found in correspondence between the parties. If no written evidence is available, the contractual relationships of the parties “must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises”\(^{42} \)\(^{43}\).

A structure may be disregarded in two circumstances: when the economic substance of a transaction differ from its form, or when the arrangements, “viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price”\(^{44}\). The transaction shall then be re-characterized in accordance with its substance.\(^{45}\)

### 2.4 Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment

#### 2.4.1 General

The increase of business restructurings by MNEs in recent years has called for the OECD to clarify issues related to the application of the arm’s length principle. The guidance under the Guidelines and the OECD Model Convention to tackle business restructurings was deemed to be insufficient. This is the reason why the Committee of

\(^{41}\)The Guidelines, para. 1.49.

\(^{42}\)Ibid., para. 1.52.

\(^{43}\)Ibid., para. 1.52.

\(^{44}\)Ibid., para. 1.65.

\(^{45}\)Ibid., para. 1.65.
Fiscal Affairs created a Joint Working Group in 2005 to initiate work on these issues. The Discussion Draft was released in 2008.46

Under the Discussion Draft, a business restructuring is defined as “the cross-border re-deployment by a multinational enterprise of functions, assets and/or risks”47. Business restructurings within the scope of the project are normally internal, however, relationships with third parties may be a reason for, or affect the restructuring.48 Four typical restructuring models are presented:

- “Conversion of full-fledged distributors into limited-risk distributors or commissaires for a related party that may operate as a principal,
- Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal,
- Rationalization and / or specialization of operations (manufacturing sites and / or processes, research and development activities, sales, services),
- Transfers of intangible property rights to a central entity (e.g. a so-called “IP company”) within the group.”49

The Discussion Draft covers transactions between related parties in the context of Art. 9 of the OECD Model Convention. It is composed of four Issues Notes, where Issues Notes 1 provides general guidance on risk allocation.50

2.4.2 Issues Notes 1: Special Considerations for Risks
The entrepreneurial risk allocation sets the basis for where return should be allocated. This is why it is of critical importance for tax administrations to assess the risk transfer of a business restructuring.51 Tax administrations shall, according to Issues Notes 1, examine risk in an Art. 9 context, starting from an examination of the existing contractual

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46 Discussion Draft, Preface.
47 Ibid., ch. A(1).
48 Ibid., ch A(1)
49 Ibid., ch. A(1) para. 3.
50 Ibid., Preface.
51 Ibid., para. 19.
terms between the parties. However, in order for the terms to be respected, they must have economic substance.\textsuperscript{52}

When a foreign related party assumes e.g. all inventory risk, it may be necessary to examine where the write-downs are taken and whether the conduct of the parties supports the allocation of risk as set in the contract. When a tax administration notices that the contractual terms do not have economic substance, they may challenge the purported allocation of exchange rate risk.\textsuperscript{53} The pricing of the transaction in, e.g. a contract determining credit risk, will also provide evidence of which entity bears the risk.\textsuperscript{54}

Where no written contract exists, evidence of the terms may be found in correspondence and/or other communication between the parties. The conduct of the parties, but also economic principles that generally govern similar but independent relationships, can lead to a conclusion of what represents arm’s length conditions. Dependent parties may not have the same interest in holding each other to the terms of existing contracts as would independent parties, and it is therefore important that the conduct of the parties do conform with the terms. If that is not the case, further analysis is needed to determine the actual terms of the transaction.\textsuperscript{55} The conduct of the parties is often the best evidence of the true allocation of risk.\textsuperscript{56}

When there is no comparables data to a situation of risk allocation, this does not \textit{per se} mean that the contractual terms are not at arm’s length. In this situation one will have to determine whether independent parties would have been expected to agree in the same way under similar circumstances.\textsuperscript{57} Factors that are helpful when making this determination include which party has control over the risk and whether that party has the financial capacity to bear it.

Issues Notes 1 defines control as “\textit{the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk},
internally or using an external provider\textsuperscript{58}. The company must i.e. have employees or directors to perform these control functions.\textsuperscript{59} The party may hire another party to perform the day-to-day administration and monitoring of a risk without it being transferred to that other party. The first party shall, however, assess the outcome of such outsourcing. The Discussion Draft gives the example of an investor who hires a fund manager; the fund manager has the authority to make all the investment decisions and thereby controls the risk, however it is the investor who decides the amount to be invested, which fund manager to hire, and who receives the profit (or loss) of the investment.\textsuperscript{60}

In another example, a principal hires a contract researcher to perform research on his behalf. Again, the researcher has control over the day-to-day monitoring but the type of research to be performed is determined by the principal, who will also be the legal owner of the outcome of the research. One could argue that the contract researcher bears a risk of e.g. penalty in case of negligence or losing its client, nevertheless, this risk is different in nature from the one borne by the principal. It is also noted that there are risks which go beyond the control of either parties although they might have a choice in whether they expose themselves to such risks, e.g. economical conditions, political environment, social patterns and trends, and, money and stock market conditions.\textsuperscript{61} When a party’s risk is allocated, the transfer pricing consequences of such shall be for the party to bear the costs of managing and realizing that risk, and be compensated by, generally, an increase in the expected return.\textsuperscript{62}

2.4.3 Case Scenarios to Clarify the Examples of the Discussion Draft

2.4.3.1 General

There are infinite scenarios and approaches that can be analyzed as part of business restructurings. In this chapter five scenarios will be discussed, in an attempt to broaden the examples in Issues Notes 1. The three tests of the Discussion Draft will be applied to the examples: the conduct test, the control test and the financial test.\textsuperscript{63} The following

\textsuperscript{58} Discussion Draft., para. 30.

\textsuperscript{59} Ibid., para. 18.1.

\textsuperscript{60} Ibid., paras. 30-32.

\textsuperscript{61} Ibid., paras. 33-34.

\textsuperscript{62} Ibid., paras. 44-45.

\textsuperscript{63} Bakker A. \textit{Transfer Pricing and Business Restructurings: Streamlining all the way}, p. 111.
scenario is the same in each case; associated enterprises Company A and Company B are situated in different countries. Company A has the contractual obligation to repurchase any unsold inventory from Company B. Company A is the manufacturer and Company B is the distributor:

<table>
<thead>
<tr>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Manufacturer</strong></td>
<td><strong>Distributor</strong></td>
</tr>
</tbody>
</table>

### 2.4.3.2 Case Scenario 1

Conduct test

Excess inventory risk is assumed by (according to the):

- **Contract**: Company A
- **Conduct (inventory write-offs)**: Company A
- **3rd party comparables**: Company A

This case may seem obvious; Company A assumes risk both according to the contract and the conduct of the parties. With reliable 3rd party comparables, no further investigation needs to be conducted to determine the control test or financial capacity test.\(^\text{64}\) To conclude, the write-offs in country A by Company A should be accepted.

### 2.4.3.3 Case Scenario 2

Conduct test

Excess inventory risk is assumed by (according to the):

- **Contract**: Company A
- **Conduct (inventory write-offs)**: Company A
- **3rd party comparables**: Company B

In this scenario the contract, as well as the conduct of the parties, imply that excess inventory risk lies with Company A. However, reliable 3rd party comparables show that in similar circumstances Company B would assume such risk. Additional comparability

\(^{64}\) Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 111-112. See also the Discussion Draft, paras. 27-28.
matters might need to be taken into consideration here, e.g. there could be functional
differences between 3rd party distributors and dependent party distributors. In a depen-
dent party situation, it might be the manufacturers and not the distributors that are re-
sponsible for making decisions regarding the quantities of products purchased by the
distributors. Hence, the 3rd party functional profile may differ, but the dependent party
profile can still be respected. It does not exclude, however, that a comparability adjust-
ment might be needed to eliminate any material difference between the controlled and
uncontrolled transaction.65

Erasmus-Koen is of the opinion that the general anti-avoidance rule of para. 1.3766(para.
1.65 of the 2010 version of the Guidelines) should not be given any further concern. Pa-
ra. 38 of the Discussion Draft mentions that when independent parties risk allocation
manners differ, this alone is not a reason to not recognize a risk allocation of a con-
trolled transaction.67 The fact that the manners differ could lead to a conclusion that the
economic logic of the controlled transaction should be examined.68 A similar approach
is presented in the Discussion Draft, as the economic logic of the transaction is
tested. Erasmus-Koen believes that a possibility for non-recognition on an individual
condition basis would only add uncertainty to the analysis.69

2.4.3.4 Case Scenario 3

Conduct test

Excess inventory is assumed by (according to the):

**Contract:** Company A

**Conduct (inventory write-offs):** Company A

**3rd party comparables:** No reliable 3rd party data exist

Where no reliable 3rd party comparables data can be found, evidence should instead be
sought for by examining who assumes the actual strategic control functions regarding
managing excess inventory. The notion of control over risk, i.e., applies only to situa-

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65 Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 112-113.
66 Referring to the 1995 version of the Guidelines.
67 Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 113.
68 See also the Guidelines, para. 1.69.
69 Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 113.
tion where no 3rd party data is available. Also, the question should be asked whether Company A has the financial capacity to bear the risk.  

If the control functions are performed by Company A, the write-offs should be accepted. If, in contrast, Company B carries the control functions, the tax authorities in country A may re-assign the risk allocation to Company B and not accept the whole inventory write-offs. This could be interpreted as an all-or-nothing approach and it is unclear how the financial capacity test could be applied. This all-or-nothing approach, suggested by the control test, appears to be similar to the anti-avoidance rule where an individual condition of a transaction is not recognized.

2.4.3.5 Case Scenario 4

Conduct test

Excess inventory is assumed by (according to the):

Contract: Company A

Conduct (inventory write-offs): Company B

3rd party comparables: Company B

The enterprises in this case fail to meet the conduct test. Since inventory write-offs are conducted at Company B, and reliable 3rd party data evidence that the distributor in similar circumstances would do the same, no further consideration needs to be taken to the control test or financial capacity test. The contract may still be accepted and recognized, but a comparable adjustment shall be made for the diverging condition.

2.4.3.6 Case Scenario 5

Conduct test

Excess inventory is assumed by (according to the):

Contract: Company A

Conduct (inventory write-offs): Company B

3rd party comparables: No reliable 3rd party data exist

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70 Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 114.

71 Ibid., p. 114.

72 Ibid., p. 115.
In this case the parties fail to meet the conduct-test, since the write-offs incurred at Company B. No reliable 3rd party data exists to suggest which party would in an independent situation carry the inventory risk.  

The control test should further be applied, taking into consideration especially the location of the actual strategic control functions regarding managing excess inventory, as well as the financial capacity of Company A to carry the risk. Again the all-or-nothing approach could be applied, whereby it may be hard to see how the anti-avoidance rule differs from the all-or-nothing approach.

When there is no documented third party evidence on risk allocation, and the parties’ conduct differ from written contracts, tax authorities are, according to Erasmus-Koen, encouraged to make an assessment based on the economic principles that generally govern relationships between independent parties. This assessment might be a too subjective criterion and lets the tax authorities infer scenarios on behalf of their own beneficial interest.

2.5 Public Comments on the Transfer Pricing Aspects of Business Restructurings

2.5.1 General
Business commentators were encouraged by the OECD to provide their opinions on various parts of the Discussion Draft. These public opinions provide further discussion on the notion of risk allocation.

