ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT IN THE POST-BEPS ENVIRONMENT

Aapo Pessi 507431
Pro gradu –tutkielma
Turun yliopiston oikeustieteellinen tiedekunta
Yritysverotus
Lokakuu 2018

TURUN YLIOPISTO
Oikeustieteellinen tiedekunta

Aapo Pessi: Attribution of profit to permanent establishment in post-BEPS environment.

Tutkielma, 75s., XI liitesivua.
Finanssioikeus
Marraskuu 2018
Turun yliopiston laatujärjestelmän mukaisesti tämän julkaisun alkuperäisyys on tarkastettu Turnitin Originality Check -järjestelmällä.

The pro gradu thesis discusses the development of permanent establishment regulation in the field of international taxation, most recently due to the Action 7 of the BEPS project initiated by The Organisation for Economic Co-operation and Development (OECD). BEPS stands for Base Erosion and Profit Shifting, and describes the aim of the project well: to halt international tax avoidance and harmful tax practices.

The new regulation and its many channels of implementation will have a material effect on how the multinational corporations shall plan and execute their businesses, resulting in changes in supply chains and operating models. This study aims to detect these changes, and analyze their outcomes regarding existing permanent establishment (PE) structures, and new PE structures created by the changes in regulation. As a separate matter, this study addresses the attribution of profits of the entire business operation between the principal entity and the PE.

The research method of this study is the legal dogmatic method. The integral sources of information are the OECD publications regarding the BEPS project, in addition to wide bibliography of Finnish and international tax law literature. Transfer pricing considerations are of essential importance, and therefore, relevant OECD and Finnish administrative guidance is utilized and analyzed.

The concluding remarks state that the BEPS project proposes significant changes to the current PE doctrines, but may fall short of its goals of implementation. It is reasonable to assume, however, that the updated PE regulation shall be adopted with time due to OECD's material influence and EU's co-operation. In terms of profit attribution the BEPS does not introduce material changes compared to the updated 2017 OECD Transfer Pricing Guidance. Rather, it relies on established principles and methods that were widely used in pre-BEPS structures as well.

Keywords:

BEPS, Action 7, OECD, permanent establishment, profit attribution, transfer pricing, tax avoidance, CCCTB, international income taxation

TURUN YLIOPISTO
Oikeustieteellinen tiedekunta

Aapo Pessi: Attribution of profit to permanent establishment in post-BEPS environment.

Tutkielma, 75s., XI liitesivua.
Finanssioikeus
Marraskuu 2018
Turun yliopiston laatujärjestelmän mukaisesti tämän julkaisun alkuperäisyys on tarkastettu Turnitin Originality Check -järjestelmällä.

Pro gradu –tutkielma käsittelee kiinteän toimipaikan sääntelyn kehitystä kansainvälisen tuloverotuksen kontekstissa, hiljattain Taloudellisen yhteistyön ja kehityksen järjestön, OECD:n, käynnistämän BEPS hankkeen toimenpide 7:n myötä. BEPS viittaa veropohjan rapautumiseen ja tulonsiirtelyyn, joka tiivistää hankkeen tavoitteet hyvin: pysäyttää kansainvälinen verovälttely ja haitalliset verotuskäytännöt.

Uudella sääntelyllä moninaisine implementointikanavineen tulee olemaan merkittävä vaikutus kansainvälisten yritysten liiketoiminnan suunnitteluun ja toteutukseen. Vaikutukset tulevat heijastumaan näiden toimijoiden toimitusketjuihin sekä liiketoimintamalleihin. Tämä tutkielma pyrkii tunnistamaan nämä muutokset, ja analysoimaan niiden vaikutuksia ensinnäkin jo paikalla oleviin kiinteisiin toimipaikkoihin ja toisaalta uusiin sääntelyn synnyttämiin kiinteisiin toimipaikkoihin. Erillisenä asiana tutkielma käsittelee tulon allokointia kiinteä toimipaikan sekä sen pääliikkeen välillä.

Tutkielman metodi on oikeusdogmaattinen. Keskeisiä tiedonlähteitä ovat OECD:n julkaisut ja loppuraportit BEPS hankkeeseen liittyen, sekä laaja kotimainen ja kansainvälinen kansainvälisen tuloverotuksen oikeuskirjallisuus. Siirtohinnoitteluaspektit ovat tutkielman kannalta keskeisiä, ja niissä tutkielma nojaa relevanttiin OECD:n sekä verohallinnon ohjeistukseen.

Tutkielman johtopäätöksenä todetaan, että BEPS hanke esittää merkittäviä muutoksia voimassaoleviin kiinteän toimipaikan säännöksiin, mutta sen tosiasiallinen vaikutus voi olla tätä vähäisempi implementointivaikeuksien johdosta. On kuitenkin realistista olettaa, että uusi kiinteän toimipaikan sääntely tulee osaksi kansainvälistä verokaanonia ajan mittaa OECD:n vaikutuksen ja EU:n yhteistyön myötä. Tulon allokointiin liittyen BEPS ei aiheuta merkittäviä muutoksia, vaan pikemmin nojaa voimassa olevaan hiljattain uudistettuun 2017 OECD siirtohinnoitteluohjeistukseen ja BEPS hanketta edeltävän oikeustilan aikaisiin perusperiaatteisiin.

Asiasanat:

BEPS-hanke, Toimenpide 7, kiinteä toimipaikka, tulon allokointi, siirtohinnoittelu, veronkierto, verovälttely, CCCTB, kansainvälinen tuloverotus

Contents

References

Bibliography:

Aarnio, Aulis: Laintulkinnan teoria. WSOY 1989.

Deloitte 2018: BEPS Actions implementation by country matrix – Action 7 (Deloitte 2018).

European Commission. Commission Recommendation on the implementation of measures against tax treaty abuse (C(2016) 271 final). 28 January 2016, Brussels (European council 2016a).

European Commission. Communication from the Commission to the European Parliament and the Council, Anti-Tax Avoidance Package: Next steps towards delivering effective taxation and greater tax transparency in the EU (COM/2016/023 final). (Commission 2016b).

EY 2017: Lifting the mist Sustainable distribution models in the post-BEPS world (EY 2017).

Helminen, Marjaana: Finnish International Taxation. E-kirja Talentum 2018.

Helminen, Marjaana: EU-Vero-oikeus: Välitön verotus. E-Kirja Talentum 2018.

Helminen, Marjaana: KHO 2013/1704 (93) ja OECD:n malliverosopimuksen kommentaarin merkitys verosopimusten tulkinnassa. Edita 2014.

Hemmo, Mika: *S*opimusoikeus I-III, e-kirja. Talentum 2006.

Jiménez, Adolfo Martín,Spain – The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, beyond BEPS or Simply a Wrong Interpretation of Article 5 of the OECD Model? Bulletin for International Taxation 8/2016.

