Profit Attribution to a Construction Permanent Establishment: A Numerical Case Study

This article provides an overview of the principles of the attribution of profits to a permanent establishment. Since there is no specific guidance on the attribution of profits to construction business, this article aims to demonstrate which transfer pricing method is appropriate to different scenarios of a construction project shown in the numerical case study.

1. Introduction

The concept of permanent establishment (PE) is a crucial criterion in the distribution of tax revenue between countries involved in a cross-border transaction. The general threshold for establishing a PE is that a foreign entity must have a fixed place of business through which all or part of business is carried on in the source state. Many different types of international transactions, e.g., large-scale infrastructure construction projects, however, are temporary in nature, and it is difficult to apply the general set of rules thereto. The separate PE provision for construction business defines that the “fixed place” can be temporary. The duration may be important for such a fixed place to constitute a PE (six to twelve months or another threshold depending on the treaty).

Article 7(1) of the OECD Model (2017) allocates taxing right over a foreign entity to a source state, but limits it to those business profits that are attributable to a PE. For the computation of profit, a PE and its head office must be treated as separate independent enterprises. There is detailed guidance on the attribution of profit to a PE, but no specific guidance on profit attribution to construction business is provided, despite its significant role in supporting the global economy. This work aims to demonstrate how profit should be allocated to a construction PE. Section 1 will provide different concepts of PE and discuss their amendment as a result of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. Section 2 will deal with the principles of profit attribution to PEs. Section 3 will provide case studies of profit attribution to PEs.

2. Permanent Establishment and Construction Business

The permanent establishment concept is a cornerstone of the international tax regime. It is the main instrument for establishing taxing jurisdiction over a foreign enterprise’s unincorporated business activities. The distributive rule of a tax jurisdiction over business profits can be found under article 7 of the OECD Model (2017), which affirms that a state (a source jurisdiction) can impose tax on a foreign enterprise’s income only when the enterprise has a PE, and that only profits attributable to the PE are taxable. The reference to PE, which is defined under article 5, shows that articles 5 and 7 are intrinsically linked. In general, a PE exists when an enterprise has a fixed place of business through which a foreign resident entity carries on business in a source state. However, construction business, in some cases, cannot be fixed in the same way as a manufacturing plant and is by definition only temporary (although the construction work may at times take several years). This section will deal with construction business and relevant PE thresholds.

2.1. Physical PE

Article 5(1) of the OECD Model (2017) provides the basic definition of PE, i.e., a fixed place of business through which the business of an enterprise is wholly or partly carried on. The existence of a PE requires the following elements:

- the existence of a place of business (place of business test and right to use test), i.e., a facility such as a premises or, in certain instances, machinery or equipment;
- that this place of business is fixed, i.e., that it is established at a distinct place with a certain degree of permanence (location test and duration test); and
- the carrying-on of the business of the enterprise through this fixed place of business (business connection test), normally by the personnel of the enterprise.

References:
4. Art. 7(2) OECD Model (2017).
7. See art. 7(1) OECD Model (2017) and UN Model (2017).
If the essential requirement of a place of business to be “fixed” is not met, no PE exists. A construction project by nature is temporary, hence does not meet the criterion of the fixed place of business. Therefore, the duration issue must be settled.

2.2. Construction PE

Construction activity by definition is not permanent, and construction work will eventually be terminated.10 The criteria for establishing a PE under article 5(1) cannot, thus, be met by a construction project. Nevertheless, construction projects such as industrial plants and infrastructure projects involve considerable interaction with the source country and create a strong link with it. It would be unfair not to allocate a fair share of tax revenue to the source country.11 Article 5(3) accordingly provides a separate threshold for construction business, stating that “a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months”.12 This recognizes that construction projects are a special case: although temporary, they can be extremely valuable.13 Article 5(3) is generally viewed as an exemption clause to the rules regarding a physical PE.14 stating that the only requirement for a construction project to constitute a PE is that the project must pass the pro rata temporis test. If this test is not met, there is no PE for such construction project. There are no alternative criteria creating a PE for construction activities.15

2.3. Construction PE and BEPS

The BEPS Project addresses issues of aggressive tax planning leading to double non-taxation.16 One of these structures, which has been recognized in the Commentary, is splitting up contracts between closely related enterprises.17