2.5.2 Transfer Pricing Associated Global Transfer Pricing Practice
The Transfer Pricing Associated Global Transfer Pricing Practice (TPA) believes that the concept of control should be understood as the decision to put capital at risk, i.e. a communication by instructions to other individuals who will then perform the day-to-day functions. The TPA suggests that it should be clarified that the control test should not be used at all for risk allocation considerations, as long as there is reliable third party data that does not differ from the arrangement at hand. The same goes for the finan-


74 Ibid., p. 116.

75 Ibid., p. 116.
cial capacity test; it should only be applied when no similar arrangement can be found between independent third parties. The TPA further asks for a clarification that the concept of control and the significant people functions concept may be similar but are however in fact applied under different articles.  

2.5.3 Business and Industry Advisory Committee to the OECD  

Business and Industry Advisory Committee to the OECD (BIAC) agrees with the definition of control as explained under Issues Notes 1. It asks however for further clarification whether the concept also involves a responsibility for the consequences that may occur after a party implements policies determined by the party in control. BIAC offers an alternative wording which would be “effective economic control”. This would also emphasize that control does not necessarily include the day-to-day responsibility to implement business decisions.

BIAC recognizes that tax authorities of different jurisdictions may use the possibility to subjectively decide regarding risks in a way that would benefit them, e.g. whether the country in question has a large amount of head offices or subsidiaries. It may be that the tax authorities will allocate the control over a risk to a subsidiary merely because the existence of, e.g. a chief financial officer, gives an impression of control in that subsidiary. The effective economic control concept would therefore be better applied.

The financial capacity test is important; however a high level of capitalization is not necessarily a proof that the party carries the risk. Other factors may influence the level of capital, such as thin cap regulations or certain regimes designed to attract capital, why financial capacity might not be a good indication of arm’s length allocation of risk. BIAC believes that as long as the written contracts are followed by the conduct of the parties, it should be irrelevant what third parties would have agreed on.

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76 TPA, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 4-5.

77 BIAC, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 6.

78 Ibid., p. 7.

79 Ibid., p. 7.
2.5.4 KPMG

KPMG interprets the Discussions Draft as explicitly stating that taxpayers’ arrangements of risk allocation should be respected until a compelling reason for the contrary is found. A risk allocation should be respected by the tax authorities as long as it is not obviously inconsistent with the arm’s length principle; any other approach would allow the tax authorities too much subjective consideration. As different tax authorities can make differing judgments, an increased risk of double taxation is at hand. Further, the OECD guidance should explicitly, according to KPMG, acknowledge that third party comparables often do not provide guidance since there is a wide range of different types of contracts with substantially different allocations or risk, and never a single arm’s length allocation of risk in a certain situation. The crucial indicative proof of risk allocation should be whether an entity has the capacity to manage and bear such risk. Concerning financial capacity to bear a risk, KPMG considers the fact that if an entity chooses to invest e.g. a billion Euros; such financial commitment in itself should speak to the allocation of risk. KPMG concludes with the statement that as long as taxpayers can show up-front identification of risk allocation between entities, tax authorities should respect this; this view should also be clearly expressed in the Discussion Draft.

2.5.5 PwC

PwC agrees with the Discussion Draft and Issues Notes 1 in general. However, concern is expressed about the language of Issues Notes 1 that gives it a too broad scope of subjective interpretation. One issue that should be addressed is when risks are managed by global teams, the members of which are employed by different parts of an enterprise. The question is whether such risk should be shared or just allocated to the contractual owner of it.

80 KPMG, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 6-7.
81 Ibid., p. 8.
82 Ibid., p. 11.
84 PwC, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 5.
85 Ibid., p. 7.
Furthermore, the notion of financial risk bearing should be given more importance. PwC believes that there are many situations in which the financial capacity is really the key element in risk allocation between independent parties, which takes precedence over day-to-day management or ultimate control over risk.\textsuperscript{86}

PwC recommends Issues Notes 1 to eliminate the requirement that the allocation of risk should be at arm’s length and to clearly state that contracts should be respected, as long as the parties’ conduct is in accordance with the contract and they have the possibility to manage and financially capacity to bear the risks assumed. It should also be recognized that in some arrangements, economic risk bearing alone should be enough to support the contractual allocation of risk.\textsuperscript{87}

\textbf{2.5.6 The Group}

The Transfer Pricing Discussion Group (the Group) expresses concern over the subjectivity offered by Issues Notes 1. Their suggestion is that tax administrations should only with empirical evidence be able to not recognize a transaction. This evidence shall show that third parties would not act in the same manner, and that there is a distortion of income or expense which cannot be addressed by a reallocation of income or expense.\textsuperscript{88}

The Group further gives an example to show the weakness of the control concept. Consider that Company A is the owner of a patent, but transfers the exclusive rights to Company B. Company B would then have control over the development, marketing and other activities. The only requirement from Company A is to undertake best efforts with respect to these responsibilities. Company B also has the possibility to sublicense the patent to another entity, Company C. If Company B does that, the compensation that both Company A and Company B receive will depend on the activities of Company C. It is only Company C who holds the control in such a situation. The Group wonders whether the OECD guidance would establish control to have been transferred to Company C. If that is the case, the question is whether there can be no compensation to Company A for the, although very little, meaningful control it has over the patents de-

\textsuperscript{86} PwC, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 7.

\textsuperscript{87} Ibid., p. 7.

\textsuperscript{88} The Group, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 25-26.
velopment. Control in different circumstances and scenarios can be hard to establish; the Group states that “control is not a conceptually sound or administrable standard.” The Group further elaborates with the idea that the OECD should use another standard to test whether affiliates have allocated risks appropriately, and emphasizes the financial capacity test. If an entity bears a risk which could amount to 100 million, but that entity only has capital of 1 million, then tax authorities should question whether that entity really bears the risk. An advantage with using the financial capacity test before the control test is also that comparables data on financial capacity are relatively easy to find.

2.5.7 Other Public Opinions

The Association of German Banks believes that there is insufficient guidance on risk allocation under both the Guidelines and the OECD Model Convention. OECD should acknowledge that risk control is often conducted from a group perspective, across regions or worldwide, and this freedom is too interfered with in the Discussion Draft. The association also asks for more guidance on questions on business restructurings in connection with Art. 5 and Art. 7.

The CEA, the European Insurance and reinsurance federation, among others, asks for clearer guidance to avoid uncertainties or room for interpretation. Deloitte elaborates on the control concept and states that it is probably not a necessary test in determining risk allocation. Either way, further examination is needed for it to be a compelling test of who controls a risk. EBIT believes that financial capacity to bear a risk should be

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80 Ibid., p. 30.
81 Ibid., p. 30-31.
82 The Association of German Banks, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 1.
83 Ibid., p. 3.
84 CEA, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 2, see also EBIT, Public comments on the Transfer Pricing Aspects of Business Restructuring, p.3, and EY, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 3.
85 Deloitte, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 3.
more important than the control concept, and this should be the starting point of the risk allocation examination.\textsuperscript{96}

Interdisziplinäres Zentrum für Internationales Finanz- und Steuerwesen (IFFS) and Institut für Deutsche und Internationale Besteuerung (IDIB) acknowledge the differences of the OECD view and the German legislation, and hope for a consensus where the German legislation is applied as the OECD standard. Either way, a clear statement and consensus of the perspectives is needed to avoid a number double taxation cases.\textsuperscript{97}

The International Tax Review believes that the focus on written agreements is wrong, and that more focus should be on actual conduct and evidence of agreement in any form. Further, the control concept should be compared to the significant people function concept to make it less subjective. It is operational control that should count, not the group wide strategic risk management.\textsuperscript{98}

2.6 Issues Notes 1 Incorporated in a New Chapter IX of the Guidelines

2.6.1 General

The four Issues Notes have been incorporated to present a new chapter IX of the Guidelines. Its aim is to provide guidance on transfer pricing aspects of business restructurings, by clarifying the application of Art. 9.\textsuperscript{99}

2.6.2 Differences from Issues Notes 1

The most significant change from Issues Notes 1 is that according to chapter IX, when the contractual allocation of risk, and the allocation where risk is actually exercised, differ, a transfer pricing adjustment is more likely to be made instead of a re-characterization. However, the guidance states that “a tax administration is entitled to challenge the purported contractual allocation of risk between associated enterprises if

\textsuperscript{96} EBIT, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 3.

\textsuperscript{97} IDIB and IFFS, Public comments on the Transfer Pricing Aspects of Business Restructuring, p. 5.


"it is not consistent with the economic substance"\textsuperscript{100}, i.e. a transfer pricing adjustment could still be applied to that effect in exceptional circumstances.\textsuperscript{101}

The elaboration on financial capacity is conducted more thoroughly in this new chapter IX. The guidance clarifies that assuming the risk could be the capacity to bear it, should it materialize, but it could also be the existence of a mechanism in place to cover it.\textsuperscript{102} If the purported bearer does not have financial capacity, the risk may have to be borne by the transferor, parent company, creditors or another party.\textsuperscript{103} It is stated that the chapter provides guidance, it is not a standard and that there is a difference in the topical approach and the authorized OECD approach (AOA) regarding PEs.\textsuperscript{104}

\textsuperscript{100} The Guidelines, para. 9.12


\textsuperscript{102} The Guidelines, para. 9.30.


\textsuperscript{104} The Guidelines, para. 9.7.
3 Permanent Establishments

3.1 Initial Comments

The transfer pricing consequences relating to PEs will be presented in this chapter. The basis for such profit attribution is established in Art. 7 of the OECD Model Convention, why it is necessary to initiate the chapter with an investigation of this article. The article is however, in part, an extension from the work of the OECD in the PE Report, which will be presented below in 3.3. The aim of this chapter is to describe how risks and profits are attributed to a PE from an OECD perspective.

3.2 Art. 7 of the OECD Model Convention

3.2.1 General

Art. 7 of the OECD Model Convention determines when a Contracting State has the right to tax a company with regard to business profit attributable to its permanent establishments in other states. Para. 1 of the article states:

“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”.

The PE definition is established in Art. 5 of the OECD Model Convention. Profits that are attributable to a PE shall be taxed in the State where the PE is situated. The profits attributable to the PE are the profits it is expected to make “taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. A Contracting State may adjust the profits that are attributable to a PE if it considers the profits not to be in line with the arm’s length principle, as stated in para. 2 of the article, and the other Contracting State shall then make appropriate adjustments accordingly, to eliminate

105 OECD Model Tax Convention, Art. 7(1).
106 Ibid., Art. 7(1).
107 Ibid., Art. 7(2).
double taxation. If necessary, competent authorities shall consult each other before determining such adjustments.\(^{108}\)

### 3.2.2 Interpretation of Art. 7 According to the Commentaries

The principle of Art. 7, that an enterprise is not regarded as participating in the economic life of a state until it has a PE situated therein, and therefore that other state shall then have the right to tax its profits, reflects international consensus.\(^{109}\) The right to tax is limited to profits attributable to the PE situated in the state; profits may derive from a State and be attributable to an enterprise but not its PE in that State: such income may not be taxed by that State.\(^{110}\)

In determining what profits shall be attributable to a PE, the basic approach is the separate entity approach. When applying this principle, a PE may be attributed profits although the enterprise as a whole has never made profits, and vice versa.\(^{111}\) All activities of a PE are included in this calculation, i.e. both transactions with independent enterprises, transactions with associated enterprises and dealings with other parts of the enterprise. The Commentaries describe a two-step analysis, starting with a functional and factual analysis, and further as a second step transactions with associated enterprises are priced in accordance with the guidance of the Guidelines.\(^{112}\)

Para. 26 of the Commentaries to Art. 7 mention that:

“[S]ome states consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries (...) these States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognized for the purposes of Articles 6 and 11”.

