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THE CHALLENGES OF PERMANENT ESTABLISHMENT CONCEPT AND THE RESPONSE OF BEPS ACTIONS

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Table of Contents

1. Introduction

I was already interested in tax issues which are related to cross-border economic transactions at Eötvös Loránd University of Budapest in Hungary, thus after graduation, I have decided to pursue the program of International Business Taxation at Tilburg University. In course of that program I realized how important role the bilateral double taxation conventions (hereafter: DTC) play in the field of international tax law: they serve as main tools to eliminate international juridical double taxation as well as double non-taxation.

I had the opportunity to get insight of the practical importance and application of the law of DTCs at the international tax service department of Ernst & Young. Multinational enterprises pay particular attention (and money) to operate in a structure which is the most beneficial for them from a tax point of view. They strive to achieve that result with legal measures without fraud or abuse of law. A potential scandal regarding tax avoidance or tax evasion may cause a huge loss of prestige for multinational enterprises which often qualify as world-wide known brands. When the tax advisor plans and implements the most advantageous tax structure tailored to the multinational enterprise concerned, he or she must also take into account the treaty network of the countries (the number and content of DTCs concluded by a given country) which are essential factors of international tax planning.

The topic of my thesis is linked to one of the segments of law of DTCs, namely to the allocation of taxing rights of business profits. I focus on the provisions laid down in OECD Model Convention with Respect to Taxes on Income and on Capital (hereafter: OECD MC) and in its Commentary. There are several reasons for doing so: first of all, the vast majority of bilateral DTCs have been concluded on the basis of the OECD MC, moreover the BEPS Actions in connection with the permanent establishment entails the modification and amendment of the OECD MC and its Commentary. As a consequence these documents are most relevant for my research.

1.1. Research question and structure of the thesis

The allocation of taxing rights between the states with respect of business profits is a very complex activity. The central notion of the allocation rules is the permanent establishment (hereafter: PE). This concept could already be found in the model convention worked out by the League of Nations in 1945.[1] However, the concept has been modified several times, the core elements have not changed significantly despite the fact that new business models have been evolved due to the globalization. As the OECD MC and the DTCs were not able to catch up with new business strategies or only with delay, it created the possibility for multinationals to make use of these shortcomings and avoid taxation. The increase of the volume of that

[1] Lara Friedlander, Scott Wilkie: Policy Forum: The History of Tax Treaty Provisions-And Why It Is lmportant To Know About It, p 914, In: http://www.uni-heidelberg.de/institute/fak2/mussgnug/historyoftaxdocuments/schrifttum/aufsaetze/AUFS00020.pdf

phenomenon challenged the countries which recognized that tackling tax avoidance of enterprises operating across borders is only possible with international cooperation. Under the aegis of OECD and G20, more than 100 participating countries (which means that also non-OECD member states are included)[2] have developed the BEPS-project (Base Erosion and Profit Shifting) which contains comprehensive measures to preclude abusive practices. The prevention of tax avoidance relating to PE is one of the central targets of the BEPS package. The countries of the project endeavor to achieve this aim by means of modifying and amending the underlying provisions of OECD MC and its Commentary.

My research question is whether the BEPS Actions addressing the PE concept are reasonable, eligible and effective to preclude abusive practices of multinationals. The above-mentioned three adjectives cover three layers of the same issue: the term ‘reasonable’ refers to the question whether the practice of multinationals is indeed abusive and conflicting with the rationale and aim of PE provisions. The word ‘eligible’ is about the examination whether the BEPS Actions (i.e. material changes in OECD MC and its Commentary regarding PE definition) are appropriate measures to prevent the real or deemed abuse of multinational companies. Under the term ‘effective’, I will scrutinize the opportunities of implementation of the changes in a way which is binding to States.

In order to provide a well-established answer, the following aspects of PE rules will be dealt with in my thesis: after the presentation of the general outline of double taxation as well as the role and legal status of OECD MC and its Commentary in Chapter 2, in Chapter 3 I will demonstrate firstly the aim of PE provisions and show the importance that the PE rules to be applied in accordance with their aims. Secondly, the current PE concept of OECD MC and the shortcomings of it will be examined. After that, in Chapter 4, I am going to present the measures within the framework of BEPS Actions which tackle the current problems of PE provisions. Within this chapter I will address the reasonable and eligible prongs of these measures. As far as the sub-question of effectiveness is concerned, the BEPS measures in question will be implemented by virtue of modification of OECD MC and its Commentary which means that the new or modified provisions will be put into the updated version of these documents. The question may arise whether these amendments will be ab ovo applicable to the already existing DTCs or they must also be included into the bilateral treaties. In the latter case, the question arises whether every single DTC must be renegotiated or it is possible to modify thousands of DTCs by means of signing a multilateral agreement. This essential question which I am going to discuss in Chapter 5, belongs to the field of public international law. The success of BEPS Actions strongly depends on this issue, too: BEPS Actions may provide a good answer to abusive practices at a theoretical level, although without the quick realization and transposition into the legally binding DTCs, the project will not be able to achieve its aim. Therefore, a complete answer to the research question requires

[2] About BEPS and the inclusive framework, Available at: http://www.oecd.org/tax/beps/beps-about.htm

an interdisciplinary approach, meaning that the BEPS Actions have to be examined not only from a tax law point of view, but also from that of international law. The latter one determines the practical applicability of the measures laid down in BEPS Actions. The issue of legal status of the OECD MC and its Commentary - which discussion will form the part of Chapter 2 together with the general problem and causes of double taxation and the presentation of short history and role of OECD MC and its Commentary – also entails an international public law analysis. In Chapter 6, I will summarize the main findings in connection with the research question.

1.2. Delimitation

The OECD MC contains rules for allocation of taxing rights of business profits in several articles: after having determined that a PE exists in a country based on Article 5 OECD MC, one must calculate which part of the profit of the enterprise is attributable to the PE under Article 7. Following the profit attribution, the state of residence has to grant a relief for that proportion of the worldwide income according to Article 23 A or 23 B. Although Article 7 and 23 are logically linked to the concept of PE, these provisions do not contribute to the solution of the research question, as a consequence they will not be dealt in a detailed way in the thesis.

Beside the OECD MC, other model conventions like the UN Model Convention exist, although they are out of the scope of the thesis. The reason of it is that the OECD MC is applied by the most of the countries including almost every developed countries and in addition, the BEPS Actions explicitly target the modification of OECD MC. It also must be noted that the model conventions do not depart from each other significantly, however the UN Model Convention puts greater emphasis on source taxation in order to ensure higher tax revenue for developing countries.[3]

I do not demonstrate the problems emerging from e-commerce and digital economy and the concept of so-called Digital PE. Although, I do deal with issues arising from e-commerce with respect of classical PE concept (e.g. warehousing activity can be part of the core business activity in case of an enterprise operating a web shop).

1.3. Methodology

In order to provide a comprehensive answer to my research question, I am going to examine the problem from a practical point of view, analyzing the current and contemplated wording of OECD MC and its Commentary, but I also consider the opinion of scholars and practical experts as well as some relevant rulings of national courts.

[3] Lang, Michael: Introduction to the Law of Double Taxation Conventions, Linde, Vienna, 2013, p. 32

2. Basic problem of double taxation

2.1. Notion of double taxation

Double taxation arises at international level when the same income is taxed by at least two different states. Within the category of double taxation, a distinction has to be made between juridical and economic double taxation. In case of economic double taxation, tax is imposed on the same economic transaction, income or capital, during the same period, either by the same state (domestic economic double taxation) or by two or more states (international economic double taxation), but at the hands of different taxpayers[4]. A typical example when economic double taxation occurs is the distribution of dividend from the profit of a company. The company is subject to corporate income tax on its profit, while the shareholders are subject to corporate income tax or personal income tax (depending on their personality) on their dividend income (which is derived from the already taxed profit of the company). As we can see, the profit of the company is taxed twice, but the subjects are different and the imposed taxes may differ.

International juridical double taxation emerges when comparable taxes are levied on the same taxpayer in respect of the same subject matter for identical periods in two or more states.[5]

Both types of double taxation have detrimental effects on trade and commerce. A relief from economic double taxation is out of the scope of DTCs (with the exception of transfer pricing rules in Article 9), this may be prevented by the operation of national corporate tax systems of the states.[6] The phenomenon of juridical double taxation hinders the efficient exchange of goods, international provision of services, furthermore, the movement of capital, technology and persons.[7] As opposed to economic double taxation, juridical double taxation occurs almost always in cross-border situations. As a result, it endangers the international economic relations between the countries by its disincentive effect on carrying on business at international level. The importance of removing the harmful impact of juridical double taxation has been recognized by the states as early as the first half of the 20th century in order to ensure the development of international economic relations.[8]

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[4] Kemmeren, E. C. C. M.: Principle of Origin in Tax Conventions: A Rethinking of Models, Pijnenburg, 2001, p. 14
[5] Ibid., p. 12
[6] Harris, Peter: Corporate Tax Law: Structure, policy and practice, Cambridge University Press, Cambridge, 2013, p. 239
[7] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Paris, Introduction, para. 1
[8] Ibid.

Elimination of double taxation can be implemented in several ways. First of all, the states can eliminate double taxation by virtue of unilateral measures. They put in place special rules in their domestic legislation according to which they relinquish to impose tax on items of income or capital which are already taxed in another state (source state i.e. where the income is derived or capital is invested/situated). These domestic rules, implemented by the states unilaterally, are similar to one of the subtypes of exemption and credit method. However, these rules are not capable to solve the problem of juridical double taxation as they do not cover completely the cases of juridical double taxation and in addition the cases concerned are qualified different manners by the states.[9]

Double taxation may also be prevented on a bilateral basis. The two Contracting States conclude a DTC in which they agree upon the allocation of taxing rights relating to the types of income and capital. As a consequence, the conflict of the different domestic laws is eliminated, although other problems may arise: on the one hand, the Contracting States may disagree upon the interpretation of their DTC, on the other hand, the different DTCs may differ from each other substantially, and therefore the system of DTCs may become chaotic. The latter problem made it obvious that it is not possible and reasonable to lay down peculiar rules and solutions in different DTCs, but unified rules are required which can be applied by the states identically. This requirement led to the creation of model conventions.[10] These model conventions have been created under the aegis of international organizations, such as the UN and OECD, but later on, states with strong economic background established their own model conventions, the provisions of which reflect their peculiar convention policy, e.g. US Model Convention. The OECD MC has the strongest influence on the DTCs[11] concluded by states as the OECD includes most of the developed countries, but many countries which are not OECD Member States, also enter into DTCs based on OECD MC.

2.2. Causes of double taxation: collision of taxation principles

Juridical double taxation can be explained as the collision of international taxation principles. Taxation principles express the nexus between the tax subject and a given state on the basis of which the tax subject may be liable to tax in that state. This nexus is of a personal character in case of principle of residence (e.g. domicile, citizenship, incorporation, place of management etc.) while the connection is of an objective character in case of source principle: the taxpayer participates in the economic life of that country i.e. he derives income from there or has a certain item of capital situated therein. In the residence state, the taxpayer

[9] Vogel, Klaus: Double Tax Treaties and Their Interpretation, 4 Int'l Tax & Business Law. 1 (1986), Available at: http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil pp. 9-10

[10] Ibid. p. 10

[11] Siklósiné Antal Gyöngyi: Felülvizsgált modellegyezmény a jövedelem és a vagyon adóztatásáról, In: Adó, XXIX. Évfolyam, 2015/1-2. szám, p. 106

has full tax liability which means that tax is levied on the worldwide income of the taxpayer irrespectively of the source of it, meanwhile the source state imposes tax on items of income derived from its territory and capital situated therein (limited tax liability).[12] When these principles collide, i.e. more than one country retain its taxing rights in connection with the same item of income, then the item of income/ capital concerned will be taxed several times in the lack of special rules. Below, I present the possible collisions of taxation principles.

a) *Collision of residence principles*

   This sort of collision occurs when both Contracting States intend to impose tax on the worldwide income of the taxpayer because the taxpayer is considered as tax resident of both countries due to the domestic laws of the Contracting States. This problem is solved in Article 4 OECD MC: this provision provides so-called tie-breaker rules to determine in which country the taxpayer has residence for tax treaty purposes. The tie-breaker rule gives precedence to one of the countries' domestic rules. Although Article 4 provides straightforward provisions to solve the problem of dual residency, it is common that following the application of tie-breaker rules, the case will be changed to the collision of residence and source principle when the taxpayer derives income from the loser state (i.e. from the country which does not qualify as residence state according to Art. 4 for treaty purposes).[13]

b) *Collision of residence and source principle*

   In that case a taxpayer resident in one of the Contracting States derives income from the other Contracting State (source state) and as a result both States impose tax on the income from the source state. This situation is the starting point of OECD MC's allocation rules whose prerequisite is the existence of one resident state and one source state.

c) *Collision of source principles*

   This phenomenon emerges when the taxpayer is resident of neither the Contracting States, but both states intend to tax the taxpayer on income which derives from one of the states. An example for that case is when the taxpayer has a PE in one of the states (but it is a resident of a third country) and the PE generates income from the other Contracting State and this income is attributable to this PE instead of the headquarters or other PE of the taxpayer. However, these cases are out of the scope of OECD MC and DTCs concluded on the basis of OECD MC because these treaties are

[12] Simon István In: Pénzügyi Jog II. (szerk.: Simon István), Osiris Kiadó, Budapest, 2012, p. 500
[13] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Paris, Commentary on Articles 23 A and 23 B, preliminary remarks para. 4-4.1.

applicable only to persons who are resident in one or both of the Contracting States (Art. 1 OECD MC).

From the short summary above it can be seen that juridical double taxation in international economic life predominantly stems from the collision of residence and source principle. The OECD MC also takes this situation as a starting point and in order to solve that problem it contains two separate set of rules: one, which distribute the taxing rights between the Contracting States regarding the different items of income. These rules ensure either exclusive taxing rights for one of the Contracting States or recognize the taxing rights of both states however with limitations. The other type of rules entail provisions according to which the state of residence has to grant a relief in respect of the items of income taxed by the source state. These rules are laid down in the method article (Art. 23A and B OECD MC). The latter rules are applicable only if the distributive rules do not allocate exclusive taxing rights to the state of residence.

The allocation rules of OECD MC take as a default case that the state of residence has exclusive taxing rights in respect of the income of their resident taxpayer. Although it is not always the case and the items of income can be categorized into six groups on the basis of the taxing rights of the Contracting States.[14]

a) *Income may be taxed in the source state without restriction*
   For instance, income derived from immovable property situated in the source state or the attributable income to the PE situated in the source state belong to that category.

b) *Source state may tax the income, but its taxing rights are restricted to a certain percentage*
   This is the case at the allocation of taxing rights related to dividend or interest income. The source state may impose withholding tax to that items of income, but the tax rate shall not exceed a certain percentage of the gross amount of income.

c) *Income may be taxed in the state of residence without restriction*
   This rule ensures not only the taxing right of the residence state, but also enables for the source state to tax the same income. Therefore this rule is the counterpart of b), so it is applicable to dividend and interest income. In this case, limited double taxation occurs without the method article (Art. 23A and B OECD MC).

d) *Income shall be taxable only in the source state*

[14] Engelen, Pötgens: Report on "The Application of the OECD Model Tax Convention to Partnerships" and the Interpretation of Tax Treaties, In: European Taxation 2000/7, p. 255

This allocation rule is not very common, but it happens for instance when profit from the operation of ships or aircraft in international traffic is derived and the place of effective management of the enterprise is situated in the source state (Art. 8 OECD MC) or when remuneration of government services is paid under Art. 19 OECD MC.

e) *Income shall be taxable only in the residence state*

This is the default case of OECD MC according to which the residence state is entitled to tax the income concerned exclusively and the source state must refrain from imposing tax on that income. In case of royalty[15] income or income which is not attributable to a PE established in the source state can be mentioned as examples to that situation.

f) *Income shall not be taxed in the source state*

Only in one case chooses the OECD MC that type of wording for the allocation rules, for payments which are received by students solely for the purpose of financing their costs related to studying in the other state (Art. 20).

