Attribution of Profits to Permanent Establishments: The 2008 Article 7 versus the 2010 Article 7 of the OECD Model Tax Convention

This article compares the 2008 article 7 with the 2010 article 7 of the OECD Model Tax Convention, illustrates the similarities and differences using a case study and briefly deals with the implementation of the 2010 article 7 in the double tax treaty network of Switzerland, Germany and Austria.

1. Introduction**

1.1. Objective of this article

In July 2010, the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD) introduced a new article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model) with corresponding Commentary. The revision of article 7 on “Business Profits” and the guidelines provided for in the 2010 Report on the Attribution of Profits to Permanent Establishments, constituted a further step in a number of years’ work dedicated to the concept of profit allocation to permanent establishments. In practice, the principles set out in article 7 of the OECD Model left room for diverging interpretations and the Committee was aiming at more consistency, especially through implementation of the “Authorized OECD Approach” (AOA).

1.2. Supporting material used

A key source to assist with the interpretation of article 7 is the OECD Commentaries on the Articles of the Model Tax Convention (“2008 Commentary on Article 7” and “2010 Commentary on Article 7”).

1.2.1. Report on Attribution of Profits to Permanent Establishments

Further guidance to the analysis of article 7 can be found in discussion drafts and reports wherein the OECD articulated a preferred approach to the attribution of profits to permanent establishments. A final Report on the Attribution of Profits to Permanent Establishments (2008 Report) aggregating the OECD’s views was released in 2008.

The Committee found that the 2008 Report’s conclusions called for a revision of article 7. Further work was undertaken which resulted in the new wording of article 7 of the OECD Model in 2010. In addition, a 2010 Report on the Attribution of Profits to Permanent Establishments (2010 Report) was published to assist with the implementation of article 7. The 2008 and 2010 reports provide further insight into the rationale underlying the changes made to article 7.

1.2.2. OECD Base Erosion and Profit Shifting

The OECD Base Erosion and Profit Shifting (BEPS) initiative endorsed by the G20 Finance Ministers refers to “tax planning strategies that exploit gaps and mismatches in tax rules to make profits disappear for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.” OECD and G20 countries have developed a package providing for 15 Actions by which profits will be taxed where economic activity and value creation occur.
OECD BEPS Action 7 called for a review of the definition of a permanent establishment to prevent the use of certain common tax avoidance schemes used to circumvent the existing definition via the use of commissionaire arrangements. Furthermore, Action 7 aims at preventing the exploitation of specific exceptions to the permanent establishment definition currently provided for in article 5 (4) of the OECD Model, in particular those referring to activities of “preparatory and auxiliary” nature. Reference is also made in this article to recent developments within the OECD as part of the OECD BEPS package.

1.2.3. OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) provide guidance on the application of the arm’s length principle between associated enterprises as stipulated in article 9 of the OECD Model. In 2010, an updated version of the OECD Guidelines was published, which supplemented chapters I-III with a new guidance on the selection of the most appropriate transfer pricing method and on ways to conduct a comparability analysis. Furthermore, a new chapter IX dealing with transfer pricing aspects of business restructurings was added.

Further amendments to the OECD Guidelines were made as part of the OECD BEPS package, especially by Actions 8-10 “Aligning Transfer Pricing Outcomes with Value Creation”, and Action 13 “Transfer Pricing Documentation and Country-by-Country Reporting”. Article 7 of the OECD Model will also be analysed with a view to the principles set out in the OECD Guidelines.

1.3. Means of interpretation

The analysis will draw from the following means of interpretation:
- the wording of article 7 (2008 and 2010);
- the rationale underpinning article 7 (2008 and 2010) as reflected in the accompanying commentaries and reports; and
- the function of article 7 (2008 and 2010) in a broader double taxation context (teleological interpretation).

2. Comparison of the 2008 and 2010 article 7

The OECD Model forms the basis of an extensive network of bilateral income tax treaties amongst OECD member states and non-OECD countries. Since 1927, a number of model tax conventions were introduced, which included a concept of profit attribution to permanent establishments. The OECD recognized that there were diverging interpretations and a need for a more aligned approach. In February 2001, a Discussion Draft on the Attribution of Profits to Permanent Establishments was published, including a first proposal for a two-step approach (i) to analyse the activities and conditions of a hypothesized distinct and separate enterprise and (ii) to determine the profits based on a comparability analysis.