\(^{108}\) OECD Model Tax Convention, Art. 7(2) and 7(3).

\(^{109}\) The Commentaries, Art. 7, para. 11.

\(^{110}\) Ibid., Art. 7, para. 12.

\(^{111}\) Ibid., Art. 7, para. 17.

\(^{112}\) Ibid., Art. 7, paras. 20-22.
Alternatively, no internal dealings will be recognized “in circumstances where an equivalent transaction between two separate entities would give rise to income covered by Article 6 or 11”\textsuperscript{113}. Art. 7(2) expressively requires arm’s length pricing when one part of the enterprise performs functions that benefits the PE.\textsuperscript{114} Art. 7(4) states that: “Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article”.

The term profit in this paragraph shall be given a broad meaning, “including all income derived in carrying on an enterprise”\textsuperscript{115}. Specific categories of income that are dealt with under other articles of the OECD Model Convention should i.e. be given precedence.\textsuperscript{116} In situations where the provisions of Art. 7 lead to double taxation, such should be avoided in accordance with Art. 23.\textsuperscript{117}

3.3 The PE Report

3.3.1 General

The notion of permanent establishment is an old concept of the OECD and the OECD Model Convention.\textsuperscript{118} However, there is a lack of common interpretation of the concept of attributing profits to a PE among the member countries. In 2008, the report Attribution of Profits to Permanent Establishments (the 2008 Report) was released as a result of further work from the OECD in trying to formulate a preferred approach of attributing profits to a PE. At the same time, a few amendments were made in the Commentary to Art. 7 to incorporate the conclusions of the report. A new version of Art. 7 was incorporated in the 2010 OECD Model Convention.\textsuperscript{119} The result of the 2008 Report was the AOA. One important part of the work was to examine how far the legally distinct

\textsuperscript{113} The Commentaries, Art. 7, para. 29.

\textsuperscript{114} Ibid., Art. 7, para. 40.

\textsuperscript{115} Ibid., Art. 7, para. 71.

\textsuperscript{116} Ibid., Art. 7, paras. 72 and 74.

\textsuperscript{117} The Commentaries, Art. 7, para. 18.

\textsuperscript{118} PE Report, Preface, paras. 1-2.

\textsuperscript{119} Ibid., Preface, paras. 3-6.
A new version, the “2010 Report on the Attribution of Profits to Permanent Establishments” (The PE Report) was published on July 22nd 2010, the main focus of which is to, in line with the conclusions of the 2008 Report, avoid difficulties in interpreting the new Art. 7 and the 2008 Report. The PE definition, in accordance with Art. 5, is not addressed in the reports.

3.3.2 The Functionally Separate Entity Approach

A PE should be attributed profits at arm’s length, as if it was a functionally separate entity. There should be no force of attraction principle, i.e. profits deriving from the state in which the PE is situated may still derive from the head office, or other entities of the enterprise, and shall be taxed accordingly. The profits the PE would have earned at arm’s length if it were a separate and independent enterprise shall be determined by applying the Guidelines by analogy.

The AOA is conducted through two steps; first by a functional and factual analysis to hypothesize the fiction of the PE as an associated enterprise, and second the remuneration of dealings between the entities is determined by applying Art. 9 by analogy. Under the first step, economically significant activities and responsibilities at the PE level must be identified. The functional and factual analysis derives from the terminology of the arm’s length principle as conducted by analogy to Art 9. However, considering that the PE is part of the enterprise and not legally a separate enterprise, the functional analysis under Art. 9 needs to be supplemented. One important factor is the notion of “significant people functions”, i.e. the management of risks performed by people in the PE. These risks shall be attributed to it, and so shall the economic ownership of assets when the significant functions of such assets are performed by people in the PE.

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120 PE Report, part I, para. 3.
121 Ibid., Preface, paras. 7-8.
122 See e.g. the 2008 Report, part I, para. 5.
123 PE Report, part I, para. 8.
124 Ibid., part I, para. 10.
125 Ibid., part I, para. 15.
steps are conducted, a calculation of profits (or losses) attributable to the PE shall be achievable.  

The PE Report stresses that the analogous application of the Guidelines and Art. 9 is a mere fiction and that a PE shall not, in other areas, be treated as an associate enterprise. There are crucial differences which complicate the analogy, such as e.g. the absence of legally binding contracts or arrangements between a PE and its head office.

### 3.3.3 Attribution of Risks

Through the functional and factual analysis, risks will initially be attributed after an investigation of the significant people functions of the PE. These functions typically involve management and active decision-making. Under the first step, so-called free capital will be attributed to the PE. The free capital shall be sufficient for the PE’s ability to perform the functions it undertakes, assets owned and risks assumed. A PE cannot by legally binding contracts assume the risks it is attributed. Therefore, it is important that the capital follows the risk; the capital is attributed to the PE by reference to the risks ascribed to it.

### 3.3.4 Recognition of Dealings

A PE is not a subsidiary and, thus, all parts of the enterprise have the same creditworthiness. There is no scope for the rest of the enterprise to guarantee the creditworthiness of the PE. In the absence of legally binding contracts, documentation becomes more important (and perhaps necessary) to recognize dealings between the PE and the rest of the enterprise. Such documentation would be given effect by the tax administrations to the extent that: the documentation has economic substance according to the functional and factual analysis; the arrangements relating to the dealing are made at arm’s

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126 PE Report, part I, para. 10.
127 Ibid., part I, paras. 12-14.
128 Ibid., part I, para. 21.
129 Ibid., part I, paras. 22-25.
130 Ibid., Part I, paras. 28-29.
131 Ibid., part I, paras. 33-34.
length; and the dealing does not violate the principles of the AOA, by e.g. segregating risks from functions.\textsuperscript{132}

The AOA applies the arm's length principle to attribute profits under Art. 7(2) by reference to Art. 9 and the Guidelines.\textsuperscript{133} The PE Report recognizes that there are factual differences between a subsidiary and a PE, and the AOA does not aim to achieve equality of outcome in terms of profits. However the principles regarding dealings within the enterprise shall apply as it does for transactions between associated enterprises.\textsuperscript{134}

Para. 1.48 of the Guidelines, which shall be applied by analogy, states that true allocation of risk needs to have economic substance and that the conduct of the parties shall be taken as evidence in determining the true allocation of risk. It refers to the contractual terms between the parties, however in a PE situation dealings or terms of the dealing shall present such terms.\textsuperscript{135}

3.3.5 **Dependent Agent PEs**

Dependent agent PEs are discussed under separate headlines in the PE Report (as they were under the 2008 version).\textsuperscript{136} The same principles of attributing profits to a dependent agent PE, defined under Art. 5(5), applies as to other types of PEs.\textsuperscript{137} The PE Report acknowledges that there is no presumption that a dependent agent PE will have profits attributed to it; in some circumstances, the amount to be attributed to the dependent agent PE will be a negligible profit, nil or a loss.\textsuperscript{138}

An example is provided, where the dependent agent is an associated enterprise, however the same principles apply also where it is not an associated enterprise. When a dependent agent is also a PE, the country where it is situated will have two different legal entities to tax, presuming that the dependent agent PE is a PE of a non-resident enterprise. The dependent agent enterprise, in turn, will be an associated enterprise to the non-

\textsuperscript{132} PE Report, part I, para. 36.

\textsuperscript{133} Ibid., part I, para. 53.

\textsuperscript{134} Ibid., part I, para. 55.

\textsuperscript{135} Ibid., part I, paras. 179-180.

\textsuperscript{136} Sec B-6 Dependent agent PEs, and Sec. D-5 Dependent agent PEs, PE Report 2010.

\textsuperscript{137} PE Report, part I, para. 47.

\textsuperscript{138} Ibid., part I, para. 228.
resident enterprise. Art. 9 is applicable to this situation for the associated enterprises. The dependent agent PE will be attributed profits according to Art 7.\textsuperscript{139}

The assets and risks related to the functions that the dependent agent enterprise performs on behalf of the non-resident will be attributed to the dependent agent PE. The dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise. Again, the significant people functions will be an important factor in attributing assets and risks to the (dependent agent) PE. Skills and expertise, such as negotiating or risk management functions performed by the personnel on behalf of the non-resident enterprise will be analyzed.\textsuperscript{140}

In case the dependent agent PE receives an arm’s length remuneration for the agency services it performs, that could lead to no profits being allocated to it. This is called the “single taxpayer approach”.\textsuperscript{141} The basic principle of the single taxpayer approach (sometimes referred to as the zero-sum game) is that as long as an agency fee paid from the foreign parent company to the subsidiary is at arm’s length, there should be no excess profit to allocate to the agent PE.\textsuperscript{142}

It is stated in the PE Report, part I para. 236 that:

“[T]he “single taxpayer” approach simply does not consider that if the risks (and reward) legally belong to the non-resident enterprise it is nonetheless possible to attribute those risks (and reward) to a PE of the non-resident enterprise created by the activity of its dependent agent in the host country”

The PE Report discusses the single taxpayer approach but concludes that certain risks may belong to the non-resident enterprise, and not to the dependent agent. These risks should under the AOA be attributed to the dependent agent PE if it performs the significant people functions relevant to the assumption and/or subsequent management of those risks. The PE Report further establishes the single taxpayer approach as having fundamental flaws by not resulting in a fair division of taxing rights, as assets and risks

\textsuperscript{139}PE Report, part I, paras. 229-231.

\textsuperscript{140}Ibid., part I, para. 232.

\textsuperscript{141}Rosalem F. B, The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention p. 15.

\textsuperscript{142}Ibid., p. 26-27.
related to the activity in the source jurisdiction are ignored just because they legally belong to the non-resident enterprise. Also, the single taxpayer approach would lead to an application of different approaches depending on what type of PE was concerned; this would be inconsistent with the arm’s length principle and Art 7. Inventory risk should be attributed to the dependent agent PE of the non-resident enterprise, if the significant people functions relevant to the assumption and/or subsequent management of the risk are undertaken by the dependent agent enterprise, on behalf of the non-resident enterprise. I.e., it is important to identify the agency functions and separate these from the PE function.

When a dependent agent PE exists, the host country will have two taxpayers liable to tax in that jurisdiction: the resident agent enterprise and the foreign enterprise, through its local agent PE. The resident agent enterprises’ services will be governed by Art. 9 while profits to the PE will be attributed by following Art. 7. After a functional analysis is conducted whereby it is determined what activities are carried by the personnel of the dependent agent enterprise, on behalf of the foreign company, risks, assets and free capital shall be apportioned to it respectively.