2.3.1. Splitting up contracts

The twelve-month test, which applies to each individual site or project, is easy to abuse; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less that twelve months and each attributed to a different company; which was, however, owned by the same group.18 A recent case before the England and Wales High Court19 showed that it is common to split a construction project into offshore and onshore contracts between a client and two related enterprises for tax efficiency purposes. There is usually also a linkage contract as a bridging agreement, in order to deal with interface issues and to ensure that the procuring entity is not prejudiced by the splitting arrangements.20 Apart from avoiding the establishment of a PE in the source state, splitting up contracts also lessens exposure to tax in the source state because some high-income generating activities are assigned to the offshore contract. This is because taxable profits of a construction PE depend on functions performed through the office or workshop, taking into account the assets used and the risks assumed through that office or workshop.21 If there is a construction PE, profit subject to tax in the source state will then be capped to the onshore contract, and not the whole construction project.

2.3.2. Amendments to existing Commentary

Splitting up contracts is recognized in the BEPS Action 6 Final Report22 as an abusive structure with the goal of circumventing the PE duration threshold,23 which is contrary to the object and purpose of article 5(3).24 According to the principal purpose test (PPT) rule, if facts and circumstances show that a construction project is divided into two contracts for the purpose of gaining treaty benefits, namely the absence of a PE in the source state, such treaty benefits need not be granted to a taxpayer.25 However, the PPT rule depends on the application of an anti-avoidance rule. To deal with the duration threshold abuse directly, the Commentary on article 5(3) of the OECD Model (2017) provides an alternative provision for determining the twelve-month threshold if the PPT rule is not available in tax treaties:

For the sole purpose of determining whether the twelve-month period referred to in paragraph 3 has been exceeded, a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding twelve months, and

11. Setta, supra n. 1.
12. OECD Model (2017). The duration requirement of art. 5(3)(a) UN Model (2017) is six months (perhaps to favour developing economies).
15. Schaffner, supra n. 10, at p. 190.
16. OECD: Addressing Base Erosion and Profit Shifting (OECD 2013), Primary Sources IBFD.
17. OECD/G20, Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report p. 11 (OECD 2015), Primary Sources IBFD.
19. UK: EWHC TCC, 30 Nov. 2017, Petroleum Company of Trinidad and Tobago Limited v. Samsung Engineering Trinidad Co. Limited
23. B. Kuzniacki, The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application, 10 World Tax J. 2, sec. 2.4.3.2 (2018), Journal Articles & Papers IBFD.
24. OECD/G20, Action 6 Final Report, at p. 64
3. Principles of the Attribution of Profits to a PE

3.1. Article 7 of the OECD Model (2017)

In regard to cross-border business, local tax authorities need to ask themselves two questions: whether a foreign enterprise carrying on business in their country has a PE; and, if yes, what the profits are on which that PE should pay tax. Article 5 provides merely the definition of PE, and sets out tests for answering the first question, but it does not itself allocate taxing rights. To determine which state may tax income derived from the PE and to what extent the income is taxable, it is necessary to turn to article 7. Article 7(1) allocates taxing rights between the residence state and source state. The principle underlying that paragraph is that the profits of an enterprise of a residence state shall not be taxed in the source state unless the enterprise carries on business in the source state through a PE situated therein. This taxing right, however, does not extend to profits that are not attributable to the PE.

Article 7(2) thus provides for the determination of profits attributable to the PE. The attribution of profits to the PE relies on the fiction that the PE is a separate enterprise and independent from the rest of the enterprise of which it is a part, engaging in the same or similar activities under the same or similar conditions and taking into account the functions performed, assets used and risks assumed through the PE and through other parts of the enterprise.

The approach to attributing profits to the PE under article 7 reflects the approach culminating in the 2010 OECD Report on the Attribution of Profits to Permanent Establishments. It involves two steps: functional and factual analysis, and determining profits based on a comparability analysis, which will be discussed in section 3.2.