In 2006, the OECD released the Report on the Attribution of Profits to Permanent Establishments (2006 Report) which was a revised version of previous discussion drafts. In July 2008, the OECD Council approved the 2008 Report together with a new Commentary on Article 7 of the OECD Model. In order to fully implement the conclusions of the 2008 Report, the Committee decided to draft a new 2010 article 7, together with the corresponding Commentary and a new 2010 Report.

In the 2010 version of article 7 (Business Profits), paragraphs 1 and 2 have been amended and a new paragraph 3 has been supplied. Paragraphs 3 to 6 of the 2008 article 7 have been eliminated whilst paragraph 4 of the 2010 article 7 (formerly paragraph 7 of the 2008 article 7) remained unchanged.

2.1. Wordings of article 7(1)

The 2010 version of article 7(1) reads as follows:

Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

The 2008 version, marked-up for the 2010 changes, reads as follows:

The 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.

11. The Final Report of OECD BEPS Action 7 mandated follow-up work to develop additional guidance on the issue of attribution of profits to permanent establishments. A Discussion Draft was issued to solicit comments until 5 Sept. 2016.
12. The practical guidance of the OECD to the arm’s length principle goes back to 1976. Since then, the OECD continuously revised and updated the guidance in order to reflect the changes and the challenges of the economy.
17. OECD Discussion Draft on the Attribution of Profits to Permanent Establishments: Part I (General) and Part II (Banks) (OECD 2001).
18. OECD Report on the Attribution of Profits to Permanent Establishments, Parts I (General Considerations), II (Banks), III (Global Trading), International Organizations’ Documentation IBFD.
19. Added words are marked underlined; deleted words appear strikethrough.
2.1.1. Permanent establishment

The notion of a permanent establishment is set forth in article 5 of the OECD Model. The basic principle for the allocation of taxing rights to the contracting states in both the 2008 and 2010 versions of article 7(1) is that the profits of an enterprise in one contracting state shall not be taxed in the other state unless the enterprise carries on business in that state through a permanent establishment situated therein. This “reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.”

In both the 2008 and the 2010 versions of article 7(1), this basic rule remains unchanged.

2.1.2. Allocation of profits/losses

The revised wording of the 2010 article 7(1) clarifies certain aspects of the allocation of profits and, especially, of losses to the permanent establishment. The first approach to the allocation of profits to permanent establishments was set forth in the 2006 Report. This concept, referred to as the “relevant business activity approach”, defined the profits of an enterprise as “referring only to the profits of the business activity in which the permanent establishment has some participation.”

Under the “relevant business activity” approach, the 2008 article 7(1) imposed a limit on the profits that could be attributed under the 2008 article 7(2) to a permanent establishment: the attributed profits could not exceed the profits that the enterprise earned from the relevant business activity. The phrase “only so much of them” in the 2008 article 7(1) could also be interpreted as meaning that until the enterprise as a whole realized profits, the permanent establishment state may not tax any; that is, if the enterprise was in a loss position, no profits could be taxed in the permanent establishment state. By striking these words the 2010 article 7(1) made it clear that such an interpretation was not intended. Furthermore, by referring to paragraph 2 and striking the words “of the enterprise”, the 2010 article 7(1) outlines that it does not intend to allocate all profits to the permanent establishment, either.

2.1.3. Force of attraction

The 2008 and 2010 Commentaries on Article 7 note that the “force of attraction” principle has been rejected in the internal tax treaty practice. “Force of attraction” means that the contracting state where the permanent establishment is located extends its taxation rights to profits (i) which the enterprise may derive from that contracting state, and (ii) which are not attributable to the permanent establishment located therein. This second principle underlying article 7(1) did not change with the revision.

2.2. Words of article 7(2)

The 2010 version of article 7(2) reads as follows:

For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The 2008 version, marked-up for the 2010 changes, reads:

For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits which it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

2.2.1. Arm’s length principle

The language of the second part of article 7(2) stems from the draft convention adopted by the League of Nations in 1933 and is known as the arm’s length principle in the context of permanent establishments.

The arm’s length principle is set forth in article 9(1) of the OECD Model.