The allocation rules of OECD MC provide in certain cases exclusive taxing rights for one of the Contracting State using the formula ‘shall be taxable only in that state’. When the wording of the distributive rules allocates exclusive taxing rights to one of the Contracting States, the other Contracting State must refrain from taxing of that item of income. As a result, double taxation is eliminated without the application of method article (Art. 23 A and 23 B). As mentioned above, the exclusive taxing rights are granted to the state of residence in general, although exceptionally also to the source state (e.g. income from government service).

However, the majority of distributive rules contains the formula of ‘may taxed in that State’. This wording provides taxing rights for the source or the resident state without excluding the imposition of tax for the other state. In the resident state, the taxpayer is fully liable to pay tax on its worldwide income, including income earned in the source state. As a consequence, merely applying the distributive rules cannot eliminate double taxation, one must also apply the method article. According to that article, the state of residence has

[15] As Lang mentions, it is quite common that countries deviate from this provision in their DTCs and give limited right to tax to the source state in terms of royalties. However, in most recent treaty practice follows the OECD MC and provides exclusive taxing right for the state of residence, In: Lang: Introduction to the Law of Double Tax Conventions, Linde, Vienna, 2013, p. 106

to give a relief for the income which has already been taxed in the source state. The method article provides two main solution for granting that relief. As they are logically linked to the problem of double (non-)taxation, I intend to present them concisely.

a) *Exemption method*

This method eliminates double taxation at the level of tax base. The state of residence does not levy any tax on the income derived from the source state (and as a result, taxed in that state). As a result, the resident taxpayers who carry out business activity abroad are exposed to the same tax burden as the residents of that foreign country and this method creates a level playing field on the foreign market. This system is called capital import neutrality because foreign and domestic investors in the foreign market compete under the same conditions.[16] We can make a distinction between the full exemption and exemption with progression. In the first case, the income derived from the source state is totally ignored when the domestic tax base and tax payable is calculated, while in the latter case, the foreign income is not included in the domestic tax base, but the state of residence takes this income into account when it calculates the tax payable regarding the other items of income of the taxpayer[17] (e.g. it considers the income from the source country at the determination of the applicable tax rate for the domestic tax base).

b) *Credit method*

This method eliminates double taxation at the level of tax payable. The state of residence calculates the tax base of the taxpayer on a worldwide basis, but it gives a credit for the tax paid in the source country. The domestic tax provisions are applied for the worldwide income, as a consequence it is ensured that the resident state's tax level is imposed on all the income irrespective of the source of them. This system is named capital export neutrality because it makes the taxpayers indifferent to invest abroad from a tax perspective as the home state's tax is levied on the entire income.[18] In case of full credit, the tax paid in the foreign country is deductible from the tax payable in the state of residence without restrictions. The ordinary credit as opposed to the full credit method, provides a limited deduction because the credit is restricted to that part of the residence state's tax that can be allocated to the income which is subject to tax in the source state.[19]

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[16] Terra, Wattel: European Tax Law, Kluwer, Deventer, 2012, p.134
[17] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Commentary on Articles 23 A and 23 B, para. 14
[18] Terra, Wattel: European Tax Law, Kluwer, Deventer, 2012, p.132
[19] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Commentary on Articles 23 A and 23 B, para. 16

2.3. The OECD MC and its Commentary

2.3.1. History

By the time the predecessor of OECD, i.e. Organisation for European Economic Co-operation (OEEC) published its first recommendation related to the issue of international double taxation in 1955, a number of DTCs have already been in force and several model conventions have been created, for instance the Model Convention of London and Mexican Model Convention. However these model conventions have not been subject to unanimous recognition and have had numerous shortcomings. In the middle of the 20th century, the international economic relations commenced to enlarge after the World War II and the interdependence between the states enhanced which resulted in an increase in numbers of DTCs. At the same time, the harmonization of DTCs by working out unified basic principles, definitions, methods as well as interpretation became urgent and crucial. The OEEC set up a special committee, the Fiscal Committee for this purpose and the elaboration of a comprehensive package of reports has commenced in that field of international tax law. The draft of this package has been adopted by the Council of the organization (which was already operating at this time under the name of OECD) in 1963 and member states has been called for concluding DTCs in accordance to that draft. Later on, the revision and amendment of the draft convention became necessary and this work was carried out by the Committee on Fiscal Affairs which is the successor of the Fiscal Committee. This revision has resulted in the creation of OECD MC and its Commentary in 1977. The work could not be finished as the quick pace of economic development challenged the OECD MC and further amendments and modifications have been required. The last update occurred in 2014.[20]

2.3.2. The role of OECD MC and the Commentary

The creation and amendment of the OECD MC and Commentary has been justified by the increase of DTCs and the necessity of their harmonization. One of the main functions of these documents is linked to the harmonization: they help achieving the accord between DTCs through laying down unified set of allocation rules and determining the scope of DTCs.[21] Moreover they promote the interpretation of DTCs in cases where the Vienna Convention on Law of Treaties (hereafter: VCLT) does not provide as exact and appropriate clues as it is required for precise interpretation. In my opinion it is a logical consequence of the fact that the VCLT is applicable to all international treaties, so it covers a very wide range of situations, as

[20] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Introduction, para. 4-11

[21] Simon István In: Pénzügyi Jog II. (szerk.: Simon István), Osiris Kiadó, Budapest, 2012, p. 508

a result of which its interpretation rules must be abstract and generic. As opposed to VCLT, the OECD MC and its Commentary specifically deal with DTCs, therefore these documents are able to give more precise guidance in their respective field.

The other main function of the OECD MC is the determination of basic outlines of allocation of taxing rights between the countries. It serves as a template for the conclusion of bilateral DTCs and as a result it facilitates the process of negotiations and after the conclusion the interpretation of the DTC concerned.[22]

The prerequisite of performing effectively these functions is that the states conclude their DTCs in accordance with the OECD MC, because only the DTCs are legally binding for the Contracting States. Nowadays that requirement is fulfilled, wide range of states recognize and apply the OECD MC. In addition, the effect of this document goes beyond the scope of OECD member states because it is used as basic reference in the course of DTC negotiations between OECD member state – non-member state and often between two non-member states, too.[23] The growing importance of OECD MC also contributes to the wide recognition of its Commentary as a guidance to the interpretation of DTCs.[24]

The role of these documents is not only outstanding in connection with the avoidance of double taxation, but also in respect of tackling tax avoidance and preventing double non-taxation. Since the acceptance of that role, amendments relating to that aim have been continuously introduced and the reference to double taxation has been cancelled from the title of the OECD MC.[25] The OECD MC clarifies that this cancellation does not mean that the states are not allowed to refer in the title of their DTCs to the elimination of double taxation or both to the elimination of double taxation and to prevention of tax evasion.

2.3.3. The legal status of OECD MC and its Commentary

First of all, it is important to highlight that the OECD MC and its Commentary do not qualify as products of legislation (as opposed to the bilateral DTCs) and no international rule prescribes the mandatory application of them. As a result, they are not legally binding documents. However, one must examine that issue into more detail and refine the aforementioned phrases in case of OECD member states. The OECD

[22] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Introduction, para. 13
[23] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Introduction, para. 14
[24] Ibid. para. 15
[25] Siklósiné Antal Gyöngyi: A nemzetközi adóelkerülés elleni küzdelem, az adóügyi információcsere, In: Adó, 2013/10. szám, p. 36

MC and its Commentary and their modifications are adopted by the principal body of the OECD, i.e. by the Council. The decisions require unanimity, therefore the approval of all member states is necessary, and consequently, it can be assumed that the provisions of these documents reflect the intentions of member states. According to VCLT Art. 31 (4) special meaning can be attributed to a term if it is established that the parties so intended. In case of DTCs of OECD member states which follow the OECD MC without changes, we can consider the OECD MC and its Commentary as applicable historical tools of interpretation of the DTC in question and the parties intended to use them to resolve their interpretation conflicts.[26] This does not mean that member states are not allowed to deviate partly or even wholly from the OECD MC at the conclusion of DTC (although it is not frequent at all) but once they concluded their DTCs in accordance with OECD MC, then they are supposed to accept the OECD MC and its Commentary as an interpretative reference. I do believe that one can assume in respect of DTCs concluded on the basis of OECD MC that the Contracting States intended to interpret their treaties in line with the interpretation of the Commentary. The states are free to make observations to certain provisions of the Commentary when they disagree the interpretation laid down there and they can indicate the fashion in which they are going to apply the provision of their DTC concerned.[27] As a consequence, in the lack of making observations, the contracting parties can be considered that they accepted the interpretation of the Commentary. The application of the Commentary has to be decided on a case by case basis, but the prevailing opinion between scholars is that the Commentary can be considered mandatory for OECD member states unless they stated otherwise explicitly.[28]

3. Concepts in connection with PE

3.1. Concept of business profit

The notion of PE in Art. 5 and the allocation rules laid down in Art. 7 are applicable to business profit. Therefore it is crucial to clarify the scope of business profit and determine which items of income are

[26] Michael Lang: Introduction to the Law of Duble Taxation Conventions, Linde, Vienna 2013, p. 48

[27] OECD (2014) Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Introduction, para. 30

[28] Simon István In: Pénzügyi Jog II. (szerk.: Simon István), Osiris Kiadó, Budapest, 2012, p. 509

covered by this concept. The term profit is not defined in the OECD MC and a broad meaning is attributed to it, including every item of income which is derived from business activity, similarly to the domestic law of the majority of OECD countries.[29] As a consequence, in the lack of a special provision, conflict may arise between Art. 7 and other Articles of the OECD MC in terms of categories of income which belong to one of the other distributive rules but which also fall within the wide scope of business profit. In order to prevent these collisions between the allocation rules, Art. 7 (4) makes clear that in case of items of income which are dealt with separately in other Articles, the rules of these special Articles have precedence over Art. 7. This limitation of the scope of Art. 7 precludes the possibility of collision of articles applied to special items of income and Art 7.

However, some of these other articles give precedence to Art. 7 in respect of income attributed to PEs. These rules are referred as PE proviso and can be found in the allocation rules related to dividend (Art. 10), interest (Art. 11), royalty (Art. 12) and other income (Art.21).[30] According to the PE proviso, Art. 7 is applicable instead of these articles if the income earned by a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividend is a resident / in which interest arises/ royalties arise through a PE situated therein and the holding/ debt-claim/ right of property in respect of which the payment is made is effectively connected with such PE.

One can observe the expansion of the scope of Art. 7 in recent times. Firstly, payments for the use of, or the right to use, industrial, commercial, or scientific equipment (ICS equipment) have been deleted from the definition of royalty. As a result, income from the leasing of ICS equipment is considered as business profit and falls within the scope of Art. 7. Secondly, in 2000, Art. 14 has also been cancelled from the OECD MC which dealt with income from professional services and other activities of an independent character. The scope of this Article covered independent free professional services, such as scientific, literary, artistic, teaching activities, activities of lawyers, engineers, architects etc., the provision of which requires higher education.[31] Similarly to Art. 7, this Article also ensured exclusive taxing rights to the state of residence unless the taxpayer has not carried on the abovementioned activities through a fixed place of business in the other state.[32] The reason of the cancellation of this Article was that there were no intended differences between the PE and fixed base and the allocation rules linked to these concepts. The deletion reflected that

[29] Commentary on Article 7, para. 71
[30] Michael Lang: Introduction to the Law of Double Taxation Conventions, Linde, Vienna, 2013, pp. 102-103; 105-106; 125
[31] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, pp.113-114
[32] Ibid. p. 114

fact and as a consequence, income earned by professional services or other activities of an independent character falls under Art. 7.[33]

3.2. Aim and rationale of PE concept

If an enterprise decides to carry out cross-border business, it can implement it in three basic fashions[34]:

a) *Parent-Subsidiary structure*

   By establishing a foreign subsidiary to compete on the foreign market. The subsidiary is created under the law of the foreign country and regularly is tax resident and as a result fully liable to tax in that country. The parent company and its subsidiary are two different legal persons and are taxed separately. Their internal dealings are subject to transfer pricing rules.

b) *Short-time activities*

   The business activity is lacking the character of geographical or duration permanence and therefore it is carried out without the existence of a PE. These activities do not evoke the taxing right of the source state and the state of residence has exclusive taxing right on the basis of worldwide taxation.

c) *PE structure*

   By establishing a business facility (branch, factory, shop etc.) which is not incorporated under foreign law and leads to the existence of a PE as a part of the enterprise. This is the most complex and problematic way of participating in international business because the tax law treatment does not follow that of private law. From the point of view of the latter one, the activities of the head office and PEs of the enterprise are inseparable and therefore assigned to the enterprise itself instead of certain part of the enterprise.[35]

As it can be seen, not every unincorporated cross-border business activity leads to the existence of a PE. The presence of the enterprise must reach a certain threshold in the source state: this indicates that a particular level of business activity and a substantial economic interest within that state must exist.[36] The examination whether an activity or a set of activities constitutes a PE or not is crucial because under Art. 7

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[33] Commentary on Article 7, para. 77

[34] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, pp. 3-4

[35] Ibid. Pp. 4-5

[36] Castro, Leonardo F.M.: Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy, In: 2 Global Bus. L. Rev. 125 (2012), p. 126, Available at: http://engagedscholarship.csuohio.edu/cgi/viewcontent.cgi?article=1000&context=gblr

the PE concept determines the source state's right to tax of the profit of a foreign enterprise deriving from this jurisdiction.[37]

There are several justifications for applying the PE concept to the allocation of taxing rights.[38]

a) The principle of international justice or fair allocation of tax revenues requires to ensure source-base taxation in a case when the foreign enterprise utilizes the infrastructure and the beneficial economic environment of the source state. The advantageous economic conditions are implemented from the budget of the state, therefore one can expect the enterprise to contribute to these costs.
b) Ensuring neutrality between the different forms of secondary establishment.[39] If a foreign enterprise makes a decision to carry on business in the source state by establishing a subsidiary, then this subsidiary will be a resident taxpayer of the source state and will be exposed to a tax burden which is applicable to all other resident taxpayers according to the domestic law of that state. Granting to the source state the right to tax of profit which is attributable to a PE, the neutrality between the business forms is fulfilled. It is especially true where the DTC contains the exemption method in order to eliminate double taxation: then, the income of the PE is taxed exclusively by the source state, creating complete capital import neutrality.
c) Formulating the concept of PE as a threshold of business activity, below which the state of residence has exclusive taxing right regarding the business profits can be justified by practical reasons. It entails that the enterprise, whose activity in the source state does not reach that threshold, is relieved from compliance and administration costs in that state which would be disproportionate to the minor business presence of the enterprise.[40] On the other side of the coin, it also waives the tax authorities to identify and audit non-residents with minor presence as well as it may be very difficult for the tax administration to gather information about these enterprises. Leaving these rights and duties at the hands of the authorities of the state of residence is also reasonable from the point of view of tackling double non-taxation.[41]

[37] Kelleher, Cormac: Problems with Permanent Establishments, p. 1, available at: http://ttn-taxation.net/pdfs/prizes/CormacKelleherEssay.pdf
[38] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p. 11
[39] Ibid. p. 12
[40] Ibid. pp. 12-13
[41] Ibid. p. 13

3.3. Profit attribution

After having concluded that a PE exists in the source state under Art. 5, the allocation issue of the business profits has not been solved yet. It is Art. 7 which addresses this question: according to Art 7 (1) – as it was stated above – the source state may also levy tax on business profits which are attributable to a PE. The outline of the attribution method is laid down in Art. 7 (2): this is the so-called authorized OECD approach (AOA).