Malmgren, Marianne: OECD:n hanke veropohjan rapautumisen ja voitonsiirron estämiseksi. Verotus 1/2015 p. 38-46.

Malmgren, Marianne: OECD:n ja EU:n hankkeet aggressiivisen verosuunnittelun rajoittamiseksi ja veropohjan rapautumisen estämiseksi. Yritys, omistaja ja verotus: juhlajulkaisu Seppo Penttilälle 2014, p. 223.

Malmgren, Marianne: Oikeushenkilön asuinvaltio verotuksessa ja yrityksen kansainvälistyminen. Edita 2014.

Nykänen, Pekka: Rajoitetusti verovelvollisen tulon verotus. Talentum 2015.

OECD 2011: Discussion Draft, Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention. 12 October 2011.

OECD 2012. Revised Discussion Draft, OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment). 19 October 2012.

OECD 2013. Action Plan on Base Erosion and Profit Shifting, OECD/G20 Base Erosion and Profit Shifting Project, 19 July 2013 (OECD 2013).

OECD 2014. OECD approves the 2014 update to the OECD Model Tax Convention. 16 July 2014 (OECD 2014a).

OECD 2014. Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status. OECD/G20 Base Erosion and Profit Shifting Project, 31 October 2014 (OECD 2014b).

OECD 2015. Comments Received on Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status. OECD/G20 Base Erosion and Profit Shifting Project, 1 January 2015 (OECD 2015a).

OECD 2015. Revised Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status. OECD/G20 Base Erosion and Profit Shifting Project, 15 June 2015 (OECD 2015b).

OECD, 2015. Final Report, BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status, OECD/G20 Base Erosion and Profit Shifting Project. 5 October 2015 (OECD 2015c).

OECD 2015: Final Report, BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation, OECD/G20 Base Erosion and Profit Shifting Project. 5 October 2015 (OECD 2015d).

OECD 2015: OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports Information Brief, OECD/G20 Base Erosion and Profit Shifting Project. 5 October 2015 (OECD 2015e).

OECD 2016: Discussion draft on the attribution of profits to Permanent Establishments, OECD/G20 Base Erosion and Profit Shifting Project. 4 July 2016 (OECD 2016a).

OECD 2016: Public comments received on the BEPS discussion drafts on the Attribution of Profits to Permanent Establishments and the Revised Guidance on Profit Splits, OECD/G20 Base Erosion and Profit Shifting Project. 8 September 2016 (OECD 2016b).

OECD: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, 24 November 2018 (MLIa).

OECD: Explanatory Statement, 24 November 2016 (MLIb)

OECD 2017: Revised discussion draft containing Additional Guidance on Attribution of Profits to Permanent Establishments, OECD/G20 Base Erosion and Profit Shifting Project. 22 June 2017 (OECD 2017a).

OECD 2017: Public comments received on the BEPS discussion drafts on the Attribution of Profits to Permanent Establishments and the transactional profit splits, OECD/G20 Base Erosion and Profit Shifting Project. 6 November 2017 (OECD 2017b).

OECD 2017: Model Tax Convention on Income and on Capital published, Condensed Version 2017. http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm (OECD 2017 MTC).

OECD 2017: Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7, OECD/G20 Base Erosion and Profit Shifting Project. 22 March 2018 (OECD 2018).

Ojala, Minna: Monenkeskeinen yleissopimus BEPS-projektin verosopimuksia koskevien muutosten toimeenpanemiseksi. Verotus 2/2017

Rapo, Petteri – Maria Volanen: Yhteinen yhdistetty yhteisöveropohja (CCCTB) – suojaisa sisäsatama vai pinnan alla piilevä karikko? Verotus 3/2017.

Raunio, Merja; Karjalainen, Jukka 2018: Siirtohinnoittelu.

Russo, Rafaele 2005: The Attribution of Profits to Permanent Establishments: The taxation of intra-company dealings.

Räbinä, Timo 2017: Verotusmenettelyn perusteet.

Skaar Arvid (2000), Erosion of the Concept of Permanent Establishment: Electronic Commerce. – Intertax 5/2000 p. 188–194.

Valtiovarainministeriö: Valtiovarainministeriön Vero-osaston kansainvälisen verotuksen yksikön muistio 8.5.2017 (VM 5/2017).

Valtiovarainministeriö: BEPS-toimenpiteiden taloudellisten vaikutusten arviointiraportti 16.6.2017 (VM 26/2017).

Verohallinnon syventävä ohje: Verotuksen maakohtainen raportti, A71/200/2018.

Verohallinnon syventävä ohje: Ulkomaisen yhteisön tuloverotus Suomessa − Liiketulo ja muut ulkomaisen yhteisön Suomesta saamat tulot FTA A70/200/2018.

Viitala, Tomi 2017: OECD:n monenkeskinen sopimus (MLI) (Viitala 2017a).

Viitala, Tomi 2017: Yhteinen yhtiöveropohja (CCTB) – vihdoin myötätuulessa? Verotus 2/2017 (Viitala 2017b).

Verohallinnon syventävä ohje: Verotuksen maakohtainen raportti, A71/200/2018.

Verohallinnon syventävä ohje: Ulkomaisen yhteisön tuloverotus Suomessa − Liiketulo ja muut ulkomaisen yhteisön Suomesta saamat tulot FTA A70/200/2018.

<u>Governmental Publications:</u>

Ministry of Finance: The reservations and notifications of the Republic of Finland for the purposes of the signature of the Multilateral Convention on Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on 7 June 2017 (Finland's MLI Position).

Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Hallituksen esitys eduskunnalle laeiksi ulkomailta tulevan palkansaajan lähdeverosta ja kansainvälisen kaksinkertaisen verotuksen poistamisesta sekä eräiden muiden lakien muuttamisesta, HE 76/1995 vp.

Hallituksen esitys eduskunnalle laiksi osakeyhtiölain ja eräiden siihen liittyvien lakien muuttamisesta, HE 89/1996 vp.

Tasavallan presidentin asetus Kiinan kanssa tuloveroja koskevan kaksinkertaisen verotuksen välttämiseksi ja veron kiertämisen estämiseksi tehdyn sopimuksen voimaansaattamisesta ja

sopimuksen lainsäädännön alaan kuuluvien määräysten voimaansaattamisesta annetun lain voimaantulosta, 104/2010.

Internet sources (all visited 24 October 2018):

OECD: MLI implementation database http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

OECD: MLI position matrix http://www.oecd.org/tax/treaties/mli-matching-database.htm.

Finnish Tax Administration: Tax treaties in force https://www.vero.fi/syventavat-vero-ohjeet/ohje-hakusivu/49062/voimassa_olevat_verosopimukse/.

Case Law

KVL 2001/68.

KHO 7.6.96 T 1928.