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22. Id., at para. 62.
24. OECD Discussion Draft on a new Article 7 (‘Business Profits’) of the OECD Model Tax Convention para. 15, 7 July to 31 December 2008, OECD. 2010 Report, supra n. 2, at para. 3: “It should be noted that under the authorised OECD approach, the same principles should be applied to attribute losses as to attribute profits. References to attributing ‘profits’ should therefore be taken as applying equally to attributing losses.”
26. Added words are marked underlined; deleted words appear strike through.
27. “… if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
29. Art. 9(1) OECD Model (2008), supra n. 3 and art. 9(1) OECD Model (2010), supra n. 1: “Where … 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.”

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By adding the terms “...functions performed, assets used and risks assumed...”, the 2010 article 7(2) is more aligned with the OECD Guidelines.

2.2.2. Authorized OECD Approach

In July 2008, the OECD Council instructed the Committee on Fiscal Affairs to prepare a new article 7 to allow for the full implementation of the “Authorized OECD Approach” (AOA) in future treaties. The AOA was developed to reflect the preferred approach to the attribution of profits to permanent establishments. The 2010 update revised the Commentary to introduce parts of the new AOA that are not in conflict with the 2008 text of article 7.

The AOA aims at aligning the tax treaty rules under article 7 for business profits with the transfer pricing rules outlined in article 9 of the OECD Model and the OECD Guidelines. “It does so by allocating profits between different parts of the enterprise under the fiction that permanent establishments are separate and independent entities to which the arm’s length standard applies” (“functional separate entity approach”). A permanent establishment does not enter into legally binding contracts with its head office. Therefore, the fiction views (i) the permanent establishment as a separate enterprise which (ii) acts independently from its head office or from any other part of the enterprise. The profit of this fictional separate and independent enterprise has to be determined under the arm’s length principles according to article 9 of the OECD Model.

The 2010 Report interpretation of article 7(2) is that under the AOA a two-step analysis is required in which first a functional and factual analysis is conducted in accordance with the OECD Guidelines. The two-step analysis is required to determine the arm’s length remuneration for any given transaction or dealing between the permanent establishment and other parts of the enterprise:

Step 1: Hypothesizing the permanent establishment as a separate and independent enterprise through a functional and factual analysis.

Step 2: Determining the profits of the hypothesized separate and independent enterprise based upon a comparability analysis.

The OECD Guidelines equally make reference to the functional separate entity approach and apply this principle: “OECD member countries have chosen this separate entity approach as the most reasonable means for achieving equitable results and minimising the risk of unrealised double taxation.” The separate and independent enterprise fiction as stated in the 2008 article 7(2) has also been applied according to the 2008 Commentary, but less strictly. With the revision of the 2008 article 7(2), “a shift from restricted independence to absolute (hypothetical) independence takes place.”

With the recent development of OECD BEPS, the AOA needs to be applied with a view to the revised OECD Guidelines developed under OECD BEPS Actions 8-10 and in particular with the revision of chapter I of the OECD Guidelines which illustrates how to perform a comparability analysis.

2.2.3. Recognition of dealings

A major difference to the 2008 article 7(2) lies in the explicit 2010 article 7(2) reference to dealings: “Deals refers to a change in functions, economic ownership of assets and/or risks, within one and the same enterprise, contrary to transactions with other enterprises.” The 2010 Commentary on Article 7(2) clearly states that the principles outlined in the OECD Guidelines for transactions between associated enterprises will be applied by analogy to dealings between the permanent establishment and its head office. The analogy equally applies with regard to dealings of a permanent establishment with other parts of the enterprise. With the application of the full AOA, the 2010 article 7(2) goes further in the recognition of intra-enterprise dealings than the 2008 article 7.

2.2.4. Notional charges

Some states consider treating permanent establishments in the same way as subsidiaries, e.g. notional charges for dealings, deducted from the profit attributed to the permanent establishment, should be treated as payments from the permanent establishment to the head office.

The 2010 Report clearly notes that such notional payments are only relevant for the attribution of profits and “should not be understood to carry wider implications as regards withholding taxes.” This also follows from the introductory wording of the 2010 article 7(2), which states that it

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30. The development of the AOA started in 1998 and was originally conceived for attributing profits to permanent establishments in the financial sector. With the publication of the 2008 Report, supra n. 6, the AOA was amended so as to have general application.

31. supra para. 7.


33. Id., at p. 327.

34. 2010 Report, supra n. 2, at para. 10.

35. With the AOA, the concept of “significant people functions” was introduced, to differentiate the assumption of risks and relevant economic ownerships of assets in different business sectors. 2008 Report, supra n. 6, at para. 19. 2010 Report, supra n. 2, at para. 16.