144 Ibid., part I, para. 242.


4 Applying the Risk Allocation Approaches of Art. 9 and Art. 7

4.1 Initial Comments
The information from chapter 2 and 3 are in this chapter applied to further investigate how the findings above should be applied in business restructuring situations. There will also be a section for the interaction between Art. 9 and Art. 7 when both articles are applicable. Case scenarios are presented to investigate whether the different approaches lead to the same results. Finally, a subchapter is devoted to the investigation of whether Art. 9 should prevail Art. 7 according to the principle of \textit{lex specialis derogate lex generali} and if so, what consequences that would have.

4.2 Key Concepts of Art. 9 and Art. 7

4.2.1 General
The OECD has through the Discussion Draft accepted risk evaluations as more important, and more demanding, if compared with the 1995 version of the Guidelines. Three relevant issues must be addressed during a business restructuring from the Art. 9 perspective. Firstly, the contractual terms must be evaluated. These terms will be respected to the extent that they have economic substance. If no documentation or contracts are available, evidence for risk allocation will be searched for by analyzing the conduct of the parties. The second question to be asked is whether the contractual terms are at arm’s length. The Discussion Draft emphasizes the importance of control over the risk in this case. Thirdly it should be evaluated who the risk holder is. The risk holder, if outsourcing the day-to-day operations, must still be the one who bears the investment or other monetary risk.\textsuperscript{147}

The risks that a PE undertakes must be identified in order to attribute the proper return, or loss, should the risk materialize. From the PE Report, two key concepts can be extracted, namely \textit{significant people functions} and \textit{active decision making}.\textsuperscript{148}


\textsuperscript{148} Rosalem F. B, \textit{The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention} p. 15.
4.2.2 The Conduct of the Parties-Test

The term *conduct of the parties*, as expressed in the Guidelines was not previously clarified as whether it related to the allocation of the cost or also the underlying performance of the functions to prevent, mitigate or manage these risks. Erasmus-Koen believes that, considering the way Issues Notes 1 is structured, the conduct of the parties-test relates to “*the actual accounting of the manifested risks*”\(^{149}\). In the draft examples, questions such as where are the write-downs taken, which entity bears bad-debt related costs etc. are relevant. In the contractual terms analysis, the functional element of economic substance is specifically dealt with when determining control over risk. This leads to a need for parties involved in international business restructurings to have internal procedures to ensure that contractual terms and conditions are actually met and recorded.\(^{150}\)

4.2.3 Notion of Control

The OECD seems to, according to Erasmus-Koen, attempt to align the significant people functions of the PE Report with the term economically significant activity of the Guidelines.\(^{151}\) By comparing the contract research and development example in the Discussion Draft to the one used in the 2008 PE Report,\(^ {152}\) and the competency threshold for the investor of the hedge fund example in the Discussion Draft,\(^ {153}\) one could assume that control means that “*the principal should have a technical qualitative (relating to the necessary know-how to manage and monitor the relevant activities) and managerial functional role*”\(^ {154}\). This, on the other hand, might not reflect reality since even third-party investors to a large extent might not meet this threshold, especially considering the current turmoil in the global markets.\(^ {155}\)

As stated above,\(^ {156}\) the examination of risk allocation from the Art. 9 perspective starts with existing contracts. Erasmus-Koen believes that the examination of the contractual

\(^{149}\) Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 101.

\(^{150}\) Ibid., p. 102.

\(^{151}\) Ibid., p. 102, see also Paras 1.20 and 1.21 OECD Guidelines (1995).

\(^{152}\) Discussion Draft, para. 33; the 2008 Report, para. 119.

\(^{153}\) Discussion Draft, para. 32.

\(^{154}\) Bakker A. *Transfer Pricing and Business Restructurings: Streamlining all the way*, p. 103-104.

\(^{155}\) Ibid., p. 104.

\(^{156}\) See ch. 4.2.1.
terms as a starting point for the analysis of Issues Notes 1 is good, since contractual terms generally define how responsibilities and risks are to be divided between parties. However, following that, the factual control over risk exercised by employees is one factor that may prove the true allocation. In this way the Discussion Draft imposes a new hypothetical test, which may be an attempt by the OECD to govern the allocation of risk between associated enterprises on basis of the AOA, developed for attributing profits to permanent establishments according to Art. 7. It could be argued that this is the best way to avoid tax planning, since it decreases the possibilities for associated enterprises to contractually separate risks and assets from the functions. On the other hand, it is under domestic law that the existence, form and content of commercial or financial relations should be determined, prior to the application of Art. 9(1) and the arm’s length principle. Therefore, one may consider this analysis to be out of the scope of Art. 9 (1). Wittendorff argues that it should be irrelevant which party in the group actually controls the risk, as long as an arm’s length price has been paid for the contractual assumption of that risk, as recognized by domestic law.

The notion of control according to the Discussion Draft differs from managing a risk on a daily basis. One of the requirements of the Discussion Draft is that the possibility to assess the outcome of the risk assessment is one of the control requirements. One may here see a distinction from the Art. 7 approach where the daily management of a risk has priority in the control analysis. In Rosalems opinion, the party who has the authority to make higher-level strategy decisions with regard to a risk should also be attributed it; the strategic decisions of disposing capital for the assumption of the risk should be decisive. The same party must also have financial capacity to bear the risk should it materialize. In an effort to encompass the OECD factors of control and financial capacity, Rosalem supports the term *effective economic control* when allocating risks. This was the suggestion by BIAC to the OECD. The term does not essentially include a day-to-day administration of the risk, but merely the financial capacity to bear any potential consequences if the risk realizes because of a poorly effected management function. One could argue that this would lead to a centralization of all risks to parent companies.

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159 See ch. 2.5.3.
of MNEs, since they impose legal control over their subsidiaries, regarding transactions between a parent and its subsidiary. This is not however a mandatory rule, according to Rosalem; if contractual terms shift the risk to the subsidiary, it may only be challenged to the extent that it differs from the conduct of the parties, or does not represent an arm’s length result. Also in the relation between sister companies, the possibility for the parent company to impose influence over the subsidiaries will not be a factor during risk allocation, as long as the contractual terms have economic substance.\textsuperscript{160}

4.2.4 \textbf{Financial Capacity to Bear the Risk}

In Para. 37 of the Discussion Draft, it is stated that “another factor that may influence an independent party’s willingness to take on a risk is its anticipated financial factor to bear that risk”. However, what financial capacity to bear the risk actually means is not described further, nor how it should affect transaction valuations. It is therefore uncertain what the OECD wants to achieve with this statement.\textsuperscript{161}

4.2.5 \textbf{Economic Substance}

In the analysis of contracts between related parties it is determined that these agreements must have economic substance. Economic substance is to be deduced e.g. through the behavior of the parties. The purpose and meaning of the term is, however, not described any closer. Economic substance differs from legal substance, which would refer to rights and obligations of a taxpayer. Instead, this would concern the economic effects of an arrangement as structured by the taxpayer.\textsuperscript{162}

Liaugminaitė understands OECD’s position as indicating that the economic substance principle is applied by an analysis of the arrangements, had they been between two non-related parties, influenced by ordinary market forces. However, this would only be relevant at a second stage of a comparability analysis, i.e. during the re-characterizing of such transaction. A problem with the economic substance-over-form principle is that different countries have different ideas on how it should be implemented. Most civil-law countries do not apply it but instead apply general substance-over-form rules or

\textsuperscript{160} Rosalem F. B, \textit{The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention} p. 19-20.

\textsuperscript{161} Bakker A, \textit{Transfer Pricing and Business Restructurings: Streamlining all the way}, p. 105.

\textsuperscript{162} Liaugminaitė G, \textit{Recognition of the Actual Transactions Undertaken}, p. 122-123.
general anti-avoidance provisions. In common law countries, e.g. the US, the economic substance doctrine is applied to a larger extent, nevertheless, US courts still do not have a common doctrine of the economic substance test. Risks of double taxation arise if countries apply domestic tests when determining whether a transaction lacks economic substance. Liaugminaite states that OECD needs to clarify the two elements in the principle of economic substance, namely disregarding the transaction and re-characterizing it in line with its economic substance. This is necessary for a uniform interpretation among member countries, and thereby the avoidance of double taxation issues.\(^{163}\)

The contractual terms are tested against the *conduct* of the parties and who *controls* the risk. When these factors are both in line with the contract, the contract has economic substance. Hence, the parties are free to dispose risks between them as long as their behavior is according to the contract and represents an arm’s length allocation. The risk may thereby, according to Rosalem, not necessarily be at the place where the function is performed. In case tax authorities want to disrespect the terms set by the parties, they should have to prove the lack of economic substance; the burden of proof should never be the other way around, nor should there be any room for subjectivity.\(^{164}\)

The control test, conducted first by an economic substance analysis and further under the general anti-avoidance rules seems to be exactly how the AOA is advocated in the PE Report, according to Erasmus-Koen. What is really unclear is the role of the financial capacity to bear the risk. Risks that are outside the control of the parties are mentioned in the Discussion Draft; however there is little or no guidance in how to allocate such risks. Erasmus-Koen further states that “it is remarkable that the majority of examples, especially those explaining paras. 126-1.29 and 1.36-1.41 of the OECD Guidelines, relate to the insignificant risks related to working capital”\(^{165}\).\(^{166}\)


\(^{164}\) Rosalem F. B, The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention p. 17.

\(^{165}\) Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 117.

\(^{166}\) Ibid., p. 116-117.
4.2.6 Significant People Functions and Active Decision Making

The significant people functions concept could cause problems in the corporate world, as managers may work from different jurisdictions. The possibility for tax administrations to interpret the terms with increasing subjectivity presents a rising concern among taxpayers and tax practitioners.\(^{167}\)

A decision making process could, generally, be described as a four step process; firstly initiative is taken, this is where brainstorming and different alternatives are formulated. The second step consists of ratification; the best alternative is chosen. A third step implements of the strategy or decision taken in step 2. At a fourth final step, monitoring and monitoring implementations are conducted.\(^{168}\)

Erasmus-Koen believes that there are two fundamental errors with the equation of economic substance with economically significant activities: it may undervalue financial risk taking and it disregards the legal principle that the residual value of intellectual property shall belong to the legal owner, who ultimately controls it.\(^{169}\) Support for that view can be found in the PE Report, according to Rosalem, where it is stated that:

"[E]conomic ownership may often be determined by functions performed below the strategic level of senior management. This is the level at which the active management of a programme toward the development of an intangible would occur, where the ability to actively manage the risks inherent to such a programme lies"\(^{170}\)

The PE Report further states that:

"It is sometimes also argued that the senior management of the bank should be regarded as "owners" of the enterprises capital in a manner similar to investors in a hedge fund. This is because, by deciding which types of business to pursue and setting the limits for particular business lines, etc., it is argued that they are also deciding where and how the enterprises capital is put at risk. However, where responsibility for implementing the bank’s strategy is devolved to the PE in

\(^{167}\) Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 104.


\(^{169}\) Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 104-105.