KHO 1986/1679 II 501.

KHO 2002:26.

KHO 2014:119

KHO 2016:72.

Abbreviations

2018 Report	See OECD 2018
Action 7	OECD BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status
APA	Advance Pricing Agreement
Art.	Article
ATAD	Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the func tioning of the internal market
BEPS	Base Erosion and Profit Shifting
CCCTB	Common Consolidated Corporate Tax Base
Commentary	The OECD Commentary to the Model Tax Convention on Income and Capital, 2014 or 2017 update.
DTT	Double Tax Treaty
Final Report	See OECD 2015c
FTA	Finnish Tax Administration
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States and the European Union)
LRD	Limited Risk Distributor
HE	Government Proposal (Hallituksen esitys)
KHO	Supreme Administrative Court of Finland
KVL	Central Tax Board
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS
MNE	Multi-National Entity
MTC	OECD Model Tax Convention, either 2014 or 2017 update. Also “OECD Model”.
OECD	Organisation for Economic Cooperation and Development
Para.	Paragraph
PE	Permanent Establishment
TP	Transfer Pricing
TVL	Income Tax Act (Tuloverolaki 1535/1992)

VHL	Act on Assesment Procedure (Laki verotusmenettelystä 1558/2995)

1. Introduction

1.1. Background

Nowadays it is quite common for larger corporations or groups to go about their business through a business model that has a multinational setup. The reasons for placing entities in countries other than the group parent company's residential country vary but taxation is certainly one of the most common ones among location of recourses, cost of labor and legislation environment in general. Of course there are also supply chain implications, which have a great effect on the operating model of a company. The end result could be envisioned to be something of a happy marriage between the operational supply chain, and the side considering taxation and legislative environment.

One of the major organizations involved in the overseeing and regulation of international trade and economy is *The Organization for Economic Co-operation and Development,* better known as "OECD". The main mission of OECD is to promote policies that will improve the economic and social well-being of people around the world. OECD provides a forum in which governmental bodies are able to seek solutions to common problems i.e. in the field on international taxation. OECD seeks to help governments around the world to restore confidence in markets and the institutions that make them function and to re-establish healthy public finances as a basis for future sustainable economic growth, in both of which taxation has an instrumental role.[1]

Due to the aforementioned tendencies of companies with international business operations, generally referred as the Multi-National Entities (MNEs), a demand for business models optimizing the placement of the functions and overall business performance of the MNEs is created. Business models come in all shapes and sizes, and they usually include several forms of entities depending on the roles of the respective roles of the aforementioned entities in the group. In a case where less significant presence is required in a certain country, various agency arrangements might be adequate. Agency is an established concept in contract law, and different agency arrangements are quite common among businesses.[2] However, agency is not

[1] www.OECD.org/about
[2] Hemmo 2006, Chapter 3.

a standard structure, and the differences and implications of various related entity arrangements are further discussed later in this study.

The key relevance for certain arrangements in relation to establishing a company in the desired foreign jurisdiction is that it usually creates neither lesser, or non-existing taxable presence in the other jurisdiction. Hence there are obvious advantages in e.g. agency arrangements that are lucrative to tax planners. On the other hand, this has caused the OECD and other bodies to regulate the agents in a rather detailed manner, aiming to reduce excessive erosion of tax base and profit shifting which can be seem harmful, especially from the country of resident agent's ("host country") point of view as they might not be able to tax the activities carried out in their jurisdiction at all.[3]

1.2. The BEPS Project

There was a growing concern among OECD and G20 countries regarding the current state of international taxation in early 2010's. Gaps and mismatches in international tax rules of the time could not consistently answer the "disappearing" of profits for tax purposes, nor stop the shifting of profits to countries with low or nonexistent tax environments, where the businesses had little to none economic activities. These aggressive tax planning measures were referred to as "Base Erosion and Profit Shifting", more commonly known as BEPS.[4] It was recognized that apart from few cases of clear misconduct, the issues were in the tax rules themselves.[5]

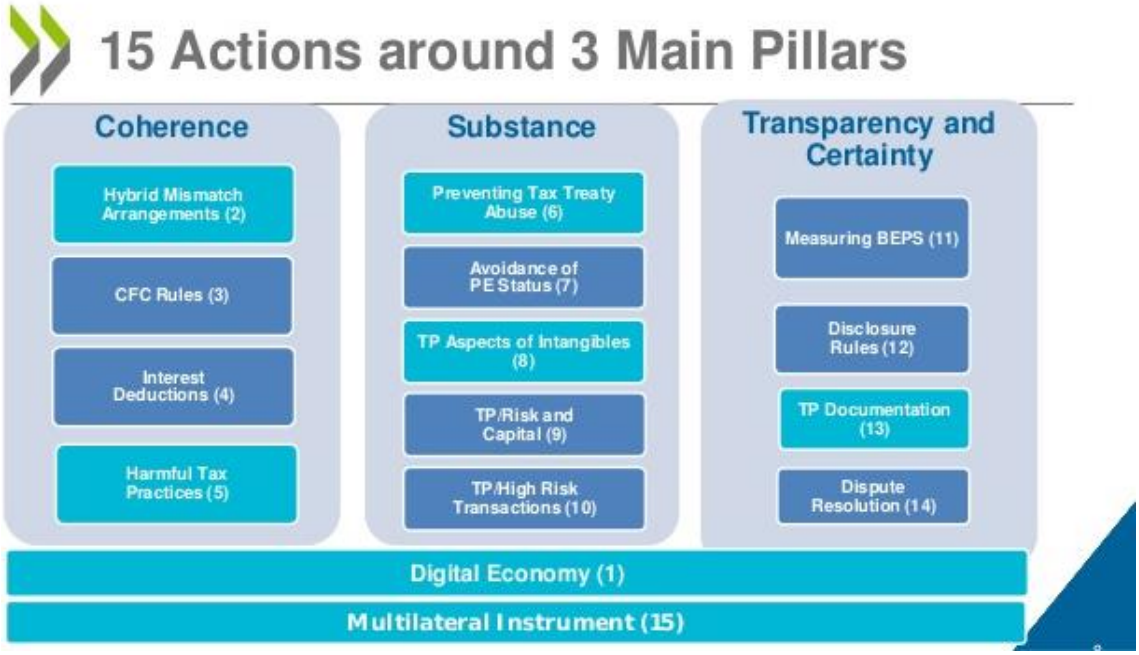
It was also noted that instead of economic reasons, companies are often tempted to make investment decisions purely for tax purposes. This would compromise the trust in the integrity of the tax system, as well as inefficient allocation of resources globally. BEPS, therefore, results in a loss of revenue for governments that could otherwise be invested to support resilient and balanced growth. Research undertaken since 2013 confirms the potential magnitude of the BEPS problem, with estimates indicating annual losses of anywhere from 4-10% of global corporate income tax (CIT) revenues, i.e. USD 100 to 240 billion annually.[6] It is important to

[3] Russo 2005 s. 30.
[4] See OECD 2010 and OECD 2012 for the early development.
[5] See OECD 2015e..
[6] See OECD 2015e.

notice that developing countries are even more reliant on corporate tax income as their revenue source, and BEPS has even more significant impact in these parts of the world.