36. For further details and guidance on the application of the AOA, reference is made to the 2010 Report.
applies, "[f]or the purposes of this Article and Article 23A [23B] ...".45

The Committee on Fiscal Affairs observes that only very few member countries provide in their domestic law for source taxation of notional charges and the Committee will observe this issue further.46

2.2.5. Methods for eliminating double taxation

The 2010 article 7(2) introduced a reference to articles 23A and 23B which describes the methods for eliminating double taxation. These articles only refer to the avoidance of juridical double taxation, i.e. the taxation of the same income in both contracting states.47 This will be done through either the exemption method (article 23A) or the credit method (article 23B).

There may be cases where differences in the domestic laws of two contracting states (e.g. regarding depreciation rates, timing of recognition of income, restrictions on the deductibility of certain expenses, etc.) result in different amounts of taxable income in each state, even though the profits attributable to the permanent establishment will be calculated based on the same principles as outlined in paragraph 2.48

2.3. Wordings of 2010 article 7(3)

In the 2010 version, a new article 7(3) has been supplied, which reads:

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

The new wording of the 2010 article 7(3) sets forth the principle of corresponding adjustments. The same rule applies under the arm’s length principle between associated enterprises in article 9(2) of the OECD Model.49 With this, the arm’s length principle and the OECD Guidelines for associated enterprises will be applied by analogy to dealings between permanent establishments and their head office.

The 2010 Commentary on Article 7(3) notes that contracting states should not make adjustments to profits on a different arm’s length basis, if they agree that the attribution of profit to the permanent establishment was made in the same manner in both contracting states and in line with the principles of the 2010 article 7(2).50 This accords with the OECD Guidelines.51

There may be cases where despite the use of the principles outlined in the 2010 article 7(2), double taxation arises. Paragraph 3 is targeted at situations where one contracting state has adjusted the taxpayer’s non-arm’s length profit to an arm’s length amount. In this case, the other contracting state should make a corresponding adjustment to the tax payable in such other contracting state.52

“The goal of the 2010 update to the Model is to ensure that the combination of Articles 7, 23 and 25 will guarantee that all cases of double taxation under Article 7 are eliminated.”53

Where a taxpayer claims that the taxation by one or both contracting states is not in line with these provisions, the mutual agreement procedure pursuant to the 2010 article 25(1) or if necessary, arbitration under the 2010 article 25(5), is available.

The OECD BEPS package – besides other action items – also contains Action 14 on “Making Dispute Resolution Mechanism More Effective.”54 The measures developed in the report aim at strengthening the effectiveness and efficiency of the mutual agreement procedures. The minimum standards defined in Action 14 require members to enact clear rules, guidelines and procedures on accessibility and use of such procedures.55

2.4. Elimination of 2008 articles 7(3)-(6)

As part of the revision of article 7, paragraphs 3-6 of the 2008 article 7 were deleted as obsolete.

2.4.1. The 2008 article 7(3)

The 2008 article 7(3) referred to the allowance of expenses for purposes of the permanent establishment, whether incurred in the State of the permanent establishment...

45. G. Kofler & S. van Thiel, supra n. 32, at p. 331.
47. Para. 1 OECD Model: Commentary on Article 23 (2010).
49. Art. 9(2) OECD Model (2008) and art. 9(2) OECD Model (2010): “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 Contracting State has been charged to tax 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 determining such 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.”
50. Para. 31 OECD Model: Commentary on Article 7 (2010).
51. OECD Guidelines, at para. 3.60: “If the relevant condition of the controlled transaction (e.g. price or margin) is within the arm’s length range, no adjustment should be made.”
52. M. Bennett, supra n. 23, at p. 30.
53. Id.
55. The implementation of treaty-related OECD BEPS measures into existing bilateral tax treaties will be conducted through a multilateral instrument as outlined under OECD BEPS Action 15: OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15 Final Report, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), International Organizations’ Documentation IBFD, also available at http://dx.doi.org/10.1787/9789264241688-en. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting will transpose the results from the OECD BEPS initiative into more than 2,000 tax treaties worldwide.
or elsewhere. This paragraph was deleted as it could have been misinterpreted as an exception to the arm's length principle in the sense of limiting the deductibility of certain charges. The paragraph was also redundant as the “functional separate entity approach” under 2010 article 7(2) requires the allocation of expenses to the permanent establishment in any event. Under the previous approach, a portion of the general administrative expenses of the enterprise was allocated to the permanent establishment on a cost basis. Allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. By contrast, the 2010 view is that article 7(2) is explicit enough to distinguish cases where an arm’s length mark-up is reasonable from cases where only an attribution of actual expenses is appropriate. A deduction of an arm’s length charge for the dealings whereby the head office performs functions for the benefit of the permanent establishment (or vice versa) is required according to the 2010 article 7(2), rather than a deduction limited to actual expenses only.