Formerly, the application of profit attribution rules differed country by country, causing legal uncertainty. As a consequence, after having adopted the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter: TP Guidelines) in 1995, the OECD intended to implement the arm's length principle also in case of PEs which was considered as a streamlined approach, suitable for contemporary multinational operations. The OECD prepared the Attribution of Profits to Permanent Establishments Report in 2008 which has already been based on the arm's length principle. However, the guidelines of that Report and that of the Commentary deviated from each other at certain points, therefore, the modification of Commentary took place in the same year. In order to fully accord this principle with the OECD MC, a new version of Art 7 has been included in the updated OECD MC in 2010. From that moment, the Report 2008 and the OECD MC as well as the Commentary have been aligned with each other in terms of essential conclusions, but the wording of the Report 2008 contained references to the pre-2010 Commentary. For the sake of easing the interpretation of Art. 7, these slight differences have been eliminated by virtue of updating the 2008 Report in 2010. As a result, the authorized OECD approach was fully implemented in the OECD MC, Commentary and in the Report.[42]

The AOA is built on two basic principles: *separate entity approach* and *arm's length principle*. The functionally separate entity approach entails a fiction that the head office and its PE are separate and independent enterprises. This distinction is made only for tax purposes, to distribute the taxing rights to the head office state (state of residence) and to the PE state (source state), respectively. This fiction enables the recognition of dealings between the head office and its PE, despite the fact, that they are one and the same entity from a legal point of view. The word 'functionally' refers to the starting point of profit attribution as firstly the functions performed by the head office and PE have to be determined.[43] One must differentiate this approach from the *relevant business activity approach*. Based on the latter one, profits derived from a business activity in which the PE is engaged, are shared between the head office and the PE without taking into account their internal dealings. As a consequence, the overall profit (or loss) of the enterprise is divided

[42] 2010 Report on the Attribution of Profits to Permanent Establishments, Preface, para. 3-8

[43] J. Monsenego: Introduction to Transfer Pricing, Kluwer, 2015, p. 132

and allocated partly to the head office and to the PE, respectively.[44] While in case of functionally separate business entity approach, as opposed to the relevant business activity approach, it is conceivable that profits can be attributed to PE notwithstanding the fact that the enterprise as a whole makes a loss and vice versa.[45] This follows from the method that we regard the PE and the head office as two separate and independent entity.

The other basic principle which is a characteristic of AOA is the *arm's length principle*. Originally it was developed for transfer pricing rules that is for determining the price of intercompany (between dependent parties) transactions for tax purposes. The arm's length price is the equivalent amount which would have been paid between independent companies making the same or comparable transaction.[46] The detailed rules of transfer pricing are laid down in OECD TP Guidelines. As for the purposes of Art. 7 OECD MC the head office and its PE are separate entities, their fictitious internal dealings are priced by the analogue application of TP Guidelines. According to the TP Guidelines, first of all, the roles of the related parties must be identified in a certain transaction. In order to do so, the functions performed, risks assumed and assets used in terms of the transaction have to be examined. This investigation procedure is the so-called *functional and factual analysis*. When these factors have been identified and attributed to the related parties concerned, the price of the transaction has to be set in course of the *comparability analysis*. This analysis entails the investigation of independent comparable transactions and the pricing of the intercompany transaction by comparing it to the comparable (none of the differences affects the outcome or reasonably accurate adjustment can be made to eliminate the effects of the differences) transactions between independent parties, using one of the methods provided by OECD TP Guidelines.[47]

As it was mentioned above, the principles and rules of TP Guidelines are also applicable by analogy to the profit attribution to the head office and PE, respectively. However, the situation is different from intercompany transactions: a PE cannot conclude legally binding contracts and therefore cannot bear any risk on its own, as it is not legally separated from the other parts of the enterprise and the risk of the transactions is borne by the enterprise as a whole.[48] In order to eliminate this contradiction and in order to be able to create the fiction of functionally separate entity, the pivotal point of the functional and factual analysis is the examination of *significant people functions*. This notion refers to the functions which are performed by persons who are physically present at the PE. After determining these functions, the

[44] Ibid. p. 132
[45] 2010 Report on the Attribution of Profits to Permanent Establishments, para. 8
[46] J. Monsenego: Introduction to Transfer Pricing, Kluwer, 2015, p. 12
[47] 2010 Report on the Attribution of Profits to Permanent Establishments, para. 183-184
[48] J. Monsenego: Introduction to Transfer Pricing, Kluwer, 2015, p. 134

assumption of risk and attribution of economic ownership of assets related to and necessary to the performed functions can be made.[49]

One can conclude that apart from taking significant people functions as a starting point, both the functional-factual analysis and the comparability analysis follow the rules of TP Guidelines. In my opinion, the separate entity approach together with the arm's length principle is a better solution than the relevant business activity approach which allocates the overall profit or loss of the enterprise to the different parts of the enterprise or than the application of a formulary apportionment which does the same by considering only certain factors in its formula. However, the two latter options may provide greater legal certainty, this characteristic stems from the fact that they oversimplify the economic reality and only certain aspects of the transactions are taken into account. The aim of the distribution rules of OECD MC is not only to eliminate double taxation and double non-taxation, but also to achieve these purposes by allocating the taxing rights between the contracting states in a fair way, giving priority to the country which has a stronger relationship with the profit-generating business activity. Therefore, it is more important to determine the profit attributable to a PE as precisely as possible, even if the outcome of such investigation may give rise to some ambiguity and uncertainty, because this method is in accordance with the aim of allocation rules.

3.4. PE concept

The different types of PE definitions are laid down in Art. 5 OECD MC and the so-called Service PE and Insurance PE can be found in the Commentary. This latter solution is problematic if we regard the purpose of the Commentary: interpretation and clarification of the provisions of OECD MC in order to ensure the unified application of DTCs based on OECD MC. Therefore it should not add extra definitions or rules to those of the OECD MC, rather only explain them. In this part of the thesis, the current elements of different PE concepts of Art. 5 OECD MC (classical PE, construction PE, Agency PE) will be scrutinized, pointing out their possible weaknesses which expose the PE rules to abuse and fraud.

[49] 2010 Report on the Attribution of Profits to Permanent Establishments, para. 15

3.4.1. Classical PE

Art. 5 (1) of OECD MC lays down the definition of the classical, basic PE concept, according to which it is a fixed place of business through which the business of an enterprise is wholly or partly carried on. In order to establish that a PE exists based on this definition, several tests have to be met.

a) *Place of business (situs) test*

   A place of business entails the physical presence of the enterprise in the source state which must have a tangible character.[50] According to the Commentary, this requirement can be satisfied by having a facility of the enterprise such as premises, installations or equipment-machinery. Most states interpret the term ‘place’ broadly and it also includes open-air places (forest) and underground places (mines).[51] This test can also be fulfilled without any staff or other personnel, i.e. without the presence of human beings. As a result a server may also be a place of business. However, it is of little importance because –as mentioned earlier- Art. 7 takes the significant people functions as a starting point to attribute profits to PE, therefore, in the lack of persons who perform functions, no profit can be allocated to that PE.[52] The question may also arise whether the object of business can qualify as place of business. The Commentary brings the following example: for a painter who works on a building, this building is not only the object of his business activity but also a place of business, therefore it can constitute a PE for him if other criteria are met.

   The place of business must be at the disposal of the enterprise. Reference is often made to that criterion as ‘*right of use’ test*.[53] The Commentary requires no formal legal right to use the place of business and even an illegal use may lead to the existence of a PE. The majority of countries’ practice accepts that factual use is enough if it entails the taxpayer’s control over the place of business. In Hotel Manager-case, German Court held that this criterion is met where the right of use cannot be taken from the enterprise without its consent, even if it has no formal right to use of the place of business.[54] This also means that the mere presence in itself is not enough to comply with the right of use test.

[50] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 23

[51] Ibid. p. 24

[52] J. Monsenego: Introduction to Transfer Pricing, Kluwer, 2015, p. 135

[53] Reimer considers this test as part of functional integration test related to the term ’through’ In: Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015. P. 56

[54] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p.36

Exclusivity is not required, a shared right of use of the same place of business can establish a PE for more than one enterprise.[55] In case of subsequent use (rather than simultaneous), however, special attention must be paid to the permanence test to conclude whether the recurrent activity qualifies as permanent activity.[56]

b) *Location test*

This criterion relates to the word 'fixed' in the PE definition together with the duration test and it encompasses the requirement of a link between the place of business and a specific geographical point of the source state. The Commentary highlights that this does not mean that it has to be fixed to the soil (therefore a tent or a van can also satisfy this test), but the place of business has to remain on a particular, identifiable point. In country practices, means of transport (taxi, truck, aircraft or vessel) will not satisfy the location test if they are used for normal operation. However, a ship, which is permanently at a certain harbor, e.g. a floating restaurant, qualifies as a fixed place. Even a ship which is used to carry on excursion trips can qualify if it makes the same route and always starts from and arrives to the same port.[57]

It is conceivable that the character of business activity requires the movement of the place of business. In these cases, one must decide whether the different locations constitute different place of businesses for the company. The Commentary gives guidance in this issue: if there is an identifiable area within which the place of business and the related activities are moved and it enables to consider that area as a commercially and geographically coherent whole, then only one single place of business exists. For instance, a mining activity along a large mine is still regarded as a single unit, therefore a single place of business. The coherence must be fulfilled both a commercial and a geographical point of view, they are cumulative criteria.[58]

c) *Duration test*

This condition is the other prong of the 'fixed' character of place of business. It entails the requirement that the place of business has been established not only for purely temporary purposes,

[55] Ibid. p.38

[56] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p.58

[57] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 27

[58] Commentary on Art. 5 (1) para. 5.1-5.4.

but it has a certain degree of permanency.[59] In many countries' interpretation the duration criterion is connected to the right of use test: the place of business has to be at the disposal of the enterprise not only temporarily.[60]

Neither the OECD MC nor the Commentary provide an exact period of time which is necessary to fulfil the duration test. However, the Commentary refers to the general practice of states according to which a 6 month period satisfies the duration requirement. It also notes that the required period may vary depending on the nature of activity, therefore a case-by-case analysis must be carried out.

Another issue is the calculation of the duration. It starts, i.e. a PE begins to exist, when the enterprise is ready to carry on its business activity. As a consequence, the time spent with preparatory works is not counted. The PE ceases to exist when the enterprise disposes of its place of business or it gives up all its business activity through the PE without the intention to continue, i.e. temporary interruption does not lead to the cessation of the PE.

When an enterprise carries on recurrent business activity (i.e. it regularly, year-to-year conducts business activity in a certain period or season of the year), then the periods must be aggregated to decide whether the duration test is fulfilled.[61]

When the intention of the enterprise is to establish a place of business only for a short period of time, but actually it lasts for a longer period which exceeds the threshold, a PE is constituted retrospectively. Although in the opposite case when the place of business was intended to be maintained for a longer period but it lasts only for a short period (e.g. due to investment failure), the intention of the enterprise prevails over the factual situation and a PE exists.[62]

d) Business activity test

This test examines whether the activity carried on through the place of business qualifies as business activity and as a consequence the income generated from these activities qualifies as business profits. The activities must be regarded as business activity under the law of the Contracting States as well as under the DTC.[63] Otherwise the activity and the income derived from it would be covered by another article of OECD MC and therefore different rules would apply.

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[59] Commentary on Art 5 (1) para. 6.

[60] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 28

[61] Ibid. p.30

[62] Commentary on Art. 5 (1) para. 6.3

[63] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 38

It has to be also determined whether the business activity is the own business of the enterprise or it is conducted on behalf of another entity. Only the former case leads to the existence of a PE for the enterprise.

e) *Business connection test / Functional Integration test*

This test relates to the 'through' element of the definition: the business activity must be carried on through the place of business. It is not required that the business activity is conducted through the place of business entirely, partly use of place of business suffices. It gives rise to ambiguities whether the income which is derived from the business activity which is not carried on through the place of business is included or excluded from the taxation of PE. The general approach by the states is that only a totally unrelated activity is excluded, other activities which are connected to the core activity conducted through the place of business are attributable to that PE.[64]

Some authors argue that the change of the word 'in' to 'through' in the OECD MC is a substantial modification which brings in the requirement that the place of business must be used as an instrument (an operating asset) for the business activity.[65] The Commentary does not consider that change in wording as a meaningful one and these words are regarded as synonyms. Making a distinction between the two words would ensue the widening of the scope of PE concept on the one hand (in terms of activities which do not entail human presence such as a vending machine), and would restrict significantly on the other hand (such as a building for the painter, where the place of business is the object of the business activity of the entrepreneur rather than an instrument). The purpose of PE concept is to allocate taxing rights to source state when the enterprise's participation in the economic life of that state exceeds a certain threshold. From that aspect it is irrelevant whether the enterprise carries out entrepreneurial activity by means of being at a certain fixed place or actively use this place to do the work. Therefore I think that the right approach is to accept the widening effect of the term 'through' without the application of its restriction, that is to apply the 'in' and 'through' as alternatives, being either of them sufficient to meet the conditions.

3.4.2. Exception to the main rule: the negative list of preparatory-auxiliary activities

Not all business activities create a PE: Art. 5 (4) enumerates certain activities which are excluded from the general PE definition, therefore these do not constitute a PE for the enterprise even if all criteria in Art. 5

[64] Ibid., p. 44

[65] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p.61

(1) or (5) are met. As a consequence, Art. 5 (4) restricts the scope of the classical PE as well as the Agency PE. The rationale of these exceptions lays on the ground that by virtue of the exclusion of them, traditional international trade can be facilitated and promoted as purchasing offices, distributing warehouses do not have a PE status.[66] The activities listed in (4) are generally regarded as preparatory or auxiliary. As they lead to the same consequence (i.e. the non-creation of a PE) it is not necessary to differentiate them, although it is crucial to make a distinction between the so-called core business activities and the preparatory-auxiliary activities. Core activity can be defined as 'an essential and significant part of the activity of the enterprise as a whole'[67], while preparatory and auxiliary activities precede and accompany the core activity, respectively. This does not mean that these activities do not contribute to the productivity, but the linkage between these activities and the actual profit-generating activity is too remote to allocate any profit to that fixed place of business.[68] Deciding whether an activity has a preparatory or auxiliary character, one must not take an absolute standard and examine only the value added by that activity. The activity has to be perceived at a micro level, meaning that its role within the enterprise is decisive and a comparison must be made to the overall activity of the enterprise concerned.[69] Therefore the same activity may be qualified as core business activity in case of one company, while as preparatory-auxiliary in another one.