To halt the BEPS, in 2013 OECD and G20 governments agreed on the most defining re-write of the international tax rules in a century. These governments and judicial bodies had a certain goal: revise the rules to align them to developments in the world economy, and ensure that profits are taxed where economic activities are carried out and value is created. In other words, one of the high level goals of the whole BEPS project remains to synchronize the value chain with taxation revenue of each country.[7] Later this co-operation led to the Action Plan on Base Erosion and Profit Shifting that identified 15 actions, along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions.[8] The 15 actions identified are presented in the below illustration[9]:

Figure 1: BEPS Actions, source www.OECD.org



[7] This refers first and foremost to transfer pricing and profit attribution issues, the very core of this study.
[8] See OECD 2015e.
[9] https://www.slideshare.net/OECDtax/beps-webcast-8-launch-of-the-2015-final-reports.

The actions most relevant to this study are Action 7: *Prevent the artificial avoidance of Permanent Establishment status*, Actions 8-10 commonly referred to as: *Aligning transfer pricing outcomes with transfer pricing* and in terms of implementation Action 15: *Develop a multilateral instrument.* Additionally, this study discusses the Action 1: *Addressing the challenges of digital economy,* in some extent regarding the relevant PE considerations. According to the BEPS Action plan, Action 7 aims to develop changes to the definition of Permanent Establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and similar strategies and the specific activity exemptions. Work on these issues will also address related profit attribution issues.[10]

Most interesting material in terms of this study is included in the last part, discussing the relating profit allocation issues. BEPS Final Report was published in 2015, but additional repot regarding the profit attribution was drafted in late 2017 and early 2018. This study discusses the new OECD guidance regarding profit attribution, and what is its impact in the post-BEPS environment. This study shall also briefly address the Action 15 and the Multilateral Instrument (MLI) that is the tool through which OECD implements its planned changes. However, for a reader of this study it is vital to acknowledge the context BEPS has in the international taxation environment of today. Therefore, it was briefly overviewed here at the beginning of this study, so it can outline all the further analysis presented.[11]

1.3. Purpose and scope of the study

The first research question this study analyzes whether and how the new PE provisions, combined with rules and regulations concerning the attribution of profits to permanent establishment, set forth in the OECD BEPS Action 7 and its later appendices affect the current PE regulation, especially concerning dependent agent arrangements and related party PE setups. The study's goal is to systemize and analyze the existing legislative position of PE's, and recognize the relevant changes to it and OECD Model Tax Convention, (MTC). However, the in depth legal and contractual analysis of agency is outside the scope of this study.

[10] See OECD 2013, pp. 1-4.
[11] For a more in depth preview of the BEPS project, see Malmgren 2015.

This study and its results seek to clarify the current turmoil surrounding the PE provisions in international corporate income taxation. Aim of the study is to analyze the practical consequences that are relevant to MNE's in Finland. Practically all MNE's in Finland and other countries affected by BEPS are dealing with these matters currently, and therefore systemization and analysis of the current regulations of related party PE structure and proper understanding of the proposed changes are absolutely vital in this point of time.

The business models this study discusses are mostly limited to related-party distribution of tangible goods. Most typically these business models include entities set up to promote and manage sales of finished tangible goods, and distribute the goods to end customers. The nuances of related party business models are further discussed in chapter 5 of this study. However, as the aforementioned changes in legislations are implemented globally MNE's are forced to evolve their business models, hence e.g. Limited Risk Distributors (LRDs) as related party entities are also included in the scope of this study in some extent.

This leads us to the second research question of this study: how do the new PE provisions adopted due to BEPS Action 7 affect existing structures? What are the actual changes in MNEs' tax positions, and which characteristics cause the possible changes in PE status and what will be the measures taken to mitigate the changes? This study shall dissect what will be the determination of global functions carried out in foreign jurisdictions in relation to the taxation power of these host countries.

A third research question discusses how the income be allocated between the newly formed PE's and principal companies? Due to the OECD's BEPS reform the amount of PEs globally is expected to rise due to the lowered and amended PE threshold, and the existing profit allocation regulation was deemed somewhat insufficient.[12] Hence OECD deemed it necessary to provide further guidance regarding the matter. This work included an additional drafting process of guidance to supplement BEPS Action 7. Whilst, detailed analysis of tax calculation of the entities and their income reporting is excluded from the scope of this study.

[12] OECD 2016a, p. 1.

1.4. Research method

The approach of this study is that of a traditional legal study. Thus primary research method that is applied to the study is legal dogmatic method. Therefore, it is eminent that the study is concerned with different interpretations and systematization of existing legal doctrines and norms, i.e. *de lege lata focusing* especially on the OECD Model Tax Convention on income and Capital (OECD model or "MTC") and its relevant changes and amendments and on the other hand regarding the expected changes that Finnish authorities might perform in the future, i.e. *de lege ferenda.*[13]

It is quite impossible to research the norms of international taxation without an international perspective. Therefore, this study contains quite a few referrals to foreign sources of information and OECD's publications are used essentially as the primary source of information regarding the BEPS reform and its by-products. Referrals are made e.g. to Swedish tax legislation and European tax practice.

The overall approach of study is quite practical of nature, with great emphasis on problem solving and change mitigation from MNEs' point of view. The study uses several tools and analyses utilized in tax consulting and in practice transfer pricing compliance work outlined in the OECD 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 ("TPG") including functional analyses and P/L sheet modelling.

1.5. Prior research and Materials relevant to this study

Permanent establishment as a concept is considered to be something of a mainstay in the context of international corporate taxation. Therefore, PE regulation is under the constant review and interest of the legislator, legal academics and taxpayers. The discussion has been constant around the subject, and primarily led by international bodies such as OECD, G20 and the EU. Hence, there is plenty of publications and research material available.

The current PE regulation under the 2014 OECD Model is analyzed in order to gain understanding of the MNEs' status prior to BEPS. Then, the measures suggested by BEPS and included in the 2017 OECD Model are compared to the earlier PE environment to detect the material differences resulting in changes in PE positions of MNEs. Only after the changes in PE

[13] Aarnio 1989, p. 17.

positions are identified, it is rational to proceed to the analysis of the relevant profit attribution and transfer pricing matters.