2.4.2. The 2008 article 7(4)

Paragraph 4 referred to the practice of certain states to allocate profits to a permanent establishment using an apportionment method based upon various formulae. This method was considered acceptable when (i) it was customary in a contracting state, and (ii) the results were in line with the principles outlined in article 7. The Committee decided to remove this paragraph in the 2010 OECD Model as its application had become very exceptional and it would be difficult to ensure that the results of this method are consistent with the arm’s length principle.

2.4.3. The 2008 article 7(5)

This paragraph made reference to the 2008 article 5(4) and activities carried on through a fixed place of business which were insufficient as such to create a permanent establishment. The Commentary noted that the purpose of the paragraph was to ensure that purchasing functions for a head office did not increase the profits to be allocated to a permanent establishment. The Committee decided to remove this paragraph as it was not considered consistent with the arm’s length principle.

2.4.4. The 2008 article 7(6)

The 2008 article 7(6) stated that for the attribution of profits, the same method shall be applied every year unless there is sufficient reason to change this. The rationale underlying the paragraph was to avoid changes in the method used for the allocation of profits from one year to the next one in an opportunistic way. The 2008 article 7(6) was meant to ensure a continuous and consistent tax treatment. This paragraph was deleted as the AOA no longer allowed for various methods (e.g. apportionment methods), which obviated the need for a consistency requirement as previously imposed by the 2008 article 7(6).

2.5. The 2010 article 7(4) and the 2008 article 7(7)

The 2010 article 7(4) and the 2008 article 7(7) are identical:

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.

2.5.1. The term “profit”

The term “profit” has not been defined in article 7 of the OECD Model, neither in the 2008 nor the 2010 version. It is commonly understood, though, that the term has a broad meaning. It may include all income derived from carrying on an enterprise. Uncertainties may arise on how to treat income dealt with in other articles of the OECD Model.

2.5.2. Rule of interpretation

The 2010 article 7(4) and the 2008 article 7(7) set forth a “rule of interpretation” that ensures that other articles of the OECD Model applicable to specific categories of income will take precedence over article 7, e.g. article 10 (dividends), article 11 (interest), and article 12 (royalties). It follows from this rule that only business profits not belonging to one of the categories of income will

56. Art. 7(3) OECD Model (2008): “In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.”
57. M. Bennett, supra n. 23, at p. 31.
59. Para. 27 OECD Model: Commentary on Article 7 (2008), supra n. 4.
60. H. Pijl, supra n. 38, at p. 49.
61. Id., at p. 48.
62. Art. 7(4) OECD Model (2008): “Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”
63. Para. 41 OECD Model: Commentary on Article 7 (2010).
64. Art. 7(5) OECD Model (2008): “No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.”
67. Art. 7(6) OECD Model (2008) and art. 7(6) OECD Model (2010): “For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.”
68. Para. 42 OECD Model: Commentary on Article 7 (2010).
69. Para. 75 OECD Model: Commentary on Article 7 (2010): Contracting States may wish to agree bilaterally on a definition.
70. Paras. 71 and 72 OECD Model: Commentary on Article 7 (2010).
71. Reference is made back by these articles to the 2008 and 2010 art. 7. e.g. OECD Model, supra n. 1, art. 11(4) for interests: “The provisions of paragraphs 1 and 2 of article 11 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”
3.1. Article 7(1)
The 2010 article 7(1) and the 2008 article 7(1) define the taxation rights and apply the same principle: State R has the right to tax the profits of Company A, unless Company A carries on business in another state through a permanent establishment. Article 5 sets forth the criteria to decide if a permanent establishment exists. Assuming that (i) the manufacturing site in State S qualifies as permanent establishment under the R/S double tax treaty and (ii) the domestic law of State S provides for the taxation of such profits, article 7(1) (as implemented in the double tax treaty) determines whether State S may tax the profit of the permanent establishment in State S.