3.2. The authorized OECD approach

The lack of uniformity in PE profit attribution rules required the OECD to work on this matter. The Working Hypothesis (WH), developed from 1994 onwards, was the first step in developing an approach to PE profit attribution that might be accepted by states as a consensus position. The WH was renamed the authorized OECD approach (AOA) in the 2008 OECD Report on the Attribution of Profits to Permanent Establishments. The AOA was developed in order to examine how far the approach of treating a PE as a hypothetical and separate enterprise could be taken, and how the transfer pricing guidelines could be applied, by analogy, in attributing profits to a PE in accordance with the arm’s length principle of article 9. In other words, the OECD intended to bring the PE profit attribution rules and the transfer pricing guidelines closer together.

The basic principle underlying the AOA is the functionally separate entity approach. Under the functionally separate entity approach, the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

There are two steps under the AOA: step one, the PE is hypothesized as a separate and independent enterprise; and step two, the profits of that hypothesized enterprise are determined based on a comparability analysis, applying the transfer pricing guidelines by analogy.

3.2.1. Step 1: Hypothesizing PE as a separate entity

A challenge of PE profit attribution is that a PE is not legally separate from the rest of the enterprise. To ensure that the separate and independent entity is properly hypothesized, a functional and factual analysis will be applied in order to:

– allocate functions to the PE;
– attribute risks based on functions performed;
– attribute the assets necessary to perform the identified functions; and
– attribute free capital based on the risks assumed and assets economically owned by the PE.

As the PE is a part of the enterprise, a functional and factual analysis for attributing risks, assets, capital and rights and obligations cannot be based on legal contracts.
or other ascertainable legal arrangements. Such attribution between a PE and its head office under the AOA is instead based on significant people functions (SPFs): that is, assets will be attributed to the PE when significant functions regarding the decision as to the economic ownership of the assets are performed by the PE’s personnel; assumption of risks by the PE will also be relevant to the SPFs, taking into account any subsequent dealings and risk management between the PE and other parts of the enterprise; free capital will be attributed to support functions the PE undertakes, assets it economically owns and risks it assumes. In other words, it is crucial to identify which functions are performed by the people who belong to the PE, because risks, assets and capital will be attributed following the functions.

3.2.2. Step 2: Determining the profit attributable to PE
The second step under the AOA is to compare dealings between the PE and the enterprise of which it is a part with transactions between independent enterprises. The nature of the dealings must be identified in order to attribute a price or profit on an arm’s length basis, which should be done using, by analogy, the guidance on transfer pricing methods. There should be a factual and comparability analysis to determine whether the PE or its head office performs activities that could generate profit if such activities were performed in a transaction between independent enterprises. A price or profit in respect of the internal dealings will then be attributed by reference to comparable transactions between independent enterprises. However, which transfer pricing methods, e.g. the comparable uncontrolled price method, the cost-plus method, etc., are most appropriate for determining the arm’s length remuneration depends on the circumstances of each business and transaction.

4. Profits Attribution to Construction PE
Sections 2. and 3. described the concept of PE and to what extent its profit is taxable in the source state. In order to compute the profits attributable to the PE, the guidance provided by the OECD should be applied. Unfortunately, there is no specific guidance on how to apply the AOA to construction business, therefore, analysis of the profit attributable to the construction PE will be conducted according to the general guidance. The absence of specific standards for construction PE profit attribution gives rise to some difficulties in practice.

Some countries, such as Finland and Germany, have introduced the application of the arm’s length principle to PEs into their internal legislation and provide guidelines on profit attribution following the two-step approach under the AOA: a functional and risk analysis, including identifying dealings within the enterprise; and a comparability analysis, remunerating the dealings in accordance with general transfer pricing rules.

It is noteworthy that there are specific regulations on profit attribution to construction PE under the German Betriebssättingewinnverteilungsverordnung [Ordinance on the Allocation of Profits of Permanent Establishments] (2014), especially regarding how tangible assets are to be attributed. Pursuant to the special provisions, tangible assets are attributable to a construction PE only if personnel functions relate to the acquisition, production, disposal or utilization thereof. In other words, tangible assets are not attributable to a construction PE if such PE does not perform any SPF beyond usage of the deployed tangible assets (the machinery and construction material). If there are no SPFs, tangible assets will be attributed to the rest of the entity and the services rendered by the PE are deemed to be routine and free of charge. Thus, no dealings between the PE and its head office are deemed to exist.