The structure of that paragraph is not appropriate in my opinion. In subparagraph a)-d) the OECD MC enumerates different activities which are deemed not to result in PE: use of a facility or maintenance of a stock for storage, display, delivery of goods and merchandise; maintenance of a stock for the purpose of processing by another enterprise; maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information. Subparagraph e) includes a generic exception, according to which any other activity of a preparatory or auxiliary character is outside the scope of Art. 5 (1) or (5). This structure implies that activities named in subparagraphs a)-d) cannot constitute a PE in themselves, therefore they form exception without the investigation of their preparatory or auxiliary character. This approach is very problematic, as with the emerge of new business models, it is very well possible that maintaining a storage from where goods are delivered to customers belongs to the core activity of an enterprise engaged in e-commerce sales activity. Under recent rules, however, these activities are subject to the exception of Art. 5 (4) and do not create a PE for this enterprise. This serious shortcoming enables companies to abuse these rules, therefore it is also targeted by BEPS project. The detailed analysis of that issue will be addressed in the next chapter of the thesis.

[66] Ibid. P. 85
[67] Commentary on Art 5(4) para. 24
[68] Ibid. para. 23
[69] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p. 91

It is often difficult to decide that a certain activity belongs to the core activity or is of an auxiliary-preparatory character. The Commentary gives some guidance which is generally reflected in the practice of states. Servicing a patent or know-how is considered as a core activity, if it forms a significant part of the enterprise's activity (e.g. it carries on extensive R&D activity). The management of the entity or part of it also exceeds the level of mere auxiliary or preparatory character and therefore belongs to the core activity. The same holds true for manufacturing and sales activity (and essential support of them).

In accordance with the wording of OECD MC as well as case law, activities can qualify as preparatory-auxiliary only if they are carried on for the enterprise itself. Exercising these functions (e.g. advertising or maintaining a stock also for other entities) on behalf of other enterprises leads in every case to the existence of a PE.

Paragraph f) clarifies that the combination of activities listed in paragraphs a)-e) must be assessed altogether. If the combined character of the different activities can still be regarded as auxiliary or preparatory, then no PE exists. The conclusion is different when preparatory-auxiliary activities and core activities are conducted through the fixed place of business. The core business activity will constitute a PE and the source state has the right to tax the PE on its entire range of activity, included the preparatory or auxiliary ones.[70] There is no place for dividing the income and tax proportionally to the ratio of the income from core activity.

3.4.3. Construction or project PE

Art. 5 (3) OECD MC deals with the Project PE which is established if a building site or construction or installation project lasts more than 12 months. This definition encompasses an exception effect which means that it precludes a building site or construction/ installation activities from constituting a PE when they do not exceed the 12 month period even if they could qualify as PE under the classical PE rules in Art. 5 (1).[71]

As opposed to the exception effect, the deeming effect of the construction clause gives rise to some ambiguities. The deeming effect entails that the activities covered by Art. 5 (3) lead to the existence of a PE if the permanence condition is fulfilled regardless of the conditions laid down in Art 5 (1). The Commentary leaves this question open. The prevailing standpoint in legal literature acknowledges the deeming effect of construction PE.[72] This point of view considers the construction PE as a separate PE definition which is

[70] Commentary on Art. 5 (4) para. 30

[71] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 45

[72] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p.72

independent from the classical PE concept, therefore it has to comply only with criteria given in Art 5 (3): the activity has to be connected with building site, construction or installation project and has to last more than 12 months. If these conditions are fulfilled, the PE exists under Art. 5 (3) OECD MC. In Waste Incineration-case, the Dutch Supreme Court also considered the construction PE provision as an extension of PE definition and not as part of the classical PE concept.[73]

However, there are scholars and countries who are of the opinion that the construction PE forms part of classical PE. According to Hans Pijl, Art. 5 (3) only replaces the permanence requirement of (1) with the 12 month duration requirement.[74] He explains this specified fixed duration test with the need of unified application of this criterion because the practices of domestic law interpret the permanence criterion of Art. 5 (1) differently.[75]

In my opinion, taking the teleological interpretation as a starting point, the purpose of this additional provision could be the inclusion of building sites and construction and installation project in the scope of PE as these places did not comply with the classical PE concept in many cases. This non-compliance may happen in the lack of fixed place or business connection test.[76] This purpose can be achieved if one substitutes all the general criteria with the 12 month duration test. If we consider this duration test as an additional condition to the general ones, then the conditions under which a construction PE exists just become stricter and, as a consequence, these activities and construction places will constitute PE even rarer.

The scope of building sites, construction or installation project must be interpreted broadly according to the Commentary and it includes construction of roads, bridges, renovation which exceeds a mere maintenance activity, laying of pipelines and also the installation of new equipment or machinery in existing building as well as on-site planning and supervision.[77] The practice of majority of OECD Member States aligns with the Commentary. The only controversy is related to on-site planning and supervision. Many countries accept these activities as covered by Art. 5(3) only if these are carried out by the building contractor.[78]

The terms site and project are further clarified in Commentary. If the different sites and projects form geographically and commercially a coherent whole, they can be considered as one single site or project

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[73] Pijl, Hans: The Relationship Between Article 5, Paragraphs 1 and 3 of the OECD Model Convention, In: INTERTAX Volume 33, Issue 4, 2005,p. 189
[74] Ibid. p. 190
[75] Ibid. p. 193
[76] Reimer, Ekkehart: Permanent Establishment in the OECD Model Tax Convention, In: Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (edited by: Reimer, Schmid, Orell), Kluwer, 2015, p.71
[77] Commentary on Art. 5 para. 17
[78] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009 p. 47

irrespective of the fact that the activities are connected to different contracts or were ordered by different persons. The commercial coherence is not broken in case of relocation of activities relating to the project due to the nature of the project (e.g. construction of road). It still constitutes one single project, therefore the time spent on these places must be aggregated for the purposes of duration test.[79]

The Commentary also provides guidance to the calculation of 12 month period. The site is deemed to exist when the entrepreneur begins his work. As opposed to the general PE definition, the term work also includes preparatory work. The site ceases to exist when the work is completed or abandoned with the intention of permanency. This implies that in case of temporary (e.g. problems emerging within the enterprise, such as labor difficulties) or seasonal (due to bad weather) interruption in the work does not lead to the cessation of the construction side. Some authors comment that this rule can cause unjust tax liability in the source state due to circumstances which occur outside the control of an enterprise. For instance, it may happen that the duration of planned activity at the construction site would not have exceeded the 12 month threshold, but because of the necessary break in the work, it constitutes a construction PE. According to Kelleher, it would be reasonable to introduce some kind of exception to the main rule in case of incurrence of abnormal circumstances e.g. natural disasters.[80] I think that the introduction of a new, exceptional provision would evoke further difficulties such as how to draw the line between events which give rise to the application of the exception and those which to the general rule. In addition, an entity who carries out business activity, assumes all the risks relating to events, for the happening of which nobody can be considered as liable (principle of casus nocet domino). Therefore, this principle should be maintained when the business activity crosses the border and the unwanted event occurs in a country other than the country of residence even if this negative circumstance results in PE and tax liability in the source state.

The Commentary also affects the cases of subcontracting of a comprehensive project. The time spent on the site of the project by the subcontractors is also imputed to the general contractor. However, the question whether there is a PE for a subcontractor must be assessed individually and independently from other subcontractors as well as the general contractor.[81] Although it does not solve the problem of horizontal division of contracts: when the (often associated) enterprises apparently carry out their own part of the work without subcontracting it, but the division of one comprehensive project only serves to circumvent the duration test and to avoid the creation of PE. This phenomenon is also addressed by BEPS Actions and I will present it into more detail in the upcoming chapter.

[79] Commentary on Art. 5 para. 18, 20

[80] Kelleher, Cormac: Problems with Permanent Establishments, p. 3 In: http://ttn-taxation.net/pdfs/prizes/CormacKelleherEssay.pdf

[81] Commentary on Art. 5 para. 19

3.4.4. Agency PE

3.4.4.1. Dependent Agent

Unlike the construction PE, there is no doubts that the so-called Agency PE in Art 5 (5) provides an alternative concept of PE. Due to this deeming effect, if the criteria laid down in (5) are met, it constitutes a PE for the enterprise without the investigation of the elements of classical PE concept. As a consequence, the enterprise is deemed to have a PE if a dependent agent carries out business activity on behalf of this enterprise. In order to ensure that only a certain extent of participation of the enterprise in the source state's economic life evokes this state's taxing rights, the dependent agent is required to have an authority in that state to conclude contracts in the name of the enterprise and it habitually exercises this right. The personality of the agent is not determined: it can be a legal entity or an individual, too. It is not required to qualify as an agent under civil law either.[82]

The right to conclude contracts in the name of the enterprise does not need to be interpreted literally. If the agent is empowered to conclude contracts which are binding to the enterprises, then it suffices this condition, even if the contracts are not concluded in the name of the enterprise.[83] The binding effect of the contract for the enterprise must be examined from an economic point of view, rather than a legal one. For instance, when the agent has legal obligations from the contract, but the principal (i.e. the enterprise) concludes a separate contract with the agent, according to which it indemnifies the agent, the contracts between the agent and the costumers will be bound to the principal regarding the economic effect.[84] The agency situation has to be judged on the basis of several relationships: the aggregated effect of the internal (principal-agent) and external (third party-principal and third party-agent, respectively) relationships are decisive.[85] The precedence of economic approach over the legal one is reinforced in the rule according to which, where the dependent agent negotiates all elements of a binding contract in the source state, the condition is fulfilled irrespective of the fact that the contract is finally signed by another entity.[86] On the other hand, the participation of the agent in the negotiations is not sufficient in itself, it can only be one of the relevant factors.[87]

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[82] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p.50
[83] Commentary on Art. 5, Para 32.1
[84] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009, p. 52
[85] A. Pleijsier: The Agency Permanent Establishment, UMP, Maastricht, 2000, p. 5
[86] Commentary Para. 33
[87] Ibid. para. 33

The other element of the Agency PE definition is that the exercise of the right of the agent to conclude contracts must take place habitually. This condition is connected to the permanence requirement, i.e. that the economic presence of the enterprise in the source state is not merely transitory.[88] This entails a case-by-case analysis as it is not possible to determine an exact frequency test which is applicable to all situations.

The contracts must be related to the core business activity of the enterprise. Therefore, contracts which cover only internal cases, or which relate to preparatory-auxiliary activities based on Art. 5 (4), do not constitute PE.[89]

If a dependent agent's activity complies with (5), then it constitutes a PE for the enterprise in the source state. In that case, all the activities conducted by the dependent agent are attributable to the PE, it is not restricted to the contracting activity of the agent which was required under (5) to the deemed existence of the PE.[90]

3.4.4.2. Independent Agent

From the provision relating to Agency PE laid down in Art. 5 (5), one can a contrario deduce that an independent agent does not constitute a PE for the enterprise on behalf of which it acts. Art. 5 (6) only underlines and clarifies that conclusion. It confirms that for an enterprise which carries out business activity in the source state through a broker, general commission agent or any other agent of an independent status, the activity of the independent agents does not create a PE upon the condition that these agents act in the ordinary course of their business. This rule ensues the examination of two conditions:

a) *Legal and economic independence*

   The legal control is of minor importance as the parent company's shareholder rights in the subsidiary is not relevant for determining whether the subsidiary acts as an agent for the parent company.[91] This is in line with Art. 5 (7) which stipulates that the parent-subsidiary relationship never creates a PE for either company in itself and the general PE requirements must be tested in order to decide whether a PE exists or not.

   As a consequence, emphasis is put on the economic relationship between the enterprise and the agent. The independent status is decided on the basis of the agent's obligations towards the enterprise. If the enterprise gives detailed instructions and the work of the agent is subject to continuous and comprehensive control, then the agent is of a dependent character.[92] When the agent is only responsible for the result of his work, but it can decide the manner of it and

[88] Ibid. para. 33.1
[89] Ibid. para. 33
[90] Ibid. para.34
[91] Ibid. Para. 38.1
[92] Ibid. Para 38

the principal relies on its skills, it is a sign of independence. The number of clients of the agent is also a factor which must be taken into consideration: when it acts exclusively on behalf of one principal, it can indicate the dependent status, although it is not determinative in itself and other factors has also to be examined.[93]

b) *Acting in the ordinary course of business*

To assess whether or not an agent acts in the ordinary course of his business, a comparison must be made with the business activity carried out in general by an independent agent engaged in the same business line. This approach which is suggested by the Commentary is followed by the majority of the states, but there are some exceptions (e.g. Russian case law examines the business activity of the agent concerned).[94]

When the agent bears his own risk and receives reward based on its own skills and knowledge, it can be assumed that it acts in his ordinary course of business.[95]

The rule that agents with an independent status do not constitute PE for the enterprise on behalf of which they act, is prone to abusive practices: multinational enterprises endeavor to restructure their classical buy-sell distributors (operating either in the form of classical PE or of subsidiary) to commissionaires which generally qualify as independent agent, thus avoiding the creation of PE in the target countries. This abusive practice is also addressed in BEPS Action 7, therefore the detailed analysis of the misuse of independent agent provision and the planned countermeasures are subject to the next Chapter.

[93] J. Sasseville, A. Skaar: General Report: Is there a permanent establishment? In: Cahiers de droit fiscal international, Volume 94a, Amersfoort: SDU, 2009 p. 53

[94] Ibid. p. 54

[95] Commentary on Art 5 para. 38.6

4. BEPS Actions addressing PE-related problems

4.1. About BEPS-project

BEPS stands for Base Erosion and Profit Shifting and covers tax planning strategies which make use of gaps and mismatches in national tax systems in order to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity carried on by the enterprise. The majority of these strategies is legal, although they are harmful to justice of international tax systems because BEPS strategies are only available to multinational enterprises engaging in cross-border business activities, but not to competitors operating purely on domestic market. In addition, these BEPS strategies negatively influence the morale of other taxpayers and their willingness to pay taxes.[96]

First of all, the G20 countries expressed their concerns about these strategies in 2012 and urged to address this issue at an international level because unilateral measures proved not to be effective and may result in double taxation as well. The work has started under the aegis of OECD and the Addressing Base Erosion and Profit Shifting Report has been released in 2013. In this document, they identified BEPS strategies which are available to multinationals under the current system and principles of international tax law.[97] Later on, in 2013, the OECD issued its Action Plan on Base Erosion and Profit Shifting in which it stated that they do not intend to change the international tax standards and principles, but to restore residence or source taxation where cross-border income would not be otherwise taxed. This document contains the actions which are necessary to address the identified BEPS strategies, the sources and methodologies which enable the implementation of actions as well as the deadlines of these measures. As far as the methodology is concerned, all stakeholders are involved in the works (including non-OECD developing countries, business and civil society) as the BEPS-project intends to be a comprehensive and internationally coordinated set of measures[98]. For the elaboration of different Actions, different deadlines have been determined and in the end of 2015, final versions of all the Actions, including Action 7 which addresses artificial avoidance of PE status, have been prepared.[99]

In accordance with the deadlines, the OECD worked out the Final Report of BEPS in 2015, which has been approved by G20. As stated above, the BEPS package does not change the international tax principles (the

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[96] About BEPS and the inclusive framework, Available at: http://www.oecd.org/tax/beps/beps-about.htm

[97] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015, p. 8, Available at: https://www.jct.gov/publications.html?func=startdown&id=4853

[98] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, Available at: http://dx.doi.org/10.1787/9789264202719-en , pp. 11, 32

[99] OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports, Executive Summaries, Available at: http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf

principle of residence and source taxation is maintained), but the 15 Actions seek to streamline these tax standards, ensuring that the place of income generating activity and the place of taxation of profit cannot be separated artificially and as a consequence, the extension of substance requirements will be implemented.[100] To achieve that aim, BEPS package provides both domestic and international instruments (via treaty provisions) to preclude the further realization of BEPS strategies.