Both states determine the profit attributed to the permanent establishment by deeming it an independent and separate entity. State S levies income tax and State R grants relief from double taxation (either exemption or credit method). There is no difference in the general rule of taxation rights under the 2008 and the 2010 article 7(1) so far.

The 2008 article 7(1) left room for an interpretation in which the profit allocated to the permanent establishment could not exceed the profit of the enterprise. In the example, this would limit the profit attributable to the permanent establishment to USD 10 million in year 1. In year 2 there could be no attribution of profits to the permanent establishment given that the enterprise as a whole recorded a loss. The wording of the 2010 article 7(1) does not allow for such interpretation anymore, i.e. the profit allocation to the permanent establishment may exceed USD 10 million in year 1 and may even lead to a taxable profit in year 2.

3.2. Article 7(2)
In contrast to the 2008 article 7, the full implementation of the AOA requires a factual and functional analysis in a two-step approach, in order to (i) identify the functions of the permanent establishment and attribute risks, assets, and free capital to it, and (ii) identify dealings between the permanent establishment and its head office.

Applying the first step, the functional and factual analysis identifies the economically significant activities and responsibilities of the permanent establishment. In the case outlined above, this may result in the following characterization of the permanent establishment in State S:

- manufacturer;
- beneficial owner of intellectual property (i.e. developed and owns trade intangibles such as technical know-how);
- distributor for the local market in State S; and
- service provider for purchasing/sourcing functions.

Under the second step, the remuneration of any dealings between the hypothesized separate entities is determined by applying article 9 and the OECD Guidelines, respectively, by analogy.

The 2010 article 7(2) goes further in implementing the AOA by taking into account not only transactions of the permanent establishment with other parts of the enterprise, but also dealings between the permanent establishment and its head office. The following dealings may be identified for the case at hand:

- manufacturing;
- provision of technical know-how for the benefit of Company A (and the group);
- receipt of administrative services from Company A (head office);
- provision of purchasing/sourcing functions for Company A (head office);
- receipt of marketing services from affiliate B in State T.

For these dealings, a transfer pricing method will be applied according to the principles set out in the OECD Guidelines.

The permanent establishment will be deemed entitled to an appropriate remuneration for providing purchasing/sourcing functions. Conversely, the permanent establishment will be deemed to incur an appropriate service charge including a mark-up for the receipt of administrative and marketing services from affiliate B.

Also, a notional royalty may be attributed to the permanent establishment for the use of the IP developed and not only from the head office but also from other entities within the group using the technology.\(^{76}\)

\(^{72}\) Para. 74 OECD Model Commentary on Article 7 (2010).
\(^{73}\) The manufacturing site produces spare parts in high quality at low price. The technical know-how for the production process has been developed by the manufacturing site located in State S.

\(^{74}\) Either Fully Fledged, Contract or Toll Manufacturer

\(^{75}\) In case of Contract or Toll Manufacturing on behalf of Company A in State R.

\(^{76}\) Some countries may levy withholding tax on the royalties by interpreting the 2008 art. 7. With respect to the 2010 art. 7, this is denied according to the 2010 Report, supra n. 2.
3.3. Article 7(3)

The newly introduced 2010 article 7 in combination with articles 23A (exemption method) and 23B (credit method) ensures that there is no unrelieved double taxation of the profits attributed to the permanent establishment and its head office. However, the contracting states may not always reach a common understanding of the application of the 2010 article 7(2).

In the case described above, State S may attribute a notional royalty of 2% on sales (i.e. USD 2 million in year 1) to the permanent establishment of Company A based on a comparability analysis, in line with the documentation provided by the taxpayer.

By contrast, the domestic law of State R may recognize an arm’s length rate of 1% only. If so, the tax authorities in R will adjust the amount of tax payable in State R upon reducing the amount of the exemption (article 23A) or the credit (article 23B) claimed by Company A with respect to the profits attributable to the permanent establishment.

In that situation, since the price of the same dealing will be determined as USD 2 million in State S and USD 1 million in State R, profits of USD 1 million may be subject to double taxation. The 2010 article 7(3) addresses the situation by requiring State S, inasmuch as there is indeed double taxation and the adjustment made by State S is in line with the 2010 article 7(2), to make a corresponding adjustment to the tax payable in State S. In case State S does not agree to the adjustment, mutual agreement procedures are available to resolve the issue.