This section will provide practical examples of profit attribution to a construction PE based on the AOA and the guidelines provided by the Finnish and German authorities.

53. There is guidance on how to apply the authorized OECD approach (AOA) to PEs of banks, global financial enterprises and insurance companies, including agency PEs and PEs under article 5(4) resulting from the amendment of article 5 by the BEPS Project.
54. Para. 35 OECD Model: Commentary on Article 7 (2017) states that “Progress paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing profits to them under Article 7.”
56. DE: Verordnung zur Anwendung des Fremdvergleichsgrundsatzes auf Betriebssätten nach § 1 Absatz 5 des Außensteuergesetzes (Betriebssättingewinnverteilungsverordnung) [Ordinance on the application of the arm’s length principle to permanent establishments under section 1(5) of the External Tax Relations Act (Ordinance on the Allocation of Profits of Permanent Establishments)] (2014) [hereinafter BoGav].
58. Sec. 31(1) BoGav.
60. Id.
61. Id.
62. Id.
4.1. Facts

SCO is a limited company engaging in construction business, including large construction projects using advanced technological construction. SCO’s head office is located in country S. SCO undertakes a project to construct a rail mass rapid transit system in country R. The construction agreement between SCO and the government of country R consists of the following:

- supply of equipment;
- technical services;
- designing and engineering of the underground structure;
- construction work; and
- construction management and supervision.

The construction agreement lasts more than twelve months; hence, a PE is constituted for SCO in accordance with article 5(3) of the tax treaty, on the basis of the duration of the construction project.  

4.2. Case 1: Construction services

In this case, it is assumed that SCO’s head office undertakes the tasks of designing and engineering the underground structure, supplying material and equipment and providing technical services. Employees who perform construction work and related management and supervision do so in country R.

4.2.1. Functions analysis

The functions can be divided between SCO’s head office and the PE as in Table 1.

<table>
<thead>
<tr>
<th>Function</th>
<th>SCO’s head office</th>
<th>PE in country R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supply of equipment</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Technical services</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Designing and engineering of the underground structure</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Construction work</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Construction management and supervision</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

From the above analysis, it can be assumed that SPFs that are crucial in generating revenue for SCO are allocated to the SCO’s head office. The PE, however, performs construction work and related management and supervision that go beyond mere usage of the deployed tangible assets and are also important for the conclusion of the project contract, therefore, the PE should be attributed some income for its performance.

A remark to be made is that there is significant Indian case law regarding a construction contract of a composite nature. The PE issue centred on the offshore supply of equipment, in regard to which the court observed that there were two components of the offshore supply, namely the supply of equipment and the rendering of relevant services. Even though the PE did not play any role with respect to the offshore supply, services were rendered in India and, thus, profits derived from such services were deemed to be attributable to the PE and taxable in India. In the present author’s opinion, the allocation to the PE of services under the offshore supply account is not in alignment with the AOA. It was based instead on the territorial nexus, i.e. the fact that the rendering of services occurred in India led to the conclusion that the income derived therefrom was taxable in India.

4.2.2. Dealings

Pursuant to the AOA, the PE must be treated as if it were a separate and independent enterprise, in particular in its dealings with other parts of the enterprise. In this particular case, if the PE were a separate and independent enterprise providing construction work and related management and supervision in country R for SCO, the transaction or dealings between them would be a service provision.

4.2.3. Profit attributable to PE

In the second step of the AOA, the dealing is to be remunerated in accordance with the general transfer pricing rules. Assume that, as a full comparability analysis is needed to determine the most appropriate method for the service fee remuneration at arm’s length, the cost-plus transfer pricing methodology is the most appropriate. Assume also that a rigorously executed benchmark analysis finds that the most appropriate comparable among independent enterprises providing construction services would be the cost of construction plus profit margin of 7.5%. The markup for computing profit attributable to the PE will then be 7.5%, as shown in Table 2.

<table>
<thead>
<tr>
<th>Table 2 – Case 1: Profit attributable to PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
</tr>
<tr>
<td>Employee cost</td>
</tr>
<tr>
<td>On-site expenses</td>
</tr>
<tr>
<td>Total costs</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

The business profit of SCO attributable to its PE from the rail transit system project is 2.25 and is taxable in country R.