\(^{170}\) PE Report, part I, para. 87.
*a way that means the traders actively take the decisions on an ongoing basis, albeit within the set limits, then it is the traders who are performing the key entrepreneurial risk-taking functions and so are putting the capital at risk, not the senior management*171

Although the senior management decides where and how the capital is put at risk, the PE shall be attributed the risk if the traders of which actively perform the day-to-day decisions. Rosalem does not agree to the statement that it is the PE’s people who put the capital at risk; the senior management still took the decision to put capital at risk while the traders implemented it. A correct interpretation is important since putting capital at risk is furthermore the meaning of control as established by the Discussion Draft.172 Rosalem states that active decision making should only regard an authority to impact the day-to-day management of a risk.173

### 4.3 The Approaches of Art. 9 and Art. 7 Compared

#### 4.3.1 General

From the subchapter above,174 one could get the idea that risk allocation from an Art. 7 perspective ought to be the same as in Art. 9, since the Guidelines should be followed by analogy. There are however differences which make this impossible. Associated enterprises have legal contracts and terms to follow. In a PE situation there will be no such contracts. Instead the analysis will be based on internal documents. A fictional balance sheet will be made for the PE and this will be the starting point instead of contractual terms. The contractual terms will in an Art. 9 situation be respected as long as they represent the actual conduct of the parties and have economic substance. A subsidiary may be allocated any amount of capital as the shareholders wish, while a PE may only be attributed free capital to the amount necessary to perform its functions, risks assumed and assets economically owned. Hence, the first step in the process will be quite different from the different perspectives of the articles. The second step of the process will set prices on the dealings according to the arm’s length principle (by applying the Guide-

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171 PE Report, part III, para. 80.


173 Ibid., p. 16-17.

174 See ch. 4.2.
lines). The one party who has greater control over the risk shall generally be allocated a greater share of it.  

A question may arise as to whether the two approaches lead to the same final result. The allocation of profits in a PE situation should be envisaged by applying the same philosophy as under Art. 9. This is provided by the PE Report when it states that profits allocated to a PE are “the profits that the PE would have earned at arm’s length (...) if it were a separate and independent enterprise”\(^{176}\) whereas the Guidelines’ wording is:

“[T]he arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members”\(^{177}\)

Thus, both articles express a vision of separate and independent enterprises.\(^{178}\) Although somewhat differing procedures, the conclusion may be that while both being treated as independent enterprises, and thereafter transactions and/or dealings are priced in accordance with the arm’s length principle according to the Guidelines, the same final result for attributing profits should be achieved.\(^{179}\)

### 4.3.2 Case Scenarios: Applying the Approaches of Art. 9 and Art. 7.

The scenarios below are examined from an Art. 7 perspective, as well as an Art. 9 perspective. Within the Art. 9 concept, a legalistic approach as well as an economic view will be considered. The question is therefore if the different approaches arrive at the same result.

As stated above, PEs are according to the PE Report supposed to take on the fiction of separate entities, as the Guidelines should be used by analogy for calculating arm’s


\(^{176}\) PE Report, part I, para. 9.

\(^{177}\) The Guidelines, para. 1.6.


length profits. There may however be crucial differences between the articles which may impact the final result of a risk allocation. There will be no written agreement or binding contract in an Art. 7 situation, also, PEs cannot legally (however economically) own an asset; the asset belongs to the enterprise as a whole. PEs are allocated free capital to the extent necessary to perform functions undertaken, risks assumed and assets used. Subsidiaries on the other hand may be attributed with any amount of capital. The PE Report attributes a risk-follows-function approach, since day-to-day management and active decision making basis are the relevant factors determining risk. The Discussion Draft, on the other hand, emphasizes a control-over-risk approach.\textsuperscript{180}

4.3.3 Case Scenario 6
Company S is a fully fledged distributor liable for inventory risk. A restructuring takes place where the inventory risk is shifted to Company P. The personnel who manage the inventory (and take the strategic decisions and decisions regarding e.g. quantity and deadlines) still work for Company S.

![Diagram showing Company P as a manufacturer in Country P and Company S as a fully fledged distributor in Country S, with an arrow indicating inventory risk being shifted from Company S to Company P.]

To start with, assume that Company S is not a dependent agent of Company P. Thereby Art. 9 will be the only relevant article. By analyzing the contractual terms as a start, it will be determined that the contractual obligation lies at Company P. The next step is to determine whether, by a factual test, the contracts are in accordance with the parties’ conduct. Company P is financially liable for the inventory risk, why the criteria for this test are also assumed to be met. Finally, it should be determined whether the allocation represents a conduct which would be found in uncontrolled transactions. Since Compa-

\textsuperscript{180} Rosalem F. B, \textit{The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention} p. 12-13.
ny P has no actual control over the risk (Company S still manages the inventory), this test is not passed. Thus, inventory risk should be reassigned to Company S.\textsuperscript{181}

In another scenario, assume that Company S is not merely a subsidiary to Company P, but also a dependent agent PE. Company P will thereby be regarded as the head office. A risk-follows-functions approach according to the PE Report will be used in this case. In a first step, the significant people functions shall determine the assumption of risk between the head office and its PE. In the scenario explained, both the day-to-day management and inventory risk is actually at the level of Company S. Hence, inventory risk shall be allocated to Company S.\textsuperscript{182}

Rosalem offers a third perspective to this situation, namely the legalistic approach. In applying a legalistic approach, an analysis is to be conducted based solely on contractual terms. As a reason for this perspective, Rosalem acknowledges that the OECD suggestion of challenging the allocation of risk may, according to part of the business community, not be in accordance with paras. 1.26 and 1.27 of the Guidelines (paras. 1.48-1.49 of the 2010 version of the Guidelines). It has therefore been strongly criticized. In applying the legalistic approach, the principle \textit{pacta sunt servanda} is applicable. According to this principle, terms and conditions in contracts are considered as law between the parties. Neither party may impact the other party’s situation in a way that makes the contract obligations excessively onerous. The contract may only be disregarded by tax authorities if it is a sham, i.e., the parties’ conduct do not reflect what was stated in the contract.\textsuperscript{183}

The legalistic approach would in the first scenario of this case (where no PE exists) accept the risk as originally agreed between the parties, at Company P. The arm’s length test would not apply. A legalistic approach in a PE situation is not relevant since no legal contracts exist.\textsuperscript{184}

\textsuperscript{181} Rosalem F. B, \textit{The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention} p. 24.

\textsuperscript{182} Ibid., p. 24-25.

\textsuperscript{183} Ibid., p. 25.

\textsuperscript{184} Ibid., p. 25.
4.3.4 Case Scenario 7

Company S is a fully fledged distributor liable for inventory risk. A restructuring takes place where the credit risk is shifted to Company P. Parent Company P bears the credit risk and takes the strategic decisions regarding risk for the MNE. The personnel in Company S collect and recover any bad debt incurred in the transactions and are responsible for implementing the strategies set forth by personnel in Company P, in the most suitable way for their jurisdiction (country S).185

Starting with the Art. 9 perspective, a factual test shows that Company P bears the bad-debt losses. Further, control may be allocated to Company P as the entity takes the strategic decisions regarding risk. Hence, the contractual terms are in accordance with the conduct and there will be no reallocation of risk.186

Now assume that Company S is not merely a subsidiary to Company P but also a dependent agent PE. Company P is regarded as the head office. The personnel of Company S are taking the appropriate measures for collecting and recovering any bad debt, and implementing any strategy as set forth by Company P. This should mean that the personnel of Company S are taking the day-to-day decisions; thus, credit risk should be allocated to Company S. The profit will generally be split between the two taxable persons; Company P through its dependent agent and subsidiary Company S will be taxed on the agency fee it receives from Company P.187


186 Ibid., p. 25.

In this case an additional scenario could be considered, namely joint control of the risk. What if the management and control are equally split between Company P and Company S? The Guidelines would give the entity with greater control the risk; however in a 50/50 situation neither party has greater control. Rosalem believes that tax authorities shall not subjectively assess either party with the greater control if they cannot objectively prove it; hence economic substance exists although there is joint control. Therefore, in an Art. 9 perspective, the inventory risk would remain with Company P. Under Art. 7, joint ownership of assets and risks is possible according to the PE Report. Hence, under Art. 7 Company P would be allocated 50% of the inventory risk, and the dependent agent in country S would be allocated the other 50%.

4.3.5 The Applicability of the Single Taxpayer Approach

Baker and Collier believe that the Commentaries on Art. 7 do not give enough attention to the single taxpayer approach and why it should be rejected in favor of the AOA. Rosalem believes that the single taxpayer approach as rejected in the PE Report contain some critical flaws; the single taxpayer approach does not allocate risks to a PE, but that might just be unnecessary if those risks are already taken into consideration in the agency fee to the subsidiary. The agency fee will be paid to the subsidiary, and although the risks are not attributed directly to the PE, the reward for such will still through the arm’s length principle and the agency fee will be taxed in the subsidiary’s jurisdiction. The income will be the same as under the AOA, although through the subsidiary and not the PE.

When there are personnel in the subsidiary jurisdiction, working for the parent company, the arm’s length principle will accordingly allocate profit to the subsidiary for the risks it undertakes. The subsidiary will, acting as an independent third party, charge an appropriate remuneration for this. The tax authorities of the jurisdiction of the parent company cannot tax it, as it does not have taxing powers over the subsidiary. Hence, as

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188 PE Report, part II, para 75.
long as an arm’s length price is set to the agency fee, no double taxation issues will arise. Pijl believes that the single taxpayer approach would make Art. 5(5) superfluous. Indeed, the arm’s length model is the same for Art. 9 and Art. 7, but to reward an agency PE nil profit by definition is not in line with the source state principle and does not meet the principle of effective tax treaty interpretation. If the enterprise wants no profit at the PE, it is free to determine the agent’s functional profile as it sees fit.

The single taxpayer approach could be the appropriate outcome for Case 6, where the subsidiary controlled and managed the inventory risk. This is regardless of whether such overlapping occurred as a result of the risk reallocation made under Art. 9. In case 7 there would be different outcomes depending on which article was applied. The single taxpayer approach cannot be applied when there is no profit allocated to a dependent agent PE. However, it seems unrealistic that a subsidiary which has risks allocated to it, will agree to manage a risk as an agent but being remunerated on a risk-free basis.

4.3.6 Case Scenario 8

Case scenario 8 is an example which is provided to show the differences of the single taxpayer approach and the AOA. Company S is also considered a dependent agent PE of Company P and has no other income. The prices paid to Company X will be used as a benchmark for the transactions between Company P and Company S.

![Diagram of Country P and Country S with Company P, Company S, and Company X labeled as manufacturer, dependent distributor, and independent distributor respectively.]


193 Pijl, H. *The Zero-Sum Game, the Emperor’s Beard and the Authorized OECD Approach*, p. 32-35.

194 Rosalem F. B, *The Agent Permanent Establishment Reconsidered: Application of Arts 5, 7 and 9 of the OECD Model Convention* p. 27.