3.4. 2008 articles 7(3)–(6)

While the 2008 article 7(3) allowed for the deduction of certain expenses incurred for purposes of the permanent establishment, an arm’s length price for the provision of services will be considered appropriate. As such, administrative services rendered by the head office for the permanent establishment will be remunerated without being limited to costs incurred by the head office.

Under the 2008 article 7(4), an allocation of the profits according to an apportionment method was allowed as long as the outcome was in line with the 2008 article 7(2), e.g. allocation of profits to the permanent establishment based on sales or on expenses for personnel retained by the permanent establishment.

In case the permanent establishment purchases goods for its head office, under the 2008 article 7(5), no profit could be attributed to the permanent establishment. With the deletion of the 2008 article 7(5) and the full implementation of the AOA, a factual and functional analysis is required and purchasing functions will be remunerated based on a comparability analysis.

The 2008 article 7(6) required consistency of the methods used for the attribution of profits to permanent establishments. Under the 2010 article 7, a factual and functional analysis will be made on a yearly basis and will determine the attribution of profits taking into account changes in functions, assets and risks.

3.5. The 2010 article 7(4) and the 2008 article 7(7)

Categories of income covered by other articles of the OECD Model take precedence over article 7, e.g. interests, dividends or royalties. The notional royalty attributed to the permanent establishment in State S will be covered by the 2008 and 2010 article 12 “Royalties” of the OECD Model. Both the 2010 article 7(4) and the 2008 article 7(7) apply the same principle.

4. Implementation of Article 7 in Double Tax Treaties

With the revision of article 7, the Committee on Fiscal Affairs of the OECD advised that the new wording should be used when negotiating future treaties and amending existing ones. The double tax treaties of Switzerland, Germany and Austria will be analysed with respect to the implementation of the 2010 article 7.

4.1. Switzerland

Switzerland has signed 53 double tax treaties, 47 of which are in force and effect. Switzerland’s treaties with the following nations reflect the wording of the 2010 article 7:

- Cyprus;
- Hungary;
- Iceland;
- Liechtenstein; and
- Slovenia.

4.2. Germany

Germany has entered into double tax treaties with 96 nations. The 2010 article 7 has been included in the double tax treaties with the following countries:

- Ireland;
- Liechtenstein;
- Luxembourg; and
- the Netherlands.
4.3. Austria

Austria has entered into double tax treaties with 91 nations, but has not yet implemented the wording of the 2010 article 7 in any double tax treaty.82

4.4. Other countries

The above findings regarding the treaty network of Switzerland, Germany and Austria are in line with the observation made under OECD BEPS Action 7, that "relatively few treaties currently include the new version of Article 7 which was included in the OECD Model in 2010."83

5. Summary and Conclusions

The revision of article 7 to its 2010 version represents a further step in the OECD’s efforts to ensure a consistent approach in the attribution of profits between a permanent establishment and its head office. A full “Authorized OECD Approach” was introduced which brought about a closer alignment to the arm’s length principle, so as to treat a permanent establishment as a hypothetical separate and independent enterprise, and to attribute profits by applying the OECD Guidelines by analogy.

Provisions entailing a risk of deviations from the arm’s length principle were eliminated. There was a broad consensus that under the AOA only paragraphs 1, 2 and 3 were required to determine the attribution of profits to a permanent establishment.

The analysis of the 2010 article 7 in the network of the double tax treaties of Switzerland, Germany and Austria shows that the new wording has been implemented in only a few renegotiated double tax treaties thus far. This is in line with the observation made by OECD BEPS Action 7 “Preventing the Artificial Avoidance of Permanent Establishment Status”.84

A Discussion Draft was issued in July 2016 to solicit comments on the application of Article 7 to determine the attribution of profits to permanent establishments by 5 September 2016.85

Austria has entered into double tax treaties with 91 nations, but has not yet implemented the wording of the 2010 article 7 in any double tax treaty.82


83. OECD Additional Guidance on Attribution of Profits to Permanent Establishments – Action 7 Public Discussion Draft para. 15, OECD/G20 Base Erosion and Profit Shifting Project (OECD 4 July – 5 Sept. 2016), International Organizations’ Documentation IBFD. Furthermore, a number of OECD and non-OECD countries have “expressly stated their intention not to include the new version of Article 7 in their treaties”.

84. OECD, Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7 Final Report, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), International Organizations’ Documentation IBFD. Furthermore, a number of OECD and non-OECD countries have “expressly stated their intention not to include the new version of Article 7 in their treaties”.

85. OECD Additional Guidance, supra n. 83.