There is not very much domestic literature and tax practice available regarding the post-BEPS PE regulation. There have not been any transfer pricing related Finnish Supreme Administrative Court (KHO) considerations after the release of BEPS final report. Furthermore, the most recent domestic PE regulation is from 1995 as the practice has leaned strongly to OECD publications. This might explain the lack of recent comprehensive domestic analysis. This further emphasizes the relevance of OECD reports and discussion stirred by them.

1.6. Outline of the study

The study kicks off with an outline of the PE concept and some of the most relevant legislative sources including the domestic provisions and international sources of legislation. Then an in depth analysis of the pre-BEPS OECD model and its provisions follows in Chapter 3.

Chapter 4 discusses the BEPS Project and especially the outcomes of Action 7 reflecting, and Chapter 5 outlines the measures taken to implement these changes. Chapters 6 and 7 include the analysis of economic relationship and profit allocation between the principal and its foreign subsidiary PE. Finally, Chapter 8 summarizes the findings and presents the concluding remarks.

2. Permanent Establishment as a concept

2.1. PE in national tax regulation

2.1.1. Legislation

In Finnish legislation, PE is defined in Income Tax Act (TVL) 13 a § as follows:

> *Permanent establishment refers to a place, in which a specific place of business exists or where specific arrangements have been made, including especially:*
>
> *a) a place of management;*
>
> *b) a branch;*
>
> *c) an office;*
>
> *d) a factory;*
>
> *e) a workshop or store or similar place for procurement or sales, and*
>
> *f) an active mine, an oil or gas well, a quarry or any other place of extraction of natural resources*
>
> *or other place comparable to that, or for sale in the business of real estate for the purpose of patched or to be patched real estates, and for the construction of such buildings, a place where such work is carried out to a significant extent, and additionally in line transportation business' maintenance location or other specific fixed place of business serving the transportation.*

In addition, PE is defined in Finland's tax treaties. It is noteworthy that the details of these definition differ significantly; given that they are both influenced by OECD Model Tax Treaty's Article 5. This raises an interesting question, can the TVL's definition be applied to PE created by tax treaty. This controversy is not entirely clear, as tax treaty cannot expand Finland's power to tax foreign entities.[14] Hence, when analyzing non-tax treaty relations national legislation TVL's definition should be used.[15]

However, it can be considered an established principle that OECD's commentary to its MTC can be used in the interpretation of national legislation[16] and tax treaties as well, at least in

[14] Nykänen 2015: pp. 309-310.
[15] This approach in this sense has not always been in accordance with the Legality Principle. See Chapter 7.1.
[16] The fact is also included in the minutes of legislator, see: HE 76/1995 1.1 as the preparatory works for 13 a §.

situations where the wording is similar enough.[17] This principle has also been recognized by the Finnish Supreme Administrative court in its ruling KHO 2013/1704 (93). In practice, the commentary has significant importance as courts and tax administrations use it regularly. It bears mentioning, however, that the MTC or its commentary are not binding sources of law, but rather OECD's recommendations.[18] Be as it may, it still creates an interesting setting for the hierarchy of norms in international taxation and leaves plenty of room for misinterpretation and disputes between tax authorities and taxpayers around the world.

2.1.2. Finnish Tax Administrations guidance

The operation of the Finnish Tax Administration ("FTA") is regulated in the Act on Tax Administration ("VHL"). According to article 2.2 §, FTA shall promote right and equal taxation and develop FTA's ability to serve taxpayers. For this purpose, FTA publishes various guides to taxpayers to clarify and explain tax procedures and regulations in Finland. They include recommendations on interpretations of tax laws and how they should be enforced. If a taxpayer acts according to the guidance, in principle, it is granted a protection of legitimate expectations and taxation cannot be carried out with a stricter interpretation. The guidance is namely given to FTA units, but as they are public, they show the FTA's stand in certain matters to taxpayers as well.[19]

However, it bears mentioning that guidance is not legally binding towards FTA's tax officers or units when it is a question of interpretation and application of a tax law. Due to Right to Equality granted in section 6 of Finnish constitution, and officers duty to grant the constitutional rights and VHL's 2 § that places a duty on the FTA to promote the equality of the taxation, the guidance has a strong *de facto* effect on how the taxation is carried out. The guidance is published on FTA's website[20], and is revised when necessary to keep it up to date.

There are several FTA's guides regarding PEs in Finland. The one defining the taxable presence and qualifications for a PE is named: "*Corporate income taxation of a foreign entity in Finland – Business income and other income sourced from Finland"*[21]*.* Its chapter 4, "*Permanent establishment in corporate income taxation"* lays the groundwork for FTA's interpretation on

[17] Nykänen 2015, p. 311.
[18] Helminen, 2014, p. 21.
[19] Räbinä 2017, p. 24-25.
[20] www.vero.fi
[21] FTA A70/200/2018

PE regulation. The guidance offers quite the extensive overview of all matters regarding interpretation on PE regulations, but also guidance on the compliance requirements of PEs in Finland. The compliance and various filing duties of PEs fall outside the scope of this study, but in essence, PE has to file the corporate income tax return like any business in Finland.

The actual PE consideration is strongly leveraged from OECD guidance, as the FTA's guide has lot of straight references to the MTC of OECD. The articles are further explained with practical implications. What deviates from the TVL's definition is mentioning the OECD's additional prerequisites for a PE to exist based on a fixed place of business doctrine. Guidance points out the three prerequisites, and discusses each of them in more detail: Geographic permanence, duration of the activities and actually carrying out the business from the fixed place of business. These factors are adopted from the Commentary on Article 5 of OECD's MTC, paragraph 6 to 8.

Hence, it is interesting that the FTA's guidance is very strongly leveraged from OECD sources rather than national legislation or the preparatory works of TVL. The actual basis for the national definition of PE rests firmly on international foundation. Of course, as mentioned in the previous paragraph, when the national wording of PE rules is in accordance with the international sources, the material provided to help interpret and apply the international rules should be applicable to the national regulation as well.

2.2. OECD Interpretation

OECD's interpretation of what creates a PE is documented in the OECD Model Tax Convention on Income and Capital ("MTC") of OECD. The MTC is updated from time to time, and implementation of BEPS is the most significant change in the 2017 version. The 2017 MTC reflects the measures resulting from action 2 (Neutralizing the Effects of Hybrid Mismatch Arrangements), action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) and Action 14 (Making Dispute Resolution More Effective).

In practice, the MTC is a starting point for many countries in bilateral tax conventions and helps creating more uniform tax regulation globally. It can be seen as an important measure pre-BEPS in tackling issues in international taxation. As there is no such thing as *status quo* in international taxation, the MTC requires frequent updating to keep up with the changing global economy. The updates of the MTC were presented 1994, 1995, 1997, 1998, 2000, 2003,

2005, 2008, 2010, 2014, and 2017. Naturally MTC lacks the firepower of BEPS due to it is completely voluntary and amendable for each bilateral situation. However, in practice many countries' tax treaties, e.g. Finland's, are very heavily based on the MTC.