195 Ibid., p. 28.
Consider that Company X is remunerated 10 000 for the services rendered, which also represents the total net profit of the company. The same amount (10 000) will present market value remuneration to Company S, after a comparison with the independent distributor X. As this is an arm’s length remuneration, no other profits should be allocated to the dependent agent PE. As a result of the single taxpayer approach, Company P needs to file no income tax return in country S.\(^{196}\)

Under the AOA, the same net income of 10 000 would have to be taxed in country S. The profits of the dependent agent PE, though, must be calculated in the two-step process of the AOA. The net income will be recorded in the PEs accounting; i.e. the agency fee and expenses to it. Two taxpayers will thereby have to file a tax return and deal with possible consequences of penalties and interest. Also the tax authorities will have two taxpayers to examine. Hence, a heavier burden applies than in the single taxpayer approach.\(^{197}\)

### 4.4 The Contradiction Between Art. 7 and Art. 9

#### 4.4.1 General

Firstly, one may conclude that the Art. 9 approach is used independently towards the approach of Art. 7. Art. 7 on the other hand cannot be applied without also applying Art. 9. In the parent – subsidiary/dependent agent PE situation, Art. 9 will be applicable to the parent – subsidiary situation, and Art. 7 will be applied to the dependent PE situation. Rosalem asks the question of which article should in this situation be applied first. It is established in Art. 7(7) that “where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article”. Para. 1 of the Commentary on Art. 7 further states that “rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are associated are dealt with in Article 9”.

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\(^{197}\) Ibid., p.28.
Rosalem argues that according to the principle of *lex specialis derogate lex generali* (a special regulation cannot be overridden by the general one), Art. 9 should be considered a “special” article and therefore be applied before Art. 7. The basis for this argumentation is in part Sec. 62 of the Commentaries on Art. 7(7) which states:

“In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives preference to the special Articles on dividends, interest etc. it follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles”

Para. 60 on the Commentary on Art. 7(7) further states that;

“[I]f the profits of an enterprise include categories of income which are treated separately in other Articles of this Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends, etc., of by the provisions of this Article”.

Her argument is that Art. 9 should be included (or at least that there is no reason for not believing that it should be included) in the “etc.” above. Thereby Art. 9 would prevail over Art. 7 as constituting *lex specialis*.\(^{198}\)

### 4.4.2 Possible Consequences of Art. 9 Being Considered as *Lex Specialis* in Relation to Art. 7

If one were to accept that Art. 9 has priority over Art. 7 as *lex specialis*, it would still be necessary to apply Art. 7 in a PE situation. This is because there will still be two taxpayers in the subsidiary’s country and the amount for each of those taxpayers in that country needs to be determined. By applying this hierarchical method, the initial assumption will be that the subsidiary is not a dependent agent PE. Allocation of risk will be determined in accordance with Art. 9, and then as a second step, profits will be attributed to the dependent agent PE under Art. 7, if Art. 9 allows for it. When the subsidiary’s profits are calculated in a first step under Art. 9, there will be no recalculation of

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these profits just because the subsidiary is also a PE. It could also seem logical that the subsidiary should not earn less just because it is also a dependent agent PE. \(^{199}\)

A problem with the application of Art. 9 may be when countries use different approaches, that is one country use the legalistic approach and another country uses the economical approach; issues of double taxation may arise. With a legalistic approach, contractual terms cannot be disregarded; only a pricing adjustment can solve a case of double taxation. By applying the economic approach, on the other hand, an adjustment may be made if the contractual terms do not present economic substance. \(^{200}\)

As an example (“case scenario 9”), assume that country P, with parent Company P, uses the credit method and applies a legalistic approach. Country S, with subsidiary Company S, applies an economic approach. In a double taxation situation, illustrated below, country P assumes risk is at Company P according to the contract, and tax accordingly. Country S, on the other hand, would reallocate the inventory risk to Company S, which actually controls it. \(^{201}\)

\[
\begin{array}{c}
\text{Country P} \\
\begin{array}{c}
\text{Company P} \\
\end{array} \\
\rightarrow \text{Risk is at Company P, according to the contract}
\end{array}
\]

\[
\begin{array}{c}
\text{Country S} \\
\begin{array}{c}
\text{Company S} \\
\end{array} \\
\rightarrow \text{Risk is at Company S who controls it}
\end{array}
\]

When Company P claims tax credits, it is unlikely that this will be granted; in country S the taxes are paid in the name of Company S and country P will probably not grant tax credits based on taxes paid by a different taxpayer. \(^{202}\)


\(^{200}\) Ibid., p. 30.

\(^{201}\) Ibid., p. 29-30.

\(^{202}\) Ibid., p. 29-30.
If country S were to apply the hierarchical approach of the single taxpayer approach, as economic countries usually do, the problem would still prevail. Even if a dependent agent PE is recognized, no profits would be attributed to it. This problem shall according to the Commentaries be solved by MAP.203 A MAP requires consensus between the nations though, and there is no guarantee for that. Rosalem believes that the definitions used in the risk approach of the PE Report and the Discussion Draft need to be harmonized, a hierarchy where Art. 9 has precedence over Art. 7 should be established and that the single taxpayer approach should be the authorized approach or at least accepted. The intention of the OECD seems to be that the different approaches of Art. 7 and Art. 9 should lead to the same outcome, but they do no. The term active decision making of the PE Report vs. control of the Discussion Draft can lead to different solutions. If the hierarchy between Art. 7 and Art. 9 was established, the single taxpayer approach would make an appropriate consequence, whereby double taxation would be less likely to occur. Further, if no PE needs to be registered, the burden of taxpayers as well as tax administrations would decrease. Mathematically, the jurisdictions would still be able to tax the same income, although to some extent at the subsidiary level instead of the PE level.204

Followers of the legalistic approach may argue that it should not be possible for tax administrations to adjust conditions of transactions because the conduct of the parties differ or that risk allocation is not at arm’s length. This brings uncertainty as contracts will not be respected. This is not, however, according to Rosalem, a disadvantage to her suggested solution but merely a problem that any OECD country will face. Another problem might be that the subjectivity which the tax administrations are now allowed may, contrary to the legalistic approach, increase the numbers of disputes between countries as they have different views on a situation. Rosalem does not agree to this as a proper argument though, as she means that whenever countries disagree with prices used in a transaction or “to make it even more general, whenever countries disagree at all, there will be room for double taxation”205.

203 Commentary on the OECD Model Tax Convention on Income and Capital, Art. 23, para. 32.5.


205 Ibid., p. 32-33.
A practical solution would be to change the wording of the PE Report and the Discussion Draft to harmonize it. Clear guidance and clear provisions are essential elements to avoid double taxation. By adopting a hierarchy between the articles in consensus between countries, several transfer pricing and tax treaty issues could be simplified. Hence, a more economic transfer pricing approach where Art. 9 has precedence over Art. 7 and the single taxpayer approach is a possible result is what Rosalem would prefer.207


207 Ibid., p. 33.
5 German Transfer Pricing and Business Restructuring Regulations

5.1 Initial Comments

In this chapter the German transfer pricing regulations will be generally described, and the regulations on business restructurings in particular. The chapter will present some general German provisions on transfer pricing, as the reader is not assumed to have any particular understanding of German transfer pricing law. The arm’s length principle is foundational in this area; therefore a subchapter will be devoted to describe how the German legislator applies it. Further, risk allocation in a German perspective will be presented. This chapter aims to give the reader an understanding on the German approach of risk allocation for associated enterprises.

5.2 German Transfer Pricing Law

5.2.1 General

Being one of the largest export countries in the world has made transfer pricing the most important issue for German tax authorities in the recent decade. Domestic transfer pricing documentation requirements with penalty provisions were implemented in 2003 (replacing the 1983 documentation regulations) and in 2005 the Administration Principles-Procedures, binding to the tax authorities, were released, which maintain principles on the audit of the profit allocation between related persons with cross-border transactions. Administrative principles and circulars published by the German tax authorities are not binding to the public; however they provide information on how the law should be interpreted and what the approach of the tax authorities will be.

Specific tax provisions governing the transfer pricing treatment of business restructurings came into effect in 2008. These provisions were a result of a concern in Germany that great deals of tax revenues were lost due to questionable tax planning. Germany was the first country to introduce specific tax regulations on transfer pricing issues re-

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210 Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way p. 273.
Regarding business restructurings.\textsuperscript{211} By doing this, there has been concerns that German law is incompatible with international law and, possibly, in particular with Art. 9 of the OECD Model Convention.\textsuperscript{212}

5.2.2 Transfer Pricing Provisions

According to the German Corporate Tax Act (\textit{Körperschaftsteuergesetz}), all legal entities operating in a registered office or place of management and control are subject to unlimited corporate tax liability.\textsuperscript{213} The Foreign Tax Code (\textit{Außensteuergesetz}) includes general rules regarding the application of the arm’s length principle and transfer pricing methods.\textsuperscript{214}

Section 1 of the Foreign Tax Code is limited to cross-border business relations. Where there is a conflict between this rule and other domestic rules, the latter shall be given precedence.\textsuperscript{215} A draft circular has been published for public comment on the Federal Ministry’s website in July 2009 to further establish how the provisions should be applied.\textsuperscript{216}

5.2.3 Arm’s Length Principle and the Hypothetical Arm’s Length Test

In determining an appropriate transfer price for a transaction, taxpayers are according to the 2008 Business Tax Reform obliged to apply the arm’s length principle. If no comparable data is available the hypothetical arm’s length price concept will be applied.\textsuperscript{217} The hypothetical arm’s length test is done by establishing a functional analysis and internal business projections and thereby determining a minimum price of a hypothetical seller and the maximum price of a hypothetical purchaser.\textsuperscript{218} Location savings and any synergies ought to be considered in this calculation, why the hypothetical arm’s length

\begin{itemize}
\item \textsuperscript{211} Bakker A. \textit{Transfer Pricing and Business Restructurings: Streamlining all the way} p. 277
\item \textsuperscript{212} Ibid., p 277-278.
\item \textsuperscript{213} Ibid., p 273.
\item \textsuperscript{214} Ibid., p. 274-275.
\item \textsuperscript{215} Wittendorff J. \textit{Transfer Pricing and the Arm’s Length Principle in International Tax Law}, p. 303-304.
\item \textsuperscript{216} Förster, H. \textit{Germany’s Transfer Pricing Provisions: A Conflict with International Principles?} p. 3.
\item \textsuperscript{217} Wehnert O. Wolff C. \textit{German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt}, p. 24-26.
\item \textsuperscript{218} Ibid., p. 26.
\end{itemize}
price is a kind of profit split among the parties.\textsuperscript{219} Tax auditors generally allocate location savings to the principal, i.e. usually the German parent, as German MNEs have had a tendency to set up contract manufacturing in countries with low labor costs.\textsuperscript{220} The hypothetical arm’s length test might lead to taxation in Germany that exceeds what the taxpayer would have been able to generate on its own, since the maximum bid of the recipient is taken into account and i.e. synergies of the recipient, location savings, tax benefits etc.\textsuperscript{221} The German legislator wants to tax the value of hidden reserves of the transferred function; both the current and the future value are included, and synergy effects.\textsuperscript{222}

5.2.4 Business Restructurings and Risk Allocation

The German regulations concerning business restructurings are applicable when a standard transfer pricing method cannot be applied appropriately. The transfer of functions should then be valued as a package, unless the taxpayer can demonstrate the contrary.\textsuperscript{223} A function is defined as “a business activity consisting of an aggregate of similar operational tasks performed by certain offices or departments of an enterprise”\textsuperscript{224}. There is also a requirement of a certain degree of economic independence; however the determination of such is rather subjective.\textsuperscript{225} The arm’s length principle shall in general be applied to transfer pricing adjustments.\textsuperscript{226}

A reallocation is assumed when assets or other benefits with related opportunities and risks are transferred by a company to another related party, or the other related party is allowed to use such assets or benefits and thereby being able to perform a function that

\textsuperscript{219} Wehnert O. Wolff C. German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt, p. 26-27.