4.2. PE in BEPS-package

In connection with PE provisions of OECD MC and those of bilateral tax treaties, several BEPS strategies have been identified which lead to the avoidance of creation of PE in the source state, although there is no doubt that the economic activity of the enterprise in the source state is significant and substantial. These strategies are mainly addressed in Action 7 (Preventing Artificial Avoidance of Permanent Establishment Status), but certain concerns are solved by general anti-avoidance rules laid down in Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances). The new PE rules are also subject to Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties) which does not contain additional tools to tackle avoidance of PE status, but enable to implement provisions of Action 7 and Action 6 in bilateral tax treaties in a swift and prompt way. Action 15 and its impact will be scrutinized in Chapter 5. In this Chapter, the solutions to identified BEPS problems will be addressed: the commissionaire arrangements and similar strategies, the misuse of preparatory-auxiliary activity exceptions as well as the splitting-up of a contract in terms of construction projects.

4.2.1. Commissionaire arrangements and similar strategies

4.2.1.1. The structure and rationale of commissionaire arrangements

Commissionaire arrangements are tax planning tools which serve to save tax expenditures in course of product distribution. They are used as a tax efficient alternative of buy-sell arrangements. The latter type of structure includes a foreign parent company which manufactures the goods and a domestic subsidiary which purchases the goods and then sells to local customers. This traditional structure has disadvantages from tax point of view: the subsidiary sells the products in its own name and on its own behalf (as the owner of the goods) which means that it will realize profits which are taxable in the state of sales because the subsidiary

[100] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, http://dx.doi.org/10.1787/9789264202719-en , p. 13

is incorporated and therefore tax resident there. In addition, profit cannot be shifted to the parent company's state as transfer pricing rules require a substantial profit margin on resales.[101]

As opposed to the buy-sell structure, the commissionaire arrangement enables the tax efficient product distribution. It entails that the foreign parent company (manufacturer) does not sell the goods to its domestic, (source state resident) distribution subsidiary, but the subsidiary acts as a commissionaire of the parent company. This means that it sells the products to the local costumers in its own name but on behalf of the parent company, i.e. the subsidiary never owns the products and the profit belongs to the parent company while the commissionaire agent subsidiary only receives commission fee for its activity, which is significantly lower amount than the profit realized in connection with the sales.[102] Moreover, the activity of the subsidiary does not constitute a PE for the parent company: under Art. 5 (5) OECD MC, the condition of agency PE is that the agent acts on behalf of the enterprise and concludes contracts in the name of the enterprise. Paragraph 32 of the Commentary on Art. 5 clarifies that the term 'in the name of the enterprise' must not be interpreted literally, but the condition can also be fulfilled when the contract is binding on the enterprise. Whether a contract concluded by a commissionaire agent is binding on the enterprise (who has the role of the principal in this relation), we must examine the content and characteristics of a commissionaire arrangement and the scope of the authority of the agent. These factors are different in common law and civil law systems, therefore one has to make a distinction between the two. In common law, agents generally are not liable toward third parties and the contract between the agent and third parties binds directly the principal.[103] As a consequence, in common law systems the agent's activity constitutes a PE for the principal, therefore this structure cannot be operated efficiently in these countries: it would ensue the taxation of the parent company in the source state (regarding the income which is attributable to the subsidiary as Agency PE of the parent) as well as the taxation of commission income which the subsidiary receives for its agent activity. By contrast, in civil law systems, the contract legally binds the principal only if the agent concluded it in the name of the principal (direct representation), however, indirect representation is also possible in these jurisdictions, according to which the agent contracts in its own name but on behalf of his principal. This is exactly what a commissionaire agent does. In that case, the principal is not liable towards the third party (his existence is often hidden from the third party, i.e. he is an undisclosed principal) and this is the commissionaire agent who is bound by the contract, the principal is only liable under the commission agreement towards the agent.[104]

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[101] McClintock-Ward: International Tax and Business Planning Opportunities Through Commissionaire Arrangements, In: 22 Int'l Tax J. 55/1996, p. 56
[102] Ibid. P.56
[103] Pleijsier: The Agency Permanent Establishment, UPM, Maastricht, 2000, p. 19
[104] Ibid. Pp.23-24

As a result, commissionaire agents concluding contracts on behalf of the enterprise, but in their own name in the source state under civil law systems do not establish there a PE for the enterprise. The shift from buy-sell structure to commissionaire structure can be implemented very easily. The fact that the enterprise enters into commissionaire agreements with its subsidiaries does not make the subsidiaries dependent agents according to Art. 5 (7) OECD MC, therefore the general criteria laid down in Art. 5 (5) must be met for the constitution of Agency PE, which are not fulfilled as presented above. In addition, Art. 5 (6) explicitly stipulates that general commission agents have to be considered as having an independent status. As a consequence, the conversion of the structure does not require the set-up of new entities, only the legal relationship between the group-member companies changes: the subsidiaries do not buy the products before selling them, but they conclude the contracts on behalf of the parent manufacturer company as agents, even if it is not disclosed to the customers. However, the distribution subsidiaries can keep dealing with the local customers in the same or similar way as they did under a buy-sell structure.[105]

The commissionaire structure not only enables to avoid the taxable presence in the source state of the parent company which realizes profits of the sales of products, but also diminishes the transfer pricing issues: instead of the pricing of sale transactions between the parent company and its subsidiary (which must be set in a buy-sell structure), only the commission fee has to be determined at arm's length which amounts to a lower volume than the former type of transaction.[106]

Certain drawbacks can be also identified in connection with the commissionaire product distribution system. The problem of loss-carryforward can be mentioned.[107] If the subsidiary as buy-sell distributor made losses, domestic anti-avoidance rules for loss trafficking may preclude the carryforward of that loss as a commissionaire agent because these rules may deny this possibility in case of change of activity.[108]The activity of an owner who sells its own goods and that of an agent can be regarded as substantially different, therefore a change in activity occurs in that case.

The enhanced value-added tax and custom duty burden can be identified as another disadvantage. As the products enter the customers' country at the end selling price (intermediary sale transaction between parent company and subsidiary at a lower price does not take place), the taxable base and consequently the tax payable will be higher.[109]

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[105] McClintock, Ward: International Tax and Business Planning Opportunities Through Commissionaire Arrangements, In: 22 Int'l Tax J. 55/1996, p. 58

[106] Ibid. P.63

[107] Ibid. P.65

[108] Endres, Spengel: International Company Taxation and Tax Planning, Kluwer,2015, p. 99

[109] McClintock, Ward: International Tax and Business Planning Opportunities Through Commissionaire Arrangements, In: 22 Int'l Tax J. 55/1996, pp. 66-67

Notwithstanding the abovementioned possible pitfalls, it cannot be questioned that the advantages of a commissionaire structure outnumber the disadvantages and this structure is more tax-efficient than the buy-sell product distribution system.

4.2.1.2. Challenges before BEPS-project

The existence or non-existence of a PE leads to a cliff-edge consequence[110]: either all the attributable profits can be taxed by the source state or the state of residence retains its right to tax. Despite this fact, litigations related to PE rules have been far less common than transfer pricing issues until recently. Several reasons can be identified as possible drivers which changed the attitude of tax authorities. Firstly, the OECD already dealt with PE challenges years before the BEPS project has been launched and these investigations also encouraged tax administrations to scrutinize the conditions of PE in a certain tax structure. Moreover, the new business models are more exposed to PE rules: outsourcing of certain functions to a global management company makes the structure vulnerable to fall within the scope of PE definitions. Finally, the new profit attribution provision (so-called: authorized OECD approach) of Art. 7 OECD MC allocates substantially more profit to PE by means of the analogue application of transfer pricing rules than the previous rules in place and this fact also incites tax authorities to find that a PE is constituted under Art. 5 OECD MC.[111]

Because of these reasons as well as the significant tax savings, the commissionaire structure triggered the tax authorities of civil law countries to challenge this tax planning instrument already in the pre-BEPS era. In Switzerland, the federal tax administration issued circular letter no. 8 'International Tax Allocation of Principal Company' in 2001. It provided a guidance to tax authorities in connection with interpretation of Art. 5 (5) OECD MC in case of commissionaire arrangements. According to the circular, the principle of substance-over-form must be applied: the term 'concluding contracts in the name of the enterprise' includes also cases when the principal is not legally bound by the contract, it is enough that the economic risks and benefits of the transactions can be attributed to the principal. As it can be seen, the Swiss practice takes a broader economic approach as opposed to the Commentary.[112] Therefore, the conversion from a buy-sell distribution scheme to a commissionaire structure is not a tool to avoid PE status in this state.

The tax authorities of other European countries also have begun to challenge the commissionaire arrangements, in the lack of any published guidance, it was the task of national courts to decide whether the tax administrations interpreted properly Art. 5 (5) OECD MC when they considered commissionaires to create a PE for the principal in the source country.

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[110] Collier: BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status, In: British Tax Review, 2013, 5, p. 639

[111] Ibid. 640

[112] Widmer: Swiss branch report, In: Is there a permanent establishment? , Cahiers de droit fiscal international, volume 94a, Sdu, 2009, pp. 639-640

In France, the landmark decision was delivered in Zimmer Limited-case.[113] Zimmer Limited was a UK tax resident company which distributed its products to the French market through a French resident subsidiary, Zimmer SAS in a buy-sell structure. In 1995, the group restructured its distribution system to a commissionaire scheme which included the transfer of assets, inventory and customers' receivables from Zimmer SAS to Zimmer Limited because Zimmer SAS only acted as a commission agent following the conversion. However, the French tax authorities regarded Zimmer SAS as an Agency PE to its parent company and taxed the profits of Zimmer Limited which was attributable to that PE. The group appealed against this conclusion. The pivotal point of the case was how to interpret the expression 'concluding contracts in the name of the enterprise' of Art. 5 (5) of DTC the wording of which was identical to the respective paragraph of OECD MC. The Commentary on Art. 5 has been amended in 1995 with para. 32.1. which clarified that the condition of concluding contracts in the name of the enterprise must be understood as it is also fulfilled if the contracts bind the principal, even if these are not concluded literally in its name. Under French commercial law, the commissionaire does not bind its principal legally by its contracts. The question has arisen whether the court would take a rather economic viewpoint (similarly to Swiss approach) or would not go beyond what the OECD MC and the Commentary implies (i.e. taking the stance of legal approach). Although the Court of Appeals accepted the substance-over-form approach of tax authorities, the Supreme Court has been of opposite opinion: it held in 2010 that the principal enterprise has to be personally (legally) bound by the contracts in order to the condition laid down in Art. 5 (5) to be met. As the customers were entitled to claim any rights derived from the contract only from the commissionaire, the activity of Zimmer SAS has not constituted a PE for Zimmer Limited in France.

The Norwegian Dell-case[114] had to be decided on similar factual basis to the Zimmer-case: Dell Products was tax resident in Ireland and it distributed its goods through Dell AS which was its Norwegian subsidiary. Dell AS acted as a commissionaire and the tax authorities considered it as an Agency PE for Dell Products. The Supreme Court examined Art. 5 (5) of the relevant DTC (equivalent to OECD MC in this regard). The Court held that an agency PE exists only if the contracts concluded by the agent legally bind the principal which is not the case under a commissionaire agreement. The Court had a look at the wording of the Commentary as well as relevant foreign court decisions such as the Zimmer-case in course of its ruling. It stated that under a general commissionaire agreement the principal will never be bound by the contracts between its commission agent and third parties, therefore 'there must be something in the contractual agreement between the principal and the commissionaire other than the normal commission agreement for

[113] Summary of the case In: Baranger, Henie, Garibay, Gordillo, Gusmeroli: The 2012 Leiden Alumni Seminar: Case Law on treaty Interpretation Re Commissionaire and Agency PEs, In: European Taxation, April 2013, pp. 176-177
[114] Ibid. pp. 177-179

the commissionaire to be able to bind the principal in relation to third parties'.[115] This is the so-called Zimmer-exception. In Dell-case the Court did not find any irregular element in the commissionaire agreement, as a result, the Zimmer-exception was not applicable.

4.2.1.3. BEPS Action 7 addressing commissionaire arrangements

Commissionaire arrangements are regarded as tools which lead to artificial avoidance of PE status and consequently, the profits on the sales are shifted from the country where the actual sales take place, while the extent of participation of the multinational enterprise in that state's economic life is exactly the same as it was under a buy-sell structure which created a taxable presence therein.[116] In order to restore the (allegedly) distorted fair allocation of taxing rights, BEPS Action 7 proposes changes in OECD MC and in its Commentary which ensure the existence an Agency PE in a commissionaire structure, too. The modifications widen the scope of Agency PE and narrow the scope of independent agent definition.

The proposed Art. 5 (5) OECD MC can be read as follows: *'Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

a) in the name of the enterprise, or

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

c) for the provision of services by that enterprise

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

Two changes affect directly the commissionaire arrangement. First of all, the new wording states that Art. 5 (5) must always be tested together with paragraph (6) and one has to examine whether the independent

[115] HR-2011-02245-A Dell Products v The State, para. 52

[116] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en , para. 2

agent provision is applicable or not. However, it is rather a clarification than a substantial change because these two paragraphs are so interdependent that they already had to be tested together before the BEPS Actions.[117]

The material amendment which influences the treatment of a commissionaire arrangement is the addition of point b) and c). It will not be a necessary criterion for the existence of an Agency PE that the contracts are concluded in the name of the principal. The new wording rejects the requirement that the concluded contract by the commission agent must legally bind the principal, therefore the fact that the customers can only claim their rights stemming from the contracts from the commissionaire is also irrelevant. It suffices if the consequences (and risk) of non-performance of the contracts must be borne by the principal. This is the case when a contract relates to services the provision of which is the duty of the principal or to the transfer of proprietary rights (i.e. sale of goods owned by the principal) or furnishing of commodities or properties (i.e. granting of a right of use of properties which are owned by the principal).[118] As a result of this change, the OECD takes a purely economic viewpoint, disregarding the contractual legal situation.

As mentioned earlier, Art. 5 (5) and (6) must be assessed together. There is nothing new with it, however the independent agent definition becomes narrower. From Art. 5 (6) the examples such as brokers, general commission agents have been cancelled. The criteria of having an independent status and acting in the ordinary course of their business have been maintained without modification. However, a person who acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, shall not be considered to be an independent agent. Before the BEPS, it was just a sign of dependence, but did not mean a decisive factor in itself. BEPS Action 7 excludes these agents from the scope of independent agents by definition. This rule is applicable only if the agent and principal are closely related enterprises. The Commentary makes it clear that agents who act exclusively or almost exclusively for one or more not closely related enterprises are not excluded from Art. 5 (6) automatically, but independent status is less likely.[119] The proposed text of OECD MC provides a concept of closely related parties: it includes a general definition under which a person is closely related to an enterprise if one controls the other (vertical) or both are controlled by the same entity (horizontal relation), considering all relevant facts and circumstances.[120] Beside the general definition, Art. 5 (6) b) states that under certain circumstances the criterion of 'closely

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[117] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, November/December 2016, IBFD, p.443

[118] Van Duijn, Ijsselmuiden: Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?, In: European Taxation, February/March 2016, IBFD, p.84

[119] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, Commentary para. 38.7

[120] Ibid. Para. 38.10

related enterprise' is met by definition. This is the case if one person possesses more than 50% of the beneficial interest / aggregate vote and value of the company/ beneficial equity interest in the other or if there is a thirds person which has one of the above mentioned extent of interest in both persons. As a parent company and its subsidiary are always closely related enterprises, a subsidiary which acts exclusively or almost exclusively for the parent company will constitute an Agency PE for its parent. However, Art. 5 (7) remains relevant, i.e. the parent-subsidiary relationship is not decisive in itself to determine whether a PE exists or not.[121]

The Commentary also makes it clear what the term 'almost exclusively' means. It covers cases when the agent acts for both closely related and not closely related enterprises and the sales making for the not closely related principal represent less than 10 % of all sales. This threshold is regarded as arbitrary, therefore it must be determined by national tax authorities in the future on the basis of domestic tax law.[122]

4.2.1.4. Similar strategies

In course of working on BEPS Actions, several tax planning strategies were identified as tools to artificially avoid PE status in the source state. Although the changes in Agency PE rules mainly challenge the commissionaire structures, these other strategies have also been targeted. These other strategies exploited the shortcomings of Agency PE definition in connection with other elements: either they artificially shifted the place of conclusion of the contract or closely related enterprises could successfully refer to having an independent agent status under Art. 5(6) OECD MC.[123]

According to the new rule of Art. 5 (6), as presented at BEPS measures relating to commissionaire arrangement, the activity of a closely related agent will automatically constitute a PE for the principal enterprise if it acts exclusively or almost exclusively for the principal. As a consequence it will be irrelevant whether the agent is able to prove its independent status and that it carries on the activities concerned in its ordinary course of business, it will become a dependent agent by definition.