62. Finnish Tax Administration, supra n. 55.
63. Deloitte, supra n. 59.
64. Van der Ham, et al., supra n. 57.
65. IN: ITAT [Income Tax Appellate Tribunal] Delhi, 26 Feb 2014, POSCO Engineering & Construction Company Ltd. v. ADIT, Case Law IBFD.
66. Van der Ham et al., supra n. 57.
67. The cost-plus method begins with the cost incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost-plus markup is then added to this cost, to establish an appropriate profit in light of the functions performed and the market conditions. For further detail, see OECD Guidelines, supra n. 47, at ch. II.D.
68. The cost-plus method is recommended by the Finnish and German guidelines.
4.3. Case 2: More SPIs

Also in this case, further assumptions may be made. Assume that, due to weaknesses of the natural ground, SCO develops an advanced technology to be used especially for the rail system construction, which could be recognized as creation of intangibles.69 The development of this technology is partly conducted by the PE’s personnel on the project site, because it requires thorough research and exploration of the actual area.

4.3.1. Functional analysis

In addition to the functions performed in Case 1, the PE in Case 2 participates in advanced technology development for the project, which is an SPF generating revenue for SCO. This participation in developing a technology means that the PE can be considered a joint economic owner70 of the intangible. Hence, additional free capital – as there should in principle be free capital also in the first case – is attributed to the PE in order to support any significant risks associated with the development of such intangible.71 In this circumstance, the PE could be characterized as a co-entrepreneur.72 Even if the PE were not a co-entrepreneur, this change will certainly have an impact on the remuneration. However, assuming that the factual and functional analysis indicates that the PE can be regarded as a co-entrepreneur or even a joint venture, the PE would be entitled to a comparable return to that of an independent enterprise performing a similar function.73

4.3.2. Dealings

In this case, in addition to the construction services provided in Case 1, the dealings between SCO and the PE are not the transfer of intangible asset, but the joint development of the advanced technology, the outcome of which the PE expects to exploit in its construction work. This is, by analogy, considered a cost contribution arrangement,74 in which the participants share the contributions, costs, risks and expected economic benefits of the development.

4.3.3. Profit attributable to PE

The AOA second step aims at finding the most appropriate method for pricing a transaction at arm’s length. The technology development jointly undertaken by the PE and SCO makes unique and valuable contributions.75 This highly integrated business operation, in which functions performed, assets used and risks assumed are interlinked and cannot reliably be evaluated in isolation,76 would be most appropriately priced by the profit split method.77 There are a number of approaches to applying the profit split method.78 One is a residual analysis,79 consisting of two steps leading to the profit attribution:

- determining profits that can be calculated at an arm’s length price based on the comparability analysis; and
- calculating the residual profit based on the profit splitting factors.80

In this circumstance in which the PE performs construction services (Case 1) and participates in the advanced technology development, the residual analysis would be most appropriate for the profit attribution because the construction service is less complex and is capable of being benchmarked81 by reference to the comparable cost-plus markup. To calculate the residual profit, the profit splitting factor82 must be identified based on the facts and information available. For the technology development, expenditures related to the development of a unique and valuable intangible would be the suitable profit splitting factor.83

In this case, assuming that the work of SCO is charged to the client for 132.25, of which 32.25 is allocated to the PE (following Case 1), and that the expenditures in relation to the unique and valuable intangible incurred by the head office and the PE are 5 and 2 respectively, the profit and loss statement will look as shown in Table 3.

<table>
<thead>
<tr>
<th>Service revenue</th>
<th>Head office</th>
<th>PE</th>
<th>SCO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of service</td>
<td>50</td>
<td>2.25</td>
<td>52.25</td>
</tr>
<tr>
<td>Expenditure in relation to unique and valuable intangible</td>
<td>5</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Net profit</td>
<td>45</td>
<td>0.25</td>
<td>45.25</td>
</tr>
</tbody>
</table>

Table 3 – Case 2: Profit and loss statement

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69. The word “intangible” is intended to refer to something that is not a physical asset or a financial asset, that is capable of being owned or controlled for use in commercial activities, and the use or transfer of which would be compensated had it occurred in a transaction between independent parties in comparable circumstances. See further OECD Guidelines, supra n. 47, at ch. VI.