The PE regulations of 2014 pre-BEPS MTC are included in the Article 5. Paragraph 1 states very clearly the essence of PE:

> 1. *For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

Consequently, paragraph 2 ("par. 2") provides further clarification on what is considered to be included in the term permanent establishment. The paragraph 2 is also referred to as the "positive list", a list of indicia that *prima facie* constitute a PE. The positive list is as follows:

> 2. *The term "permanent establishment" includes especially:*
>
> *a) a place of management;*
>
> *b) a branch;*
>
> *c) an office;*
>
> *d) a factory;*
>
> *e) a workshop, and*
>
> *f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

For the purposes of this study, subparagraph b), a branch, has the most significance. According to Finnish Companies Act ("OYL") branch is considered to be an unit that company has set up abroad that conducts business is not an independent legal entity.[22] Thus it is evident that there is a basis in the OECD regulation to deem a PE to exist e.g. based on foreign distribution activities.[23]

Par. 4 presents a list of exceptions that do not constitute a PE even if there is a fixed place of business as mentioned in par. 2 through which the business of an enterprise is carried on:

---

[22] HE 89/1996 p. 123.

[23] In fact OECD recognizes a situation where PE is constituted due to a construction project or installation under certain circumstances. As this is not relevant to this study it is not addressed here but is presented briefly in Chapter 2.6.

> *4.1 Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*
>
> *a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
>
> *b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
>
> *c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
>
> *d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
>
> *e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
>
> *f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

MTC also recognizes another way for a corporation to create a PE. A MNE may carry out its business activities abroad through different agent arrangements. MTC also includes provisions regarding agents and in which cases agents create a PE for the MNE. It is important to note, that agent might create a PE, in a case where the MNE has no fixed place of business in the country. [24]

Depending on whether the agent is dependent or independent and what kind of authority it has, the actions carried out by the agent may or may not create a PE for the principal. The detailed provisions are included in the OECD MTC's pars. 5.5 and 5.6:

> *5.5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not*

[24] Helminen 2018, chapter 6.

> *make this fixed place of business a permanent establishment under the provisions of that paragraph.*
>
> *5.6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.*

It is very interesting to recognize that OECD's PE mechanism is two headed, including PE created by fixed place of business through the business of the enterprise is carried on and PE created by actions of an agent, an intermediary. Hence, as mentioned in previous chapter, national legislation has a more limited wording in what kind of activities create a taxable presence in Finland.

The aforementioned systematic is referred to as "OECD's positive list" of circumstances that promote the existence of a PE. Naturally, also the national legislation recognizes and includes this positive list as a part of national legislation. This list should not be seen as exhaustive, rather than exemplary. However, OECD also utilizes "a negative list" of circumstances and factors that promote the conclusion that no PE in fact exists in light of these aforementioned factors and circumstances. This, of course, leads to a more informative rule base from tax payers' point of view as they can model their behavior and business setups according to the negative list.[25] It creates an interesting setting between national and OECD legislation: what would be the protection of legitimate expectations in regard of the taxpayer, if it sets up the business precisely according to the negative list should the national tax authority respect that even though the country has not included "the negative list" in the legislation. In the light of conclusion of the previous chapter, the answer in my opinion should be yes. Taxpayer should be granted protection for acting according to the more accurate OECD rules as the national rules would not provide exact enough guidance. The negative list and its implications are discussed in more detail in chapter 2.7 of this study. To conclude the two above chapters regarding national and OECD PE rules, the national PE rules are narrower than the OECD rules.[26] Due to the mechanics of BEPS and overwhelming importance of OECD model, it is used as the base PE regulation of this study. Therefore, an in depth analysis of its contents follows in Chapter 3.

---

[25] Helminen 2018 pp. 311-312.
[26] Helminen 2018 pp. 312-313.

2.3. United Nations MDT

In addition to national legislation and multilateral organs like OECD, also United Nations ("UN") has decided to kick in to the bilateral model tax conventions by publishing its own version "Model Double Tax Convention between Developed and Developing Countries" later also "UN MTC". As is well known, UN was founded in 1945 after World War II to take action on issues confronting humanity. In modern context, that means global peace and security, climate change, sustainable development, human rights disarmament, terrorism humanitarian and health emergencies, governance and more. The purpose of UN is contained in its founding Charter. Currently UN headquarters is located in New York, United States.[27]

More specifically, UN's department of economic and social affair is responsible for supervising sustainable development and multilateral trade globally. Therefore, UN saw fit to publish UN MTC to prevent double taxation and tackle tax evasion[28], which it estimates to cost countries $3.1 trillion annually[29]. According to Alex Trepelkov, Director of the Financing for Development Office in the Department of Economic and Social Affairs, "International law places very few limits on the taxation sovereignty of countries"[30]. That is very much true, and the core reason for multilateral such as BEPS. On the other hand, it is very understandable that countries aim to maintain a firm grasp of their legislative power and do not hand it away lightly. This creates a situation where less powerful countries might feel coerced to accept worse terms in their bilateral tax conventions with mightier counterparties, such as United States or China.

It is quite natural that UN MTC was not created in a vacuum. The introduction stated that the OECD MTC had "a profound influence on the international treaty practice and it has significant common provision". What separates the UN MTC, it has a clear protective nature especially towards developing economies. This is clearly visible from introduction chapters 3-5. The downside to the UN MTC is that it lacks the regular updates e.g. OECD has undertaken. The

---

[27] http://www.un.org/en/sections/about-un/overview/.
[28] UN MDT p. 6: "The United Nations Model Double Taxation Convention between Developed and Developing Countries (the United Nations Model Convention) forms part of the continuing international efforts aimed at eliminating double taxation. These efforts were begun by the League of Nations and pursued in the Organisation for European Economic Co-operation (OEEC) (now known as the Organisation for Economic Co-operation and Development (OECD)) and in regional forums, as well as in the United Nations, and have in general found concrete expression in a series of model or draft model bilateral tax conventions".
[29] Survey of 145 countries, carried out by Tax Justice Network in 2011, UN MDT update of 2011.
[30] UN publishing news press conference, New York 2011.

previous UN MTC was published in 2001, and the newest update was not published until 2011. Unfortunately, this tends to lessen its importance in international bilateral treaty practice.[31]

The core PE regulations of UN MTC are practically identical to OECD MTC of the time (OECD MTC 2010).

> *Art. 5.1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*
>
> *Art 5.2. The term "permanent establishment" includes especially: (a) A place of management; (b) A branch; (c) An office; (d) A factory; (e) A workshop; (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

Hence, unfortunately, UN MTC offers very limited additional insight to PE definitions from the standpoint of this study. However, in global practice the treaty is mighty important, considering that significant part of global economy in the future could reside in countries that do not abide the OECD tax regulations, e.g. Brazil and India. In these jurisdictions, UN MTC and the development of its amended versions in the future are very significant.