\textsuperscript{220} Kroppen H. and Eigelshoven A. Germany – Transfer Pricing, sec. 5.2.

\textsuperscript{221} Kroppen, H-K. et al. Germany- Transfer Pricing and Business Restructurings, sec. 3.5.

\textsuperscript{222} Cauwenbergh, P and Lucas Mas, M. German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis p. 518.

\textsuperscript{223} Beck, K. Business Restructuring in Germany, p. 273.


\textsuperscript{225} Ibid., p. 9.

\textsuperscript{226} Wittendorff J. Transfer Pricing and the Arm’s Length Principle in International Tax Law, p. 304.
was previously performed by the transferring enterprise.\textsuperscript{227} A transfer of functions could include outsourcing functions, if the transfer means that the function as a whole (with associated profit and risks, as well as decision making power) is closed down completely at the transferor, and set up at a new place of business in another jurisdiction. It also includes the reduction of functions, where a full-fledged manufacturer is converted into a contract or toll manufacturer.\textsuperscript{228}

According to Sec. 1 Para 2. of the Foreign Transactions Tax Law (FVerlV) a transfer of functions needs to include assets. When a fully fledged distributor is converted to a limited-risk distributor, there is generally no transfer of tangible or intangible assets. Therefore it can be argued that the criteria of Sec. 1, Para. 2 of the Foreign Transactions Tax Law are not fulfilled.\textsuperscript{229} It is primarily the risk profile that changes and not the physical activities. If the foreign company receives no support from the principal, e.g. by staff transfers, it could be argued that there has not even been a transfer of function from Germany to the foreign company, hence no reduction in relevant business activities at the German principal.\textsuperscript{230} The new principal has to be able to manage and control the risk transferred, and have the financial capacity to bear the risk should it materialize or the arm’s length profit level may be impacted.\textsuperscript{231}

Sec. 42 of the General Tax Code (Abgabenordnung) stipulates that legal structures must not be abusive and must not be used to circumvent tax law.\textsuperscript{232} A structure which is made for pure tax saving purposes will be ignored for tax purposes. The transaction will instead be taxed as if an appropriate legal structure had been implemented.\textsuperscript{233} Other reasons than tax saving purposes may be of economic or personal nature, however, it is enough that the main purpose of the structure is to save tax. The burden of proof in this


\textsuperscript{228} Cauwenbergh, P and Lucas Mas, M. German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis p. 517.

\textsuperscript{229} Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 283.

\textsuperscript{230} Ibid., see also Kroppen, H-K. et al. Germany-Transfer Pricing and Business Restructurings, sec. 2.2.4.

\textsuperscript{231} Kroppen, H-K. et al. Germany-Transfer Pricing and Business Restructurings, sec. 2.4.

\textsuperscript{232} Bakker A. Transfer Pricing and Business Restructurings: Streamlining all the way, p. 289.

\textsuperscript{233} Lieber B. and Roeder A. Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Germany p. 1.
scenario seems according to Lieber and Roeder lie on the taxpayer.\textsuperscript{234} If an uncommon legal structure is used, this will constitute abuse, unless the taxpayer can provide justifications for it, which are not tax related.\textsuperscript{235}

Contracts are usually the main source in allocating risks and assets. A transaction is recognized according to the German substance-over-form rules.\textsuperscript{236} This has an effect on risk allocation as a party who bears a risk should also control that risk. Legal agreements may therefore be limited by this provision.\textsuperscript{237} The substance of a transaction will be judged by determining how functions, risks and assets of a transaction are allocated between the parties. The function and asset allocation will typically, limit the potential scope of risk allocation, as the arm’s length principle is applied. There is some indication that Germany tries to expand its possibilities to re-characterize a transaction. Sec. 1 para. 1 sent. 1 of the Foreign Tax Code seems to open up for the arm’s length principle to be applied not only to the transfer price of a transaction, but also to the other terms and conditions agreed by related parties. This is contrary to the OECD guidance.\textsuperscript{238}

Cauwenbergh and Lucas Mas mean that the German transfer pricing provisions might not reflect economic reality. Under the fairly new legislation, a large part of restructurings may be considered to be tax motivated and to potentially impact the national tax base. It is obvious that the concern over losing tax income to other jurisdictions has made Germany produce tight rules, however perhaps too restrictive.\textsuperscript{239} It is part of reality that taxes do present a large cost for MNEs, why they will often, if not always, play a role in determining how to conduct a restructuring. The German legislation seems to attack any type of business restructuring, not just the ones which are purely tax driven. This is not in line with the OECD approach. Another remark is that tax authorities should not at all intervene in the MNEs reasons for a restructuring; this is part of their

\textsuperscript{234} Lieber B. and Roeder A. \textit{Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Germany}, p. 2.

\textsuperscript{235} Bakker A. \textit{Transfer Pricing and Business Restructurings: Streamlining all the way}, p. 289.

\textsuperscript{236} Kroppen, H-K. et al. \textit{Germany- Transfer Pricing and Business Restructurings}, sec. 3.4.

\textsuperscript{237} Rasch, S. and Schmidtke R. \textit{OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: Germany} p. 106.

\textsuperscript{238} Kroppen, H-K. et al. \textit{Germany- Transfer Pricing and Business Restructurings}, sec. 3.4.

\textsuperscript{239} Cauwenbergh, P and Lucas Mas, M. \textit{German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis} p. 519-520.
commercial freedom. Tax authorities should refrain to apply correct existing tax and transfer pricing rules. Hence, the entrepreneurial freedom is interfered with.\textsuperscript{240} When a business function is transferred from a German enterprise to a foreign enterprise, it will be assumed that both parties have complete information about the transaction in calculating a minimum price (of the transferor) and a maximum price (of the transferee). These provisions have been criticized as to violate the German tax treaties. There has not yet been any case law developed which deals with these provisions.\textsuperscript{241}

5.2.5 Compliance Issues

The German transfer pricing regulations have been considered not to be in line with current OECD guidance. The way the arm’s length principle is applied presents an issue as it is applicable to contractual arrangements as well as prices. If a transaction of a loan was paid for in Yen, the transaction may be re-characterized merely because a prudent business manager would only have agreed to a loan in Euro. Under the OECD guidance, contractual terms may only be disregarded in exceptional cases. Another crucial difference in the German application of the arm’s length principle is that participants are assumed to have complete and reliable information when determining transfer prices. This does not reflect the situation of independent parties.\textsuperscript{242}

The German rules are applied to such an extent that its transfer pricing might actually be characterized as an exit tax, where an excess value over the arm’s length value shall be paid from the foreign company to the transferring company. This would also depart from the basic premises of the Guidelines.\textsuperscript{243} The Guidelines do not include opportunities such as profit potential or business opportunities in their valuation approach of assets. In the transfer of a risk, where no assets are transferred, the risk on its own should not entitle the seller to a compensation for any in the future expected performance.\textsuperscript{244}

\textsuperscript{240} Cauwenbergh, P and Lucas Mas, M. \textit{German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis}, p. 520.

\textsuperscript{241} Andresen, U, \textit{Germany – Commissionaire Agency Permanent Establishment}, p. 5-6.

\textsuperscript{242} Cauwenbergh, P and Lucas Mas, M. \textit{German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis} p. 520-521.

\textsuperscript{243} Ibid., p. 522.

\textsuperscript{244} Ibid., p. 523.
The extensive German transfer pricing regulation will result in increasing double taxation issues according to Cauwenbergh and Lucas Mas; taxpayers will be exposed regardless of whether or not they follow the German rules. This will most likely lead to German and foreign competent authority proceedings, “since the new rules contravene 95% of the tax treaties concluded by Germany.”245 246

The German regulations are still new in the area and its applicability will still need to be clarified in some instances. It does however give rise to a growing concern in the business community and national tax administrations that double taxation issues will arise and is described as tough and far-reaching.247 Rasch and Schmidtke believe that the German law on business restructurings is not formulated in an unambiguous way and that this creates unacceptable uncertainty for taxpayers.248


246 Ibid., p. 526.

247 Ibid., p. 526.

6 Analysis

6.1 Initial Comments

The previous chapters of this thesis aimed at giving a foundation on what the current guidance available for allocating risk in an OECD perspective is, according to Issues Notes 1. It has also been investigated how this approach relates to the AOA, as established in the PE Report. The information from the previous chapters will now be used to answer the research questions.

6.2 Does the Approach Given in Issues Notes 1 Contradict the Approach for PEs as Stated in the PE Report?

6.2.1 General

From the guidance under Issues Notes 1, some key concepts concerning risk allocation can be identified. These concepts are: the conduct of the parties, notion of control, financial capacity to bear the risk and economic substance. The PE Report provides guidance on risk allocation to permanent establishments whereby two key elements can be identified regarding risk allocation, namely the significant people functions and active decision making.

The main approach of risk allocation from an Art. 9 perspective starts with the contracts; in a PE situation there will be no legal written contracts, as a PE cannot constitute a legally independent and separate entity. However, it may seem to be the intent of the PE Report to make the fiction of a PE as an independent enterprise, why this would at first hand appear to present evidence that risk allocation for associated enterprises and PEs should be the same.

Erasmus-Koen is of the opinion that the anti-avoidance rule of para. 1.65 of the Guidelines should not be given any further concern under Issues Notes 1, however para. 38 of the Discussion Draft imply that if the manners differ from 3rd party comparables, the economic logic of a controlled transaction needs to be examined. Case scenario 3 shows a situation where country A would reassign the risk allocation to Company B; this approach is not different from the approach of para. 1.65 of the Guidelines. In case scenario 5, the parties conduct test was not passed, which leads to the control test to be applicable. The question is, again, if this approach is not similar to the anti-avoidance rule. The case scenarios show how Issues Notes 1 can give tax authorities a possibility to
make an assessment based on the economic principles that generally govern such contracts. This criterion may be too subjective because, according to Erasmus-Koen, it gives them authority to infer scenarios on behalf of their own beneficial interest. The arm’s length principle still needs to be applied by the tax authorities, but I think Erasmus-Koen makes an interesting point, the approach of the Discussion Draft is similar to the approach of para 1.65 of the Guidelines and the OECD should make it clear that the challenge from tax authorities regards a pricing adjustment and not re-characterization unless the threshold of para. 1.65 is met.

6.2.2 The Risk Allocation Concepts
The conduct of the parties test, as established in the Discussion Draft, basically states that the conduct should be as stipulated in the contract. Tax authorities can deduce this by looking at e.g. where write-downs are taken. The conduct test makes it necessary for associated parties to have internal procedures which ensure that the conduct does not differ from the contract.

The control test has led to further inquiries about the Discussion Draft. It has been questioned whether it is an attempt by the OECD to align the Art. 9 approach with the AOA of the PE Report, where daily management is a key determinant. This test adds to the notion that terms of a contract are not enough to stipulate where risk is. There have been arguments that this test may be contrary to Art. 9 because it should not be relevant which party in the group actually controls the risk, as long as an arm’s length price has been paid for the assumption of that risk.