71. Id. at p. 54.

72. Van der Ham, et al., supra n. 57.

73. OECD Report (2010), supra n. 5, at p. 53.

74. A cost contribution arrangement may be understood as a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or obtaining of intangibles, tangible assets or services, with the understanding that such intangibles, tangible assets or services are expected to create benefit for the individual businesses of each of the participants. See further OECD Guidelines, supra n. 47, at ch. VIII.

75. Contributions (for instance functions performed or assets used or contributed) will be “unique and valuable” in cases in which (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations.


77. That is, by a transactional profit split method that identifies the relevant profits to be split for the associated enterprises from a controlled transaction, and then splits those profits between the associated enterprises on an economically valid basis approximating the division of profits that would have been agreed at arm’s length.

78. OECD/G20, Guidance on Profit Split Method, supra n. 76, at sec. C.3.1, para. 2.149

79. Id., at sec. C.3.12, para. 2.182.

80. Id., at sec. C.5.1.

81. Id., at sec. C.3.1, para. 2.149

82. Id., at sec. C.5.1.

83. Id., at sec. C.5.1, para. 2.181.
It is assumed that independent comparable constructors without unique and valuable intangibles earn a return on construction costs of 10%. The calculation of the initial return for the construction service provision under Case 1 will be as shown in Table 4.

| Table 4 – Case 1: Initial return for construction service provision |
|---------------------------------|-----------------|
| Head office                     | 50 + (50 × 10%) = 55 |
| Initial return for head office  | 5               |
| PE                              | 30 + (30 × 10%) = 33 |
| Initial return for PE           | 3               |
| Total profit allocated          | 8               |

The next step is the allocation of residual profit, which could be split 5/7 to the head office and 2/7 to the PE, as demonstrated in Table 5.

<table>
<thead>
<tr>
<th>Table 5 – Case 2: Allocation of residual profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCO net profit</td>
</tr>
<tr>
<td>Profit already allocated</td>
</tr>
<tr>
<td>Residual profit to be split between the head office and PE</td>
</tr>
<tr>
<td>Residual profit allocated to the head office</td>
</tr>
<tr>
<td>Residual profit allocated to the PE</td>
</tr>
<tr>
<td>Total profits allocated to the head office</td>
</tr>
<tr>
<td>Total profits allocated to the PE</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Applying the profit split method in cases in which the construction PE performs SPF other than routine services seems to be appropriate for profit allocation at arm’s length, and is accepted in the domestic law of some countries, such as Germany. One should keep in mind that profit splitting factors are important in computing the arm’s length profit in highly integrated business operations between the head office and the PE, as they reflect key contributions to value in relation to the transaction or dealing concerned. There should be sufficient reliable information to prove that such method is the most appropriate.

5. Conclusion

The concept of PE has long been a solid pillar of the international tax community, establishing a taxing right over income derived from a foreigner’s undertaking. There are schemes exploited by multinational enterprises to avoid constituting a PE in the source state. One of them is splitting up contracts relating to a construction project, so that each lasts less than twelve months. As a result of this, the project would not be taxed in the state where activities are performed and income is generated. BEPS Action 7 dealt with this issue. However, it is up to domestic legislation and local tax authorities to make use of the anti-avoidance rule.

Despite extensive work on PE, there are no specific guidelines on how to attribute profit to a construction PE under article 5(3). The two-step AOA will be applied in attributing profits to a construction PE. The core of the AOA is to conduct a functional analysis in which the PE is hypothetically a separate and independent entity, so that transactions between the PE and its head office are priced in accordance with the arm’s length principle.

The determination of which transfer pricing method will be most appropriate depends heavily on the SPF performed by the PE. As shown in the case studies, if the construction PE merely performs routine services, the cost-plus method is wholly appropriate for calculating profits attributable to the PE. If the PE undertakes other significant people functions, however, other methods will be more suitable, such as the profit split method for functions in relation to unique and valuable intangibles.

84. This equation derives from the expenses related to the unique and valuable intangible incurred by the head office or PE divided by the total expenses.
85. Van der Ham et al., supra n. 57.
86. OECD/G20, Guidance on Profit Split Method, supra n. 76, at sec. C.5.1, para. 2.169.