2.4. Summary of legislative sources and their applications

Above are presented several different sources for PE legislation. To clarify in which situations each regulation would be applicable, I will present below a typical scenario of each setup where respective source of legislation would be the go-to choice in determining the PE definition and other relevant matters.

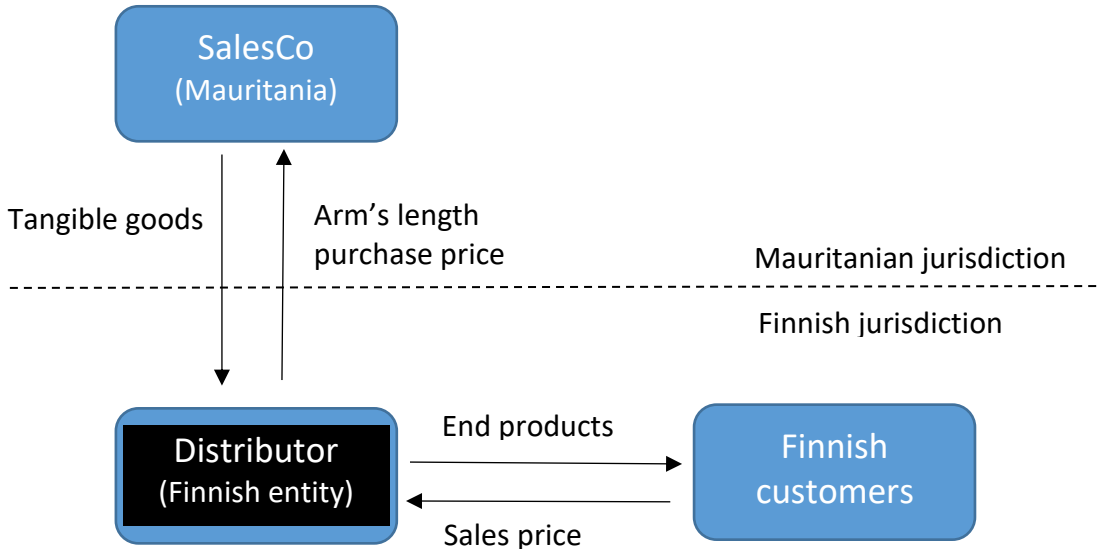
2.4.1. Non-OECD country with no bilateral tax treaty

In this situation Finnish legislation, in practice TVL, would be the primary norm. The most typical situation would be where a corporation based in a non-OECD country (SalesCo) without a bilateral tax treaty with Finland would carry out business through a fixed place of business, i.e. a branch, in Finland. In below setup, a Mauritanian company sells tangible goods through a Finnish distributor:

---

[31] See http://www.un.org/en/development/desa/publications/double-taxation-convention.html.Cited 12.6.2018.

Figure 2 Setup with non-OECD country without tax treaty



In this setup Finnish legislation, in practice TVL, would be used in determining whether the activities of the Finnish distribution entity create a PE for SalesCo. As no multi-lateral sources of legislation apply, there is no bilateral tax treaty nor is Mauritania a BEPS-country, the definition has to be set by the "bottom line" of national legislation. This is naturally sub-optimal for Mauritania and companies residing in Mauritania, as they have no say in what kind of legislation is passed in the independent host country. Hence, in actual business MNEs are understandably cautious with this kind of setups, as they do not provide the same stability and foreseeability than bilateral tax treaties or OECD governed multilateral regulation. This could be a situation where a large MNE would engage in negotiations for an advance pricing agreement (APA) with the target country's tax authorities to secure a stable tax treatment for years to come.

2.4.2. Non-OECD country with bilateral tax treaty

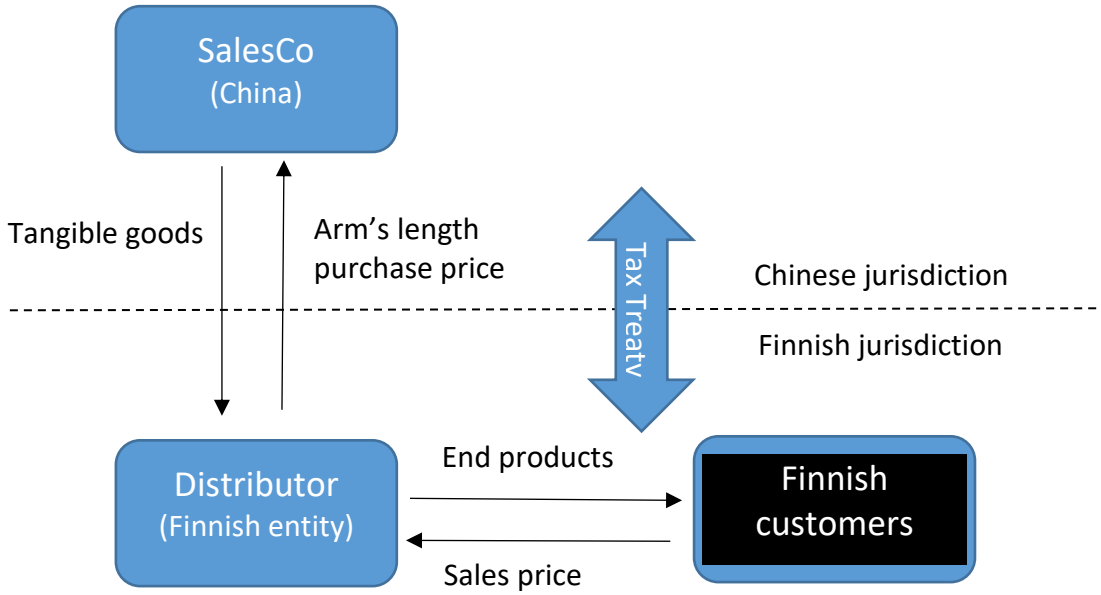
In a situation where the principal company, SalesCo, is residing in a country with bilateral tax treaty[32] with Finland, the treaty would supplement the Finnish legislation and provide the de facto basis for the PE analysis. A good example of such country is the People's Republic of China with which Finland has significant trade relationship.[33] Here it should be mentioned that the text of the tax treaty is often heavily affected by some earlier source of regulation.

[32] Treaty 104/2010.

[33] According to the statistics of the Finnish customs, the trade between Cina and Finland amounted to over 4,000 million euros in 2016 and 2017. https://tulli.fi/tilastot/tilastojulkaisu/-/asset_publisher/suomen-ja-kiinan-valinen-kauppa-vuonna-2017-1-7-. Referred 30 July 2018.