The definition and applicability of the control test has led to excessive comments from the business world. Most of the commentators ask for more detailed guidance and some, although they agree to the concept, believe that the wording of Issues Notes 1 may provide too much room for subjectivity for the tax authorities. Deloitte goes to the extension to state that the control test is unnecessary. An alternative concept is proposed by BIAC, namely the “effective economic control” test. This test leans toward the financial capacity test; it does not necessarily include a day-to-day administration but the financial capacity to bear a risk, should it materialize because of a poorly effected management function. The party who has the responsibility for the consequences of an implemented policy should, i.e., bear that risk.
Liaugminaite thinks that the OECDs position is that an analysis of the arrangements should be conducted, in order to establish whether it has economic substance. This would only be relevant at a second stage of a comparability analysis, i.e. during the re-characterization of a transaction. A problem with the economic substance-over-form principle is that it can lead to different interpretations, as shown in the US example where it is commonly applied but still there is no uniform doctrine of it. Also, most civil-law countries apply the substance-over-form test. Risks of double taxation arise when countries use domestic tests to determine whether a transaction lacks economic substance. Liaugminaite asks for a clarification by the OECD, regarding the two elements of the principle of economic substance, namely disregarding the transaction and re-characterizing it. This is necessary for a uniform interpretation.

The emphasis on a financial test was desired by a majority of the referred business commentators. Most business commentators agree to a financial capacity test, although they ask for clearer guidance on how it should be applied. Some believe that financial capacity is more important than control; financial capacity is crucial to bear a risk should it materialize, and it should also be easier to find comparables data. This may not be quite true though; in obvious situations it can provide good proof, but in many scenarios it may be hard to determine the economic significance of a risk or the real financial capacity of a company. In that sense I agree with BIAC, stating that financial capacity does not provide any real proof and it is the legal contracts that should be followed by the parties. Clearer guidance is needed though, as there is too much uncertainty to how it should be applied.

When these three tests are met, a contract, the terms of risk allocation between associated enterprises, is said to have economic substance. Economic substance can also be explained as the economic effects of an arrangement as structured by the taxpayer. There are however several ways of interpreting this concept, and different countries interpret it in different ways, thus leading to double taxation.

6.2.3 The Risk Allocation Approaches

Both Art. 9 and Art. 7 express a vision of treating associated enterprises and PEs as separate and independent entities. The OECD stresses that the approaches are different, however the subject has been elaborated on in academic articles. Risk allocation in an Art. 9 perspective starts at the contractual terms. A PE has no legal written contractual
terms as it is not a legally separate entity. Further, a subsidiary may receive any capital the parent sees fit, whereas a PE can only be attributed free capital of an amount that is necessary to support the functions and risks assumed. The question is whether these differences lead to different results, although the vision seems to be that the result should not differ? The Guidelines clearly state that the AOA and risk allocation for associated enterprises are different approaches to be applied in different situations. This has now been further emphasized in ch. IX of the Guidelines.

Rosalem believes that a PE is attributed profits because the people who perform the day-to-day decisions are putting the capital at risk, and this is important because the meaning of control according to the Discussion Draft is just putting capital at risk. The PE people are, according to Rosalem, merely implementing the risk, as a third step of a decision making process. Active decision making should only regard the day-to-day management of a risk.

The International Tax Review suggests an alignment of the control test and significant people functions of the PE Report. In allocating risk regarding to where the operational control takes place, there would be less room for subjectivity and double taxation issues. Active decision making according the PE Report is basically the notion that a PE should be attributed a risk when it makes the day-to-day decisions regarding that risk. This model could be put contrary (or in line with) the control approach of Art. 9. There is a crucial difference here where control in Issues Notes 1 refers to putting capital at risk, as active decision making is preferably made at a lower level of an entity where personnel is taking the day-to-day decisions and implementing strategies.

In case scenario 7, the parent company bears bad-debt losses and takes strategic decisions. By applying the Art. 9 concept, risk would be at the parent. However, the personnel of the subsidiary implement the strategies and take the day-to-day decisions. So, in an Art. 7 perspective, risk would be allocated to the subsidiary. This shows how the different approaches lead to different results.

Rosalem believes that the single taxpayer approach have flaws, as it does not allocate risks to a PE, but that might just be unnecessary if those risks are already taken into consideration in the agency fee. The income of the enterprises will be the same as under the AOA, although through the subsidiary and not the PE. Pijl does not agree. He be-
lieves that the single taxpayer approach would make Art. 5(5) superfluous; to reward an agency PE nil profit by definition is not in line with the source state principle and does not meet the principle of effective tax treaty interpretation. If an enterprise wants no profit to be allocated to its PE, it is free to determine the agents functional profile. The AOA does in some circumstances impose a heavier burden of the taxpayer, and in some cases it may seem unnecessary as shown in case scenario 8.

6.2.4 Alternative Approaches

The differences between associated enterprises and PEs make it necessary to also have different approaches when attributing risks (and profits). Apart from these differences, there are other approaches available, which may lead to other results of risk allocation. An example of this is where a country uses the legalistic method, where the concept of pacta sunt servanda means that contractual terms must be respected as long as it is not a question of abuse or fraud. This approach goes further than the control concept, whereas the control concept is easier to prove than abuse or fraud. One may assume that a pure legalistic approach is rarely used by OECD member countries as this is not a method envisaged by the Guidelines. Some business commentators, although, think of it as a proper method since it gives MNEs full entrepreneurial freedom to allocate risks as they see fit. The benefit of the legalistic method is that contracts will be respected to the extent that they do not present fraud or abuse. This would lead to fewer cases of double taxation, however only on the premises that it is the position of all countries involved in a transaction. It is not likely that member countries will agree to adopt a strict legalistic method, as it gives enterprises a significant freedom to contractually negotiate risk allocation sets that are not seen between independent third parties, hence do not present arm’s length.

Another aspect when the approaches of the articles lead to different results is when there is actually a joint control over risk. A PE may be attributed a portion of a risk (e.g. 50%) while this is not possible for associated enterprises. In the case of joint control of 50/50, the tax authorities will most likely allocate the risk to the entity which bears it according to the contract.

Rosalem asks the question of whether Art. 9 or Art. 7 should be applied first. She argues that there may be a hierarchy between the articles. She refers to Art. 7(7) which gives precedence to articles concerning other items of income, and to the Commentaries
where it is stated that Art. 9 deals with associated enterprises. Her argumentation is lacking though as these provisions do not expressively give the Art. 9 approach precedence over Art. 7. She argues that Art. 9 should be considered as lex specialis and precede Art. 7 as lex generalis, mainly because she sees no reason for why this should not be the case. Also here, her argumentation is lacking substance.

If one were to consider that there actually was a hierarchical method established, risk allocation would be conducted under Art. 9, and Art. 7 would apply only if Art. 9 allowed for it. There are however problems also with this idea; when countries use different approaches, such as an economic approach vs. a legalistic approach. This is exemplified in “Case scenario 9” where the different approaches lead to different results and double taxation issues. A hierarchy between the articles could provide an approach where profits would never be attributed to a PE unless Art. 9 would allow for it. The PE concept would be insufficient if the single taxpayer approach was used, since the whole principle of Art. 7 would be abandoned; that profits should be allocated to a PE where such exists in a host country jurisdiction.

So what needs to be done in order to avoid an increasing number of double taxation cases? It seems that the major factor for differences is not perhaps in the approaches provided for by the OECD, but the different ways of interpreting these by different jurisdictions. The problem could still however be solved by, e.g. more thorough guidance by the OECD which gives less room for subjective interpretation.

6.3 The German Attempt to Provide Domestic Provisions Governing the Transfer Pricing Treatment of Business Restructurings

6.3.1 General
Germany was one of the first countries to implement domestic transfer pricing business restructuring regulations. The underlying reason was to protect their tax base as MNEs to a large extent had shifted their profit potential to “cheaper” countries. One may ask, however, whether by doing this, Germany’s regulations lead to an increased uncertainty and an enhanced risk of double taxation issues to arise. The German interpretation of the arm’s length principle may constitute a proof for this as, contrary to the OECD, location savings and other synergies are to be included in the calculation of an arm’s
length price. The parties of a transaction are assumed to know all relevant information about a transaction; in an independent third party situation this would not be the case.

6.3.2  German Transfer Pricing and Business Regulations are not in Accordance with OECD Guidance

An important aspect of German transfer pricing law is that a restructuring may not be made for tax purposes. The main purpose of a restructuring or transaction cannot be tax purposes. This is a controversial decision of the German legislator as taxes present a significant expense for MNEs and it would seem natural that costs of taxes are taken into consideration as part of any restructuring.

The arm’s length principle goes beyond the OECD approach as it applies not only the contract but also the conditions and terms thereof. The example where a transaction can be re-characterized merely because it was conducted in Yen and not in Euro is one example of this. The tax authorities in Germany have been given very broad means of interpreting whether a transaction may be challenged. The choice to implement domestic regulations was an attempt to secure tax income however the provisions violate tax treaties signed by Germany. This is why domestic legislation is not a preferable approach to challenge risk allocation situations.
7 Conclusion and Recommendations

7.1 Issues Notes 1 of the Discussion Draft Does Not Provide Satisfactory Guidance on Risk Allocation for Associated Enterprises

7.1.1 The Key Concepts of Risk Allocation Need to be Clarified

The notion of control and the economic substance test needs to be clarified. The OECD needs to clarify whether the term control relates to the managerial functional role or if it is meant to be based on the day-to-day management. Although it is clearly stated that the notion of risk allocation from an Art. 9 perspective should not be aligned with the AOA, the guidance provided gives too much room for interpretation for tax authorities. A suggestion would be to follow the suggestion from BIAC, and use the term “effective economic control” and to focus more on contractual agreements instead of third party comparables.

The OECD should also provide for more examples in the guidelines to show how different risks should be evaluated and allocated. The Association of German Banks recognizes the difference between the OECD approach and the one of Germany, and emphasizes the need for a consensus on these matters. The German choice to implement domestic regulations is an attempt to secure tax income however the provisions violate tax treaties signed by Germany. This is why domestic legislation is not a preferable approach to determine risk allocation.

Further guidance is needed and should be provided for by the OECD. It will never be possible to provide guidance to the extent that every possible scenario is presented and analyzed, but the existing guidance under Issues Notes 1 is insufficient. It is of critical importance that there is consensus among jurisdictions on how to apply the arm’s length principle, and the German choice to develop their own formula for business restructurings has lead to a situation where Germany is said to violate most of its tax treaties. When guidance is implemented in the Guidelines, it is not considered as law for contracting nations, but it presents a soft law obligation for member countries, why it is a good tool in the search for a common principle on the notion of risk.
7.1.2 The Risk Allocation Approach Under Art. 9 Differs from the AOA and the PE Report

The different approaches under Art. 7 and Art. 9 are not the same. Under the AOA, day-to-day management is key, and this is not the case under Art. 9 where risk is allocated under the control test. The different approaches should not be the same, as the PE merely takes on the fiction of a separate entity when in fact it is not. The essential difference is the absence of legally binding documents and that a PE in itself can never assume financial risks. The PE Report and the Discussion Draft should not be harmonized as they address different situations.
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