Other tax planning practices made use of the flaws of the element 'habitually conclude contracts in the Contracting States' of the dependent agent definition. This condition has given rise to tax planning as the

[121] Ibid. Para.38.12
[122] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, November/December 2016, IBFD, p.445
[123] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, para. 7

place of the conclusion of a contract is determined by the respective domestic contract law.[124] Depending on the domestic law it can be the place of acceptance of offer, place of sign of the contract or the place where all elements and details are negotiated.[125] Therefore, BEPS Action 7 provides an alternative of the criterion of concluding contract in the source state which can be easily circumvented: it is enough if the representative habitually plays the principal role which leads to the conclusion of contracts that are routinely concluded without material modification by the principal enterprise. If this condition is met, an Agency PE may exist even if the conclusion of contracts occurs in a different country according to domestic law. The Commentary gives some guidance in terms of the interpretation of principal role: the conclusion of the contract must be the direct result of the activity of the agent, consequently it must go beyond the mere advertising or promotion activity. However, it can be said that the representative plays principal role leading to the conclusion of contracts when it solicits and receives orders and the principal routinely approves them.[126] Similarly to the conclusion of contracts, the agent has to perform the principal role on a regular basis and not only in isolated cases.[127]

The principal role test has already been criticized by many authors. This amendment is considered as open-ended and this fact can result in uncertainties and debates between the tax authorities and the taxpayers.[128] In addition, Pleijsier draws attention to other problems in connection with this concept: the new rule will bring almost every sales agent under the umbrella of dependent agent definition as their activity covers the solicitation and reception of orders. This is especially problematic because this rule is detrimental to sales agents who perform their work well, as in their case it is easily conceivable that the contracts will be concluded by the principal without material modification because a successful agent can predict the requirements of its principal and negotiates the contract according to these conditions.[129]

Another concern about this rule is related to its efficiency. Carrying out the principal role leading to the conclusion of contracts in the source state can also be circumvented by means of changing the sales process: by reinforcing the approval process at the hands of the principal in order to go beyond the 'routinely

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[124] Van Duijn, Ijsselmuiden: Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?, In: European Taxation, February/March 2016, IBFD, p. 83

[125] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, Commentary para. 32.4

[126] Ibid. Commentary para. 32.5.

[127] Ibid. Commentary para. 32

[128] Van Duijn, Ijsselmuiden: Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?, In: European Taxation, February/March 2016, IBFD, p.84

[129] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, November/December 2016, IBFD, p. 443

concluded without material modification' limitation. Another possibility is the restriction of the agent's activity to promotion and technical assistance to the clients, while the contractual process is to be outsourced to a group member company established outside the source country. It will be likely to happen in the sector of high-tech products.[130]

4.2.1.5. Low risk distributors

BEPS Action 7 explicitly states that it does not address low-risk distributor arrangements, they belong to the scope of BEPS Action 9 which deals with contractual allocation of risk in transfer pricing issues.[131] A limited risk distributor is a subtype of buy-sell distributors, i.e. it is generally a subsidiary being tax resident in the source state which sells the products in its own name and on its own behalf.[132] The fact that the profit of the sales is taxable in the source state justifies why it is out of the scope of BEPS Action 7. However, this structure may trigger BEPS Action 9, as under this arrangement certain risks (which are regularly borne by the seller) are shifted to another group company. According to Pleijsier, this evokes some concerns: these arrangements generally entail only the transfer of inventory risk. The shift of distribution risk from distribution companies to a central supply chain company mainly serves to make the management of inventory more effective, instead of a tax planning tool. As there is a sound business reason behind this structure, it should not be subject of any BEPS Action, as it would go against economic efficiency.[133]

4.2.2. Artificial avoidance of PE status through the specific activity exemption (Art. 5 (4) OECD MC)

Art. 5 (4) OECD MC contains a negative list which enumerates activities which do not lead to the existence of PE even if the conditions of a classical PE or Agency PE are met. The current structure of this paragraph is built as follows: subparagraphs a)-d) mentions different activities (such as warehousing, delivery or display of goods) while subparagraph e) ensures that any other preparatory and auxiliary activity belongs to the scope of activity exemption. As a consequence, activities in subparagraphs a)-d) do not constitute a PE irrespectively of whether these activities have a preparatory or auxiliary character. This approach was appropriate until the appearance of the e-commerce, because these activities could not form part of core business activity. With the emergence of e-commerce business models, it became possible to carry on substantial economic activity in a given country by virtue of maintaining a warehouse and delivery service there. Without doubt, the supply chain function (i.e. the delivery of the goods to the customers) is so closely

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[130] Ibid. P. 443

[131] Executive Summaries 2015 Final Report, Actions 8-10, p. 28, Available at: Available at: http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf

[132] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, November/December 2016, IBFD, p. 442

[133] Ibid. p. 443

related to the main business activity (i.e. sale of products) in the case of retail companies engaged in e-commerce, that it cannot be regarded as preparatory or auxiliary activity.[134] The purpose of BEPS Action 7 is to streamline the exemption rules in order to adapt to the changed business environment. The rationale of the activity exemptions is that these activities are remote from the core, income-generating business activity, therefore they do not exceed the threshold which would justify the taxing right of the source state. However, exempting (and as a result, the PE status is avoided) certain activities which belong to the core activities of the enterprise falls afoul of the principle of fair allocation of taxing rights and gives rise to BEPS strategies. BEPS Action 7 provides two alternative solutions to eliminate BEPS opportunities in connection with the activity exemptions.

The first option is perfectly in line with the original rationale of Art. 5 (4) and intends to restore the purpose of this paragraph by means of *extending the auxiliary-preparatory test to all subparagraphs*. This modification ensures that paragraph (4) is only applicable to activities which have a preparatory or auxiliary character. I agree with this change and with the underlying arguments, although I cannot see the point why the list of activities in subparagraphs a)-d) has not been omitted. Subparagraph e) grants the exemption from the existence of a PE to every activity which satisfies the preparatory-auxiliary test. Therefore, maintaining the enumeration of certain activities which are also subject to that test is superfluous: it is indifferent that the activity in question is delivery (which is mentioned in subparagraphs a)-d) or something else which is not mentioned there (e.g. packaging), the only decisive factor is whether the activity fulfils the auxiliary-preparatory test (no PE) or not (PE is established).

As the importance of that test became greater, the amendments of the Commentary provide more detailed descriptions of preparatory and auxiliary character, supplemented with various examples. Preparatory activity is ‘carried on in contemplation of the carrying on of’ the core business activity, while auxiliary activity includes any activity which supports the performance of core business activities, without being part of it. In addition, activities carried on by significant proportion of assets or employees are unlikely to have an auxiliary character.[135] These definitions and the related examples do not mean material changes, they serve to clarify the meaning of already used concepts.

Some States are of the opinion that the activities enumerated in Art. 5 (4) a)-d) have inherently a preparatory or auxiliary character in themselves and they become part of core activity only when their combination is carried on and their effects are aggregated. Although Art. 5 (4) f) requires to the applicability of the activity

[134] Ibid. P. 445

[135] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, Commentary, 21.1

exemption that the overall, combined activity be of an auxiliary or preparatory character, but this requirement is examined within one single enterprise: either within one fixed place of business or several fixed place businesses maintained by the same enterprise provided that they are not separated organizationally and locally.[136] However these rules can be circumvented easily: by means of fragmentation of these activities between closely related parties.[137] BEPS Action 7 provides an alternative wording of OECD MC for the States according to which BEPS strategies are related to fragmentation of the combination of activities and not to certain activities mentioned in Art. 5 (4) a)-d). The proposed *anti-fragmentation rule* precludes the application of the activity exemption if the several activities carried on by the same enterprise or by closely related enterprises at the same place or at different places constitute complementary functions that are part of a cohesive business operation and the overall activity cannot be considered as preparatory or auxiliary or one of these places creates a PE for an enterprise.[138] The States which advocate this option also argue that it can diminish uncertainties relating to the preparatory-auxiliary test which gives rise to ambiguities despite the more detailed clarification of the Commentary.[139] I do believe that this alternative circumvents the problem of uncertainty only if the enterprise and enterprises closely related to the former one carry on only one sole activity from the list Art. 5 (4) a)-d) because this is the only case when the activity concerned is regarded as intrinsically preparatory or auxiliary. If the enterprise or a group of closely related enterprises are engaged in several activities, the overall activity is subject to the auxiliary-preparatory test according to the anti-fragmentation rule. However, I agree with the presumption that one single activity from a)-d) cannot form a core business activity: if we observe the operation of typical e-commerce companies, we can conclude that at least the performance of two activities is needed for substantial participation in the economic life of the source state: storing the product in a warehouse (in the lack of a warehouse in the source state the time of delivery becomes longer than that of the other competitors) and supply of delivery services. From that point of view, it is reasonable that only one activity is not subject to the preparatory-auxiliary test.

[136] Commentary on Art. 5 para. 27.1
[137] OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, para. 13
[138] Ibid. OECD MC 4.1
[139] Van Duijn, Ijsselmuiden: Will the Netherlands Threshold for Levying Taxes on PEs Be Lowered by Proposed Changes in Line with BEPS Action 7: Preventing the Artificial Avoidance of PE Status?, In: European Taxation, February/March 2016, IBFD, p.85

4.2.3. Splitting-up of contracts

BEPS strategies leading to the artificial avoidance of PE status have been identified in connection with Construction/Project PE definition of Art. 5 (3), too. These strategies seek to circumvent the 12 month minimum period criterion by dividing the contract into several contracts (neither of them exceeds the minimum duration of 12 months) which concern connected activities between closely related enterprises. The current wording of the Commentary prevents only the avoidance of PE status of general contractor when it subcontracts its activity to other enterprises. However, this rule does not tackle the horizontal split-up of contract. The BEPS Actions provides two possible solutions to that abuse.

One of them can be found in BEPS Action 6 (titled: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances). This is the Principal Purposes Test. According to that rule if one of the principal purposes of a transaction or structure is to obtain treaty benefits, these benefits shall be denied excepted when the grant of these benefits is in line with the object and purpose of the provision of the treaty.[140] The general character of this anti-avoidance rule enables the application of it to many cases. The proposed amendment of the Commentary under the aegis of BEPS Action 7 explicitly states that the PPT rules can be applied to prevent this form of treaty abuse (i.e. splitting-up the contracts between related parties).

The other possible countermeasure for countries which do not implement the PPT rule or which intend to address that issue expressly is the amendment of the Commentary related to the Construction PE. According to that rule, the different periods (which exceed the 30 days) spent on a building site or construction/ installation project by closely related enterprises engaged in connected activities in terms of the building site or construction/installation project have to be aggregated when the duration requirement is calculated.[141] Furthermore the Commentary provides guidance with regard to the determination whether the activities performed are connected or not. Relevant factors can be the persons who concluded the different contracts, the relationship between the contracts, nature of work and the change of employees performing of the work or the lack of that change.[142]

I think general anti avoidance rules such as the PPT can play a very useful role to protect the provisions of DTCs from abuses because these rules allow tax authorities to examine the measures of taxpayers in the light of the underlying rationale or aim of the provision in question. Therefore these rules are less likely to

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140 Executive Summaries 2015 Final Reports, Action 6, p.22, Available at: Available at: http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf

141 OECD (2015), Preventing Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en, Commentary para. 18.1

142 Ibid. Para. 18.2

be exposed to obsolescence as opposed to concrete anti-avoidance rules which target a special abuse and as a consequence it can be easier circumvent by inventing new forms of abuse. However, on the other hand, the general nature of this type of anti-avoidance rules may generate more uncertainty and as a result more debate. In order to the advantages of these general anti-avoidance rules prevail over the drawbacks, it is essential that the purpose of provisions be well-established and well-known for all stakeholders.

5. Implementation of BEPS Action measures

As it has been presented in the previous chapters, the BEPS Actions which address the current concept of PE are going to be implemented by virtue of changes in the OECD MC as well as in its Commentary. These documents are not legally binding to the States and the modification of the legally binding DTC network (consisting of more than 2000 DTCs) may last for ages. However, the realization of BEPS Actions requires prompt and swift solution. The issue of this chapter is not the presentation and assessment of anti-BEPS measures, but the examination how these Actions can be implemented effectively, without significant delay in a binding form. This question belongs to the area of public international law: this field of law provides guidance to the interpretation of DTCs, including the role of the OECD MC and its Commentary as well as to the simultaneous application of a multilateral agreement and a bilateral treaty to the same subject matter. Without answering these questions, we can discuss the BEPS Actions only at a theoretical level. Therefore, it is essential to effectively enter the contemplated measures into force. As the solutions to this problem are out of the ambit of tax matters, the BEPS Project entails very important public international law issues, too. As a consequence, under the BEPS Project aims can be achieved only with an interdisciplinary approach: the BEPS Actions which concern material tax law must be introduced to the legally binding international treaties by virtue of public international aw instruments.

5.1. Applicability of changes in OECD MC and the Commentary to existing DTCs (dynamic vs static view of OECD MC and Commentary)

One possibility may be the interpretation of existing DTCs in the light of the updated (following BEPS Actions) OECD MC and Commentary. Although every country (which concludes their DTCs on the basis of OECD MC) recognizes the interpretative role of these documents, they disagree upon the static and dynamic view of OECD MC and its Commentary.

According to the static view, only the version of OECD MC and Commentary which has already existed at the time of the conclusion of DTC is applicable as a tool of interpretation. Scholars and countries which follow this stance argue that the national parliament, which has approved the conclusion of the DTC, could not consider the content of later versions of OECD MC and its Commentary in course of negotiations and approval of DTC, therefore the new version cannot be regarded as 'context' of this DTC for the purposes of Art. 31 VCLT.[143] This approach has the disadvantage that to different DTCs concluded by the same country different versions of OECD MC and Commentary are applicable depending on their date of entry into force. It may happen even if the wording the DTCs concerned is identical but there is a change in the context of DTCs (i.e. update of OECD MC and Commentary.[144] This impact of static view is detrimental to the principle of uniform interpretation and may lead to uncertainty and disputes.

According to the dynamic view, always the most recent version of OECD MC and its Commentary must be applied when it comes to interpretation of DTCs. This approach is in accordance with uniform interpretation principle, but there is an ensuing legitimacy deficit: it places into the context of DTCs certain rules which have not existed (and have not been approved by the parliamentary body of the State) at the date of entry into force of the DTC at issue. One can argue that this approval can be traced in the approval of the updated version of these interpretative documents: the Council of the OECD makes its decisions with the consent of the OECD Member States and additionally, when a Member State intends to interpret a certain provision differently from these documents, it has a possibility to make reservations to the Articles of the OECD MC and observations to the Commentary. In my opinion, this explanation is inappropriate from a public international point of view as updated OECD MC and its Commentary cannot be regarded as a subsequent agreement under Art. 31 (3(a)) VCLT: the Council consists of the minister of finance of Member States, therefore the modification of these documents requires governmental approval instead of parliamentary which is a prerequisite for the conclusion of DTC. As a consequence, any subsequent agreement which aims at alteration of DTCs or that of their interpretation must be approved in the same manner as the original international treaty (i.e. DTC).

However, OECD takes the stance of a limited dynamic approach according to which the existing DTCs should be interpreted in the spirit of the revised OECD MC and the Commentary excepted where the new or modified provisions deviate from those of the DTC in substance. [145] This means that where the changes encompass clarification or minor modifications compared to the former version, then the latest version must be applied while in case of significant, substantive changes the new version is irrelevant.

In my view, this solution is a trade-off between the two approaches. Although it goes against international law (it allows the application of the latest documents without proper parliamentary approval), it eliminates

[143] Lang: Introduction to the Law of Double Taxation Conventions, Linde, Vienna, 2013, p.51
[144] Ibid. P. 51
[145] MATERIALS on International, TP & EU Tax Law, Volume A (edited by van Raad), ITC Leiden, 2016, Introduction OECD Model 2014, para.33-35

the problem of different interpretations caused by timing differences in the conclusion of DTCs. At the same time, the sovereignty of States is preserved in case of substantial changes, meaning that the modifications of these non-binding documents do not affect their bilaterally agreed, legally binding DTCs.

The countries' practices are not identical: it varies from the limited dynamic (e.g. USA, Norway) to the static approach (e.g. Austria, Canada)[146], however there is a consensus on the refusal of an absolute dynamic approach. This also follows from common sense: it would contradict to legal certainty and to the principle of pacta sunt servanda if all later modifications formed part of the agreement or at least the context of the agreement and the Contracting Parties would not be able to predict of the future interpretation of the their DTCs.

The contemplated modifications of OECD MC and the Commentary in connection with BEPS Action 7 predominantly entail substantial changes, as a consequence of which the treatment of entire business structures will be different from the current one (e.g. in case of commissionaire arrangements) and the scope of PE notion will become wider in almost all aspects (i.e. the narrowing of the scope of activity exceptions and that of the independent agent as well as widening the ambit of dependent agent). Therefore it is indifferent whether a State belongs to those which endorse the dynamic approach or to those which apply the static view, the BEPS Action measures will be effective only if the changes are explicitly included in DTCs. As mentioned above, the extended DTC-network with more than 2000 DTCs would make the implementation of this change very time-consuming and burdensome. Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties) explicitly deals with this problem and provides a unique solution to this: the automatic modification of all DTCs together by signing a multilateral agreement. The details of this instrument are presented in the next subheadings.

5.2. Multilateral Instrument

As it has been shown in the previous paragraph, the limited dynamic interpretation of OECD MC and its Commentary does not enable the application of BEPS Action provisions without the modification of existing DTCs, let alone the static interpretation. However, the treaty-by-treaty modification of the entire treaty network would be very cumbersome and time-consuming. According to Owens, the general time which elapses between the change to the OECD MC or/and to the Commentary and the implementation of the change in DTCs worldwide is 5-15 years.[147] This long delay would make BEPS Actions inefficient, as this period would provide multinationals to move towards new tax planning strategies and OECD (and its

[146] Engelen-Pötgens: Report on 'The Application of the OECD Modell Tax Convention to Partnerships' and the Interpretation of Tax Treaties, In. European Taxation, July 2000, IBFD, p. 267

[147] Miller-Kirkpatrick: The Use of Multilateral Instruments to Achieve the BEPS Action Plan Agenda, In: British Tax Review, 2013, 5, p.684

Member States) would be left behind in the course of the continuous catch-up game.[148] The OECD considered that danger and in Action 15, it called for the creation of a Multilateral Instrument (hereafter: MLI) i.e. a multilateral treaty the ratification of which would automatically modify the existing DTCs between the signatory parties. Such an instrument is well-known in the field of international law and the idea also came up in connection with international tax law, however it has never been implemented until now. Firstly, the basic nature of multilateralism will be presented, then the focus will be cast specifically on the MLI of BEPS Action 15: the character of the instrument, its relation with DTCs, and the tools of achieving a balance between consistency and flexibility will be presented.

5.2.1. Multilateralism in international law and international tax law

In the area of international law unilateral, bilateral and multilateral relations coexist and sometimes overlap each other. The definition of multilateralism has been changed along the time. At the beginning of 1990s, Keohane described that phenomenon as follows: *'practice of coordinating national policies in groups of three or more states, through ad hoc arrangements or by means of institutions'*, while Bouchard and Peterson gave the following definition in 2013: *'Multilateralism is three or more actors engaging in voluntary and (essentially) institutionalized international cooperation governed by norms and principles, which rules that apply (by and large) equally to all.'*[149] The second, 21st century concept also includes the cooperation of non-state organizations and requires the cooperation to be institutionalized. The latter element does not necessarily encompass permanent staff and headquarters, but the policy making must be governed by norms and principles. For example, the G20 functions exactly in the same way.[150]

Multilateral agreements are quite common in international relations, such as in case of Law of Sea, or the collective defense system of NATO and there are many other instances. However, international tax law is based on bilateral relations: States enter into DTCs with the other contracting party and the DTC concerned is only applicable to taxpayers who are residents of one or both of the contracting states (as a main rule, but exceptions may occur, as in case of the non-discrimination rule for PEs). The fact that bilateralism is the prevailing structure of international tax law does not mean that multilateralism is absolutely lacking. We can mention multilateral tax treaties (e.g. Nordic Multilateral Double Taxation Convention or Double Taxation Agreement of the Caribbean Community). These conventions, however, can be seen as regional agreements concluded among geographically, historically and culturally connected States. Their success can be explained by the similar tax systems as well as by similar economic interest of the contracting

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[148] Ibid. P.685
[149] Multilateralism in the 21st century, Europe's quest for effectiveness (edited by Bouchard, Peterson and Tocci), Routledge, 2013, pp. 16, 18
[150] Ibid. P.18

States.[151] Multilateralism can also be traced in the OECD MC and in its Commentary: their provisions provide multilateral basis for DTC negotiations and additionally, these documents have significant impact on DTC interpretation. These roles (i.e. model and tool of interpretation) of OECD MC and the Commentary also extend to non-OECD countries.[152] A unique multilateral feature can be observed in the DTCs of India in which a most-favored-nation clause is frequently included. This means that if India grants to a taxpayer based on its DTC with a third State a more beneficial tax treatment in terms of certain item of income, then this more advantageous treatment will also be applicable to the taxpayer of the other contracting State.[153]

The above mentioned examples provide evidence of the existence of multilateralism in international tax law, although neither of them addresses the modification of other, already existing treaties. There are cases in international law where exactly the same happened: bilateral treaties have been modified by multilateral ones: for instance in the field of extradition, fight against terrorism or Investor-State Arbitration.[154] This non-exhaustive list of examples has proved that the modification of several bilateral treaties by one multilateral treaty is viable from an international law point of view. Although this type of instrument has never been implemented in international tax law, the multilateral instrument of BEPS Action 15 is not the first attempt to modify many DTCs automatically.

In 2006, Baker and Avery Jones proposed a standard protocol: the signatories would have undertaken that the changes in the wording of OECD MC would be implemented without alteration into the DTCs concluded with the other signatories.[155] Although it would have accelerated the transposition of the new wording of OECD MC into DTCs, this instrument would have required uniform wording: it would have left no space for bilateral peculiarities. In my opinion, this possible consequence is undesirable as certain historical-economic relations may justify the different DTC practice with different States. Moreover, it would have prolonged the discussions about the new wording of OECD MC due to the fact that the multilateral protocol would have promoted the OECD MC from the position of means of interpretation of DTCs to an authoritative document regarding the future wording of DTCs. Additionally, the changes relating to

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[151] Antón: The 21st Century Multilateralism in International Taxation: The Emperor's New Clothes?, In: World Tax Journal, June 2016, p.172

[152] Ibid. P.162

[153] Ibid. P.164

[154] The referred agreements are European Convention on Extradition, International Convention for the Suppression of the Financing of Terrorism and United Nations Convention on Transparency in Treaty-based Investor-State Arbitration, In: Bravo: The Multilateral Tax Instrument and Its Relationship with Tax Treaties, In: World Tax Journal, October 2016, p.281

[155] Miller-Kirkpatrick: The Use of Multilateral Instruments to Achieve the BEPS Action Plan Agenda, In: British Tax Review, 2013, 5, p.284

provisions to which, certain States added reservations (either prior to the amendment or following the amendment) may have caused uncertainty and confusion.[156] This proposal finally has not been realized.

I consider important to mention another multilateral agreement regarding taxation: the Mutual Assistance Convention[157] which covers assessment assistance, recovery assistance, service of documents and initiation of criminal procedure due to tax offences.[158] It did not modify DTCs, but it went further as regards mutual assistance than the OECD MC and DTCs which have been drafted according to the former document: it laid down additional requirements in this field. This Convention has become successful, 66 countries joined as signatories, including all the G20 countries as well as many non-OECD States.[159] The signatories achieved closer cooperation than they were entitled based on their DTCs, without modifying them one-by-one. In my view, the Mutual Assistance Convention cannot be compared to the Multilateral Instrument of BEPS Action. It did not modify the DTCs, but simply superseded them in connection with mutual assistance vis-á-vis all the other signatories. Secondly, it encompasses only one special tax issue, namely the mutual assistance by means of exchange of information that can be found in Art. 26 OECD MC, therefore one cannot consider it as a comprehensive reform of DTC provisions.

5.2.2. Multilateral Instrument of BEPS Action 15

In the light of the previous subparagraph, it is clear that the idea of MLI is a very unique innovation in the tax world. The participants of BEPS Project recognized that it is not enough to reform the wording of OECD MC and that of the Commentary and wait for the States to transpose them into DTCs years later, if they transpose it at all. This would undermine the effectiveness of the measures. Therefore Action 15 calls for the development of a MLI: this is a multilateral treaty which will modify the DTCs of the signatory States in accordance with other BEPS Actions. Action 15 set up an ad hoc Group to create the MLI. As the BEPS Actions are to be implemented globally, it is emphasized that the Group is not an OECD body and all the interested States, thus including non-OECD members can participate in the Group on an equal footing.

The MLI respects two very important principle: the sovereignty of States and the bilateral nature of DTCs. The sovereignty of States will not be breached, as it is not mandatory to sign the MLI even if the State at issue is a member of the ad hoc Group. If the States decide to ratify it, the procedure is subject to the same parliamentary approval as in the case of ratification of DTCs. The bilateral feature of international tax

[156] Ibid. P.285
[157] Joint Council of Europe/OECD, Convention on Mutual Administrative Assistance in Tax Matters
[158] Terra, Wattel: European Tax Law, Kluwer, 2012, p.414
[159] Miller-Kirkpatrick: The Use of Multilateral Instruments to Achieve the BEPS Action Plan Agenda, In: British Tax Review, 2013, 5, p.285

treaties will persist, as the aim of the MLI is to modify them swiftly and consistently instead of replacing them.[160] From the bilateral nature it follows that the relationship between parties to the MLI that have not concluded DTC will not be affected with the exception of the multilateral dispute resolution mechanism, which will be applicable to the parties also in the lack of bilateral DTC between them.[161] The maintenance of bilateral DTCs entails the coexistence of the MLI and thousands of DTCs, therefore their relationship must be unequivocal.

5.2.2.1. Relationship between MLI and DTCs

Public international law provides for rules to the application of several international treaties being in force. When they are simultaneously applicable to at least one of the parties in the same circumstances, they can accumulate or conflict. In case of accumulation, the treaties do not contradict to each other, because one of them either complements the provisions of the other or confirms them. In that case, no problem arises, the simultaneous application of the treaties leads to consistent result. However, the treaties conflict when it is impossible to fulfil the obligations or exercise the rights emanating from one of the treaties without violating the other treaty.[162] This conflict occurs when 'both an earlier and a later treaty deal with the same subject matter in a different manner and at least one State is party to both treaties.[163]

VCLT serves solutions to treaty conflicts. Art. 30 (2) allows the parties to introduce a compatibility clause in their treaties which can specify that the treaty at issue is subject to or it is not to be considered as incompatible with an earlier treaty, and as a consequence, that other treaty will prevail. This paragraph does not mention the opposite case, when the compatibility clause declares that the treaty which contains the clause will prevail over the already existing treaties, although it cannot be disputed that it is also possible. The reason of this deficit is that this type of compatibility clause would only reproduce the principle of lex posterior.[164]

The principle of lex posterior derogat legi priori is laid down in Art. 30 (3)-(4) of VCLT as a residual rule to solve treaty conflict according to which the later treaty takes precedence over the earlier one, and the

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[160] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 –Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para. 19, Available at: http://dx.doi.org/10.1787/9789264241688-en
[161] Ibid. para. 22
[162] Bravo: The Multilateral Tax Instrument and Its Relationship with Tax Treaties, In: World Tax Journal, October 2016, p.282
[163] Aufricht: Supersession of Treaties in International Law, In: 37 Cornell L. Rev. 655 (1952), Available at: http://scholarship.law.cornell.edu/clr/vol37/iss2/6 , pp.655-656
[164] Bravo: The Multilateral Tax Instrument and Its Relationship with Tax Treaties, In: World Tax Journal, October 2016, p.285

latter is only applicable to extent that its provisions are compatible with those of the later treaty. As a result, when a new treaty remains silent regarding its relationship with the earlier treaty (i.e. no compatibility clause is entered into it), then in case of conflicting provisions, the later treaty must be applied. Although this principle provides certainty in the majority of cases, its flaw is that it cannot solve the conflict when the treaties have been concluded among different States: if one of the States is not party to the later treaty, this treaty cannot create obligations for this State because of the principle of pacta tertiis nec nocent nec prosunt which means that a treaty binds the parties and only the parties. For example, when a multilateral treaty among A-B-C and a later treaty among A-C-D are not compatible, A and C have to decide which of the treaties they will comply with, but they will violate one of the treaties, even if they follow the lex posterior principle, because vis-á-vis B they cannot refer to that principle, as B is not contracting party of the later treaty.[165]

However, I cannot see it as a problem in case of MLI: it maintains the bilateral nature of DTCs, thus a State which signs the MLI can comply all of its DTCs. It can apply the modified DTCs towards States which are also signatories of MLI and at the same time can apply the DTCs concluded with States which are not parties of MLI without any modification. The reason why I still advocate the use of compatibility clause instead of lex posterior principle is that it can cause uncertainties that a certain anti-BEPS measure affects which provisions of DTCs. It is crucial to identify the spots of treaty conflicts because the parts of DTCs which are compatible or not affected by BEPS Actions will remain effective. In order to achieve this aim and to cease uncertainty a well-designed compatibility clause is required which is not general but refers to specific provisions. There are several difficulties to implement it: DTCs use different terminology, have different enumeration styles (which often depart from those of OECD MC), different wording and different scopes. Therefore the compatibility clause must apply a description of the type of provision of DTC which makes possible the unambiguous identification of the provision concerned.[166]

The ad hoc Group has adopted the above mentioned solution, i.e. each provision of the MLI contains a specific compatibility clause which refers to the modified provision of the DTC. In case of PE changes, the wording of Multilateral Convention provides the following reference to the addressed provision of DTCs:

'Paragraph 1 shall apply in place of provisions of a Covered Tax Agreement (i.e. the affected DTCs) that describe the conditions under which an enterprise shall be deemed to have a permanent establishment in a Contracting Jurisdiction (or a person shall be deemed to be a permanent establishment in a Contracting Jurisdiction) in respect of an activity which a person other than an agent of an independent status undertakes

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[165] Ibid. Pp.288-289

[166] Bravo: The Multilateral Tax Instrument and Its Relationship with Tax Treaties, In: World Tax Journal, October 2016, p.297

for the enterprise, but only to the extent that such provisions address the situation in which such person has, and habitually exercises, in that Contracting Jurisdiction an authority to conclude contracts in the name of the enterprise.'[167]

As it can be seen, the wording of this compatibility clause avoids the use of numerical cross-references and not only mentions the term PE as in some DTCs different term is used for this concept. Instead of these solutions, it gives the description of PE concept by means of presenting the essential features of it. I believe that this solution will contribute to greater certainty and prevent treaty conflicts between existing DTCs and the MLI.

5.2.2.2. Flexibility vs Consistency

There is a tension between the requirement of consistency (i.e. identical or at least very similar implementation of BEPS Actions by different States) and broad acceptance of MLI in the international arena (i.e. ratification by a lot of countries) as States may not agree with all the measures or they intend to implement them to a different extent towards different parties. If States are not entitled to different implementation at all, it would endanger their commitment towards the MLI and other BEPS Actions which cannot be successful without a critical mass of signatory States.[168] In order to reconcile consistency and flexibility, the MLI applies several tools. As far as consistency is concerned, the MLI requires signatory States to commit themselves to a core set of provisions (without the possibility of making reservation to these parts of MLI.)[169] On the other hand, flexibility will be provided by virtue of the possibility for States to make reservations to certain parts of the MLI, to opt-out provisions (which would be otherwise automatically applicable), to opt-in provisions (undertaking additional level of commitment vis-á-vis all parties or certain parties (which would not be otherwise applicable) as well as to choose between different alternative measures.[170]

In case of BEPS Actions connected to PE, the Multilateral Convention allows States to exclude the application of the entire Article dealing with this issue. Moreover, this part of MLI also gives example for alternative choice regarding specific activity exemptions which do not create PE as it has been presented in

[167] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Art. 12, para. 3a), Available at: http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf

[168] Miller-Kirkpatrick: The Use of Multilateral Instruments to Achieve the BEPS Action Plan Agenda, In: British Tax Review, 2013, 5, p.289

[169] [169] OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 –Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, para. 16, Available at: http://dx.doi.org/10.1787/9789264241688-en

[170] Ibid. Para. 43-44

the relevant chapter.[171] Also, States are entitled to make reservations to any of these Articles. In my views, in this case the balance between consistency and flexibility has been tilted towards flexibility. Providing alternative measures and reservations to certain provisions of these Articles would have been enough for creation flexibility. The possibility for exclusion of the entire part relating to BEPS Action 7 of MLI can result in no change in the existing DTCs, if States exercise their right to do so which would cause inefficient outcome of BEPS Project in terms of PE reform.

The MLI in the form of a multilateral convention has been opened for signature on 7 June 2017 and it has already been signed by 68 States, and other 9 States expressed their intention of signing it,[172] however the United States is not among them. The relations among these States cover more than 1100 DTCs. The MLI will enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification, acceptance or approval.[173] The depositary of the MLI is the OECD, it has to follow the ratification procedure of signatories. The date of entry into force is expected to take place in 2018.[174]

[171] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Art. 12 para.4, Art. 13 para. 1-6, Available at: http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf

[172] Information brochure about Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Available at: http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf , p.3

[173] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Art. 34, Available at: http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf

[174] Information Brochure about Multilateral Convention to Implement Tax Trety Related Measures to Prevent Base Erosion and Profit Shifting, Available at: http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf, p. 7

6. Conclusion

To bring my thesis to a close, I summarize and assess the main findings of my work. My research dealt with the challenges of PE concept: I examined whether the relevant BEPS Actions are able to give proper answers to these challenges. In my view, a proper solution must fulfil three requirements: firstly, it must be reasonable (i.e. the practice of multinational enterprises which the BEPS Actions intend to prevent goes indeed against the rationale of PE concept and therefore it is abusive). Secondly, the solution has to be eligible to preclude the identified abusive practice, as well as it has to be exempt from spillover effects, that is it should not be applied to cases or practices where there is an underlying business reason. Thirdly, the measures have to be effectively and swiftly implemented in a legally binding way.

In the course of the BEPS-project, several business models and practices have been identified as abusive. One of these structures is the *commissionaire arrangement* under which the enterprise (the principal) sells goods in the source state by virtue of its subsidiary which acts as a commissionaire agent. As a result, the subsidiary does not become the owner of the goods which it sells in its own name but on behalf of the enterprise, thus it avoids creating a PE for its parent company under Art. 5 (5) OECD MC. I consider reasonable the involvement of this structure in the ambit of BEPS Action 7, as this arrangement does not reduce the extent of participation of the multinational enterprise in the economic life of the source State compared to a buy-sell structure, but at the same time, it leads to significantly different tax consequences: the multinationals are able to circumvent the taxable presence (both the parent company as no agency PE exists and its subsidiary as the income is attributed to the owner of the sold goods, i.e. to the parent company). Therefore, no taxing right is allocated to the source state jurisdiction (apart from the lower amount of the commission fee), although the economic activity of the multinational company in this state exceeds the threshold. Additionally, one cannot identify any underlying non-tax driven business reason for operating the sales in a commissionaire arrangement instead of a buy-sell arrangement.

The proposed change in the wording of OECD MC does not require the principal to be legally bound by the contract concluded by the commissionaire and the customer for the creation of an Agency PE. It also suffices if the risk of non-performance is borne by the principal in the end of the day. This is the case when the commissionaire sells goods that are owned by the principal. The new wording ceases the decisive role of the clause ‘in the name of the enterprise’ thus, the word ‘binding’ is to be interpreted in a broader, economic sense instead of a pure legal one. Regarding that the commissionaire arrangements are based on the legal view of ‘binding by a contract’, it is highly probable that this loophole will be closed under the new text of

OECD MC. Therefore I agree with Pleijsier,[175] that under commissionaire arrangements, the commissionaire subsidiaries will create Agency PE for the principal parent companies and ensuing taxation on the sales in the source state will take place in the post-BEPS era. The proposals of BEPS Action 7 in connection with avoiding PE status by means of commissionaire arrangements seem to be adequate and eligible.

The so-called *low tax distributors* are out of the scope of BEPS Action 7 because in that case the distributing subsidiary sells the goods in its own name and on its own behalf, therefore the local distributor is taxed on the sales in the source state as it is tax resident of this state. However, this structure may trigger the measures of BEPS Action 9 which deals with contractual allocation of risks and may result in transfer pricing adjustments. Although Action 9 is not subject to this thesis and the eligibility of the provisions of this Action has not been examined, I am of the opinion that attacking low tax distributor structures is generally not reasonable: normally this structure encompasses the contractual shift of inventory risk to another group member company (central supply chain company), but this transfer of risk makes the management of the global inventory of the multinational more effective, therefore this structure of supply chain management does not depart from economic reality and one can identify a sound business reason behind the transaction. Thus, in a default case, it is not reasonable to target this structure in BEPS Action 9 either.

Other similar strategies have been also regarded as abusive. These are related to the avoidance of Agency PE status by means of *artificial alteration of the place of conclusion of contracts* (i.e. contract between the agent and customer). The place of conclusion of contract has to be decided on the basis of domestic contract law, which is an essential factor because, according to the current wording of Art. 5 (5) OECD MC, it is necessary for the creation of Agency PE that the agent concludes contracts in the source state. I think it is reasonable to expect that the same level of participation in the economic life of the source state (i.e. contracting with local customers relating to the business activity of the enterprise) entails the same level of taxation therein, irrespective of the artificial outsourcing of a given step of the contracting process which is decisive under domestic law in the determination of place of conclusion of contract.

BEPS Action 7 introduced the principal role test which is intended to be interposed into the wording of Art.5 (5) OECD MC. According to the principal role test, it suffices that the agent plays the principal role in the source state which leads to the conclusion of contracts (even outside the source state), if these contracts

[175] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, Nov/Dec 2016, IBFD, p. 444

are routinely concluded without material modification by the enterprise. This solution received a lot of criticism from scholars: there is not a well-established definition of principal role which can result in many disputes between the taxpayers and tax authorities. Moreover, it creates new possibilities to avoid Agency PE status by means of reinforcing the formal approval process in the hands of the principal enterprise in order not to fulfil the criterion 'routinely concluded without material modification' or by means of outsourcing the entire contractual process in order to argue that the agent only carries on promoting or advertising activity. Additionally, this new provision may affect all the sales agents who do their job well as they are likely to agree with the customers on contractual terms which are accepted by the principal without modification.[176] In my view, the proposal of BEPS Action 7 relating to that type of abusive practice is not eligible due to the potential danger of further abuse as well as the undesired spillover effect of bringing potentially all sales agents under the concept of dependent agent.

Even the *activity exemption provision* (Art. 5 (4) OECD MC) gave rise to abuses: some activities do not establish a PE status for the enterprise by definition, without being investigated whether they are remote from the core business activity of the enterprise or they are part of it. This goes against the rationale of the exemption, therefore I find it reasonable to reform this paragraph of OECD MC in order to align it with the business models of the 21st century.

BEPS Action 7 provides two countermeasures to abusive practices relating to activity exemptions. One of them is making all the activities subject to *preparatory-auxiliary test*. I regard this option as being in line with the rationale of this paragraph of OECD MC because it would ensure that only activities with a preparatory or auxiliary character are entitled to the exemption. Although it can evoke debates between taxpayers and tax authorities, this measure theoretically seems to be eligible to prevent abuses.

The second option is an *anti-fragmentation rule* which precludes that an enterprise or closely related enterprises avoid PE status by means of fragmenting complementary activities which are of a preparatory or auxiliary character separately, but together they form part of core business activity. This solution is also eligible to preclude abusive practices if one presumes that one single activity mentioned in subparagraphs a)-d) of Art. 5 (4) cannot be core business activity. Considering a typical e-commerce company, at least delivery and warehousing activities are required to be carried on in the source state, thus this presumption is correct in my opinion and this option is also a proper tool to curtail this kind of abuse.

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[176] Pleijsier: The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report, In: International Transfer Pricing Journal, Nov/Dec 2016, IBFD, p. 443

Construction PE concept suffers abuses as well, namely the *split-up of contracts* between related enterprises in order to circumvent the 12-month condition and avoid PE status. The duration test is a very important indicator of taxable presence of the enterprise in the source state, so the abuse of this criterion goes against the rationale of PE concept and tackling this type of practices of multinationals is reasonable.

BEPS Action 6 contains an anti-avoidance rule, the *Principal Purpose Test*, which is explicitly declared to be applicable to the abuse of splitting up of the contracts. Other alternative is the *modification of the Commentary* on Art. 5 (3) OECD MC, provided for those countries which intend to address this problem expressively or for those which do not include PPT in their DTCs. The change of the Commentary states that the duration of the connected activities on the same building sites or construction/installation project carried out by closely related enterprises must be aggregated. As this rule provides guidance both to the notion of connected activities and to the notion of closely related enterprises (it is clarified within the independent agent provision), in my opinion, this solution is straightforward and appropriate to curb abuse of Construction PE. However, the instrument of PPT is of a general nature which can be applied to many forms of abuses (and as a result, it can cause uncertainty), therefore I believe it should be utilized as a residual tool to address abuses. When a special kind of abuse is identified and it is targeted by a customized countermeasure, this special anti-abuse provision should be used, the scope and effect of which is more predictable than that of a general abuse rule. The latter one should serve as a tool to tackle unforeseeable abuses which are out of the scope of any special anti-abuse measure.

Although the assessment of *reasonableness and eligibility* of BEPS Action provisions connected to the PE concept required separate, provision-by-provision investigation, the *effectiveness* prong of my research can be examined jointly, as all the provisions entail the modification of OECD MC and its Commentary. This issue, i.e. the swift and consistent transposition of these changes into the legally binding DTCs belongs to the territory of public international law, therefore an interdisciplinary analysis had to be carried out in order to answer the research question. Considering the rules of public international law and the practice of countries, one can state that the substantial change in OECD MC and its Commentary cannot serve as a tool of interpretation of DTCs which have been concluded before the changes at issue.

In order to avoid the cumbersome and time-consuming treaty-by-treaty modification of DTC network, BEPS Action 15 developed a Multilateral Instrument (MLI) which is a multilateral convention that would modify automatically all the existing DTCs between the signatory states. It is feasible to modify several bilateral treaties by means of a multilateral one. Although the coexistence of DTCs and the MLI can evoke treaty conflicts, these can be solved by a well-designed compatibility clause to each provisions of the MLI. The VCLT provides that possibility and the creators of MLI did not miss to utilize it. It will decrease the number of treaty conflicts and the uncertainty which pertains to it, compared to the application of lex posterior principle.

The clash between the consistent implementation and broad acceptance of MLI by the states is mitigated by providing the possibility for the states to make reservations or exclude the application of certain BEPS provisions or opt-in/opt-out for certain provisions as well as to choose between alternative solutions. The MLI allows states to make reservation or exclude the application of any BEPS Action measures addressing PE definition. In my opinion, this rules became too flexible, which endangers consistency. The final positions of the signatory states are not known yet, however they got too much discretion in this aspect and the provisions of BEPS Action 7 will be effective only if the states are willing to mutually relinquish their abovementioned power.

To conclude, I can state that the working groups dealing with BEPS Action 7 identified real and existing abuses, therefore their measures are reasonable. However, the contemplated measures to tackle the abusive practices are not always eligible. They may give rise to further abuses or they may create Agency PE where it is not in accordance with the rationale of PE concept. Moreover, the majority of these measures will cause uncertainty to a large extent because the new notions are not defined very precisely and there is no case law relating to them or because the anti-abuse measure at issue is too general. At the same time, the solutions to challenges regarding commissionaire arrangements and activity exemptions are expected to be appropriate. The MLI is a unique and cutting-edge instrument to effectively implement BEPS measures. Already 68 states signed this convention and it is predicted to enter into force in 2018. The effectiveness will not only depend on the number of committed states, but also on how the states are going to exercise their broad power to exclude the application of certain BEPS Action 7 provisions or make reservations on them. If it works out well, it can be a good example of the quick implementation of changes in OECD MC throughout the DTC network for the future works.

The BEPS-package is the outcome of a globally coordinated project which enabled the participation of all the interested countries on equal footing and includes comprehensive measures to tackle identified abusive practices by multinationals. I believe that notwithstanding its flaws, this type of international coordination can be the way to counter the abuses of internationally operating companies as the mismatches between domestic rules and the shortcomings of DTC provisions can be effectively mitigated. It is also important to find the right balance and only target artificial, tax-driven measures of multinationals and allow business structures where sound business reasons can be seen behind them.

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