Typically, it is OECD, but when Finland deals with a developing economy, the UN MTC could provide some provisions to the treaty as well.

Figure 3: Setup with non-OECD tax treaty



In the setup, both respective tax administrations would refer to the treaty text when analyzing and determining whether a PE exists. Being a contract, the tax treaty also includes a notice for termination that gives the taxpayers, principally the corporations, a reasonable time to re-asses their tax paying position and contemplate a possible re-location. Hence, the tax treaty gives corporations foreseeability and stability as a taxpayer, especially when compared to the "bottom line" situation explained in the previous chapter.

Regarding the PE analysis itself, in leans to the principal rule included in OECD MTC Article 5.1 "*For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."* The aforementioned rule is included in all Finland's tax treaties as such[34]. Due to the heavy OECD-influence in the contract text, the OECD MTC commentary might come into play in some interpretation questions of the tax treaty. On the other hand, as the definition has been rather similar for the past years in Finland's tax treaties, the tax authorities have produced a fair deal of precedents on taxation of foreign affiliates in Finland, and the interpretation is quite set.

[34] FTA A70/200/2018

This makes it even more interesting from this study's point of view: how will the new OECD PE regulations affect the existing tax treaty PEs? The obvious answer would be that it could not have any affect, as the text of the treaty has not changed. In practice, however, the changed OECD definitions and regulations might affect existing tax positions more than one would think.

2.4.3. OECD BEPS Country

Finally the most relevant scenario from this study's point of view, a setup with a fellow OECD country. For this purpose, we may use Germany as an example, as it is an OECD country with significant trade relationship with Finland. When both countries are members of OECD the OECD MTC is usually used, and amended with appropriate OECD material. For example, OECD's Transfer pricing guidelines, BEPS final reports and other OECD material are utilized. Hence, when BEPS project proposes and aims to implement changes to PE regulation, the changes are adopted fluidly into the taxation relationship between OECD countries. In practice, these changes are implemented with MLI that is discussed in depth in chapter 6 of this study. The changes brought by MLI are not embedded in the tax treaties between countries, but are included in the MLI that creates an additional layer of regulation between the contracting states.[35]

The setup as such is similar to any tax treaty based setup, only difference being the mechanics behind the contracting system and its updates. OECD creates a unique platform for countries to contact on, and BEPS with MLI is going to make the structure even more multi-faceted. As in practice OECD model is the one laying the groundwork for domestic interpretation, it is in order to analyze it further in the following Chapter.

3. Pre-BEPS OECD PE Model

3.1. Principal PE rule, the fixed place of business – Paragraph 1

As described in the different sources of PE definitions addressed in more detail earlier in this study, all of them find common ground on the principal rule of fixed place of business, to the extent that the national TVL interpretation derives from the OECD interpretation when

[35] See OECD 2014a, introduction.

considering the definition of fixed place of business[36]. As stated before, PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The fixed place as such can be whatever premises the company utilizes in its business. It does not have to be a clearly marked out premise, as in a room. Also, a de facto use is enough to create the presence, therefore i.e. a right based on a lease agreement is not required.[37] Hence, the fixed place of business can exists in the premises of another enterprise, e.g. in a situation where a company has a continuous access to certain premises or part of them in another enterprise's facilities.[38]

In addition there are three clear factors that are analyzed while conducting PE analyses for Finnish taxpayers. These are discussed in more detail in below subchapters.

3.1.1. The geographic fixity of business activities

For a place of business to be fixed, it has to be considered to be geographically fixed. This is rather natural, i.e. if a fixed place would be highly mobile and having a vast geographic range its fixed nature would be less evident. However, for a place of business to be considered fixed it shall not have to be attached to a certain spot or location on the ground or certain real estate lot. Also a wider area inside of which the business activities take place may support a creation of a PE if the operations form a coherent whole economically and geographically. These requirements shall be met simultaneously.[39]

According to the FTA's guidance addressing the matter such geographical fixity is met e.g. in case of an office building inside of which the specific office might vary and a quarry, which might span on a rather large geographical area. The minutes of TVL state that the definition corresponds the definition of Finland's tax treaties, which in turn follow the OECD MTC and its commentary. The commentary states the following: "According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of

[36] Helminen 2018: The concept of permanent establishment.
[37] This is an embodiment of a widely recognized "substance over matter" principle, where tax authority interprets the actual circumstances and acts of the taxpayers instead of contractual or legal form that lays behind the arrangement.
[38] FTA A70/200/2018.
[39] FTA A70/200/2018.

a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site."[40] This reflects the national guidance rather accurately, and leaves little uncertainty of the application of the rule.

In the Finnish tax practice it has been stated that a mere use of a financial institution in form of e.g. a bank account or having a web page of the company in a certain jurisdiction does not constitute a PE. In Finnish Tax Board's (KVL) case 2001/68 a Swedish company sold and leased digital content mainly to advertisement agencies in Nordic countries. The content was visible on the company's website, where the content could be extracted from to user's possession. Invoicing was done either electronically or from Sweden. It should be noted that the company did not have any kind of premises in Finland in form of a warehouse or an office in Finland. Neither did it have a server nor did any other tangible infrastructure to support its activities placed on the Finnish soil. The customer facing activities were carried out by two representatives placed in Finland. As the representatives were not considered independent agents, and their activities were considered to be auxiliary and preparatory.[41] Hence, there were no ground to deem a fixed place of business in Finland only due to the presence of a web page and a bank account.

3.1.2. The timeframe of the business activities

It would be very difficult to set a fixed time after which business activities would be deemed to create a fixed place of business. Alas, it is generally acknowledged that only temporary or short-term carrying out of business activities will not create a PE. This is also stated in the OECD MTC commentary's paragraph 6: "A permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time."[42]

---

[40] 2014 OECD MTC commentary article 5.21.
[41] KVL 2001/68.
[42] 2014 OECD MTC commentary article 5.6.

An exception to the aforementioned is included in the OECD MTC article 5.3 as follows:

> *3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.*

According to some tax treaties, even shorter term of a building site or construction or installation project than twelve months creates a PE. Such treaties exist e.g. between Finland and Estonia and Latvia, according to which PE is created by a project that spans for over six months. In addition, PE is created by relating supervisory or advisory activities given that such activities take place for over six months in a twelve month time period.[43]

However, as a main rule in tax practice activities carried out for less than six months have not been considered permanent. This is also stated in the 2014 MTC commentary: " Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months)."[44]

Contrary to the aforementioned main rule, activities shorter than six months may be deemed permanent in some instances. Firstly, activities that were planned permanent come to a halt prematurely. E.g. if a company pursues a business opportunity in a foreign jurisdiction, but after a few months finds the venture unprofitable and decides to shut it down. Secondly, if the activities carried out are seasonal and recurrent. When considering the permanency of seasonal activities the individual durations are evaluated together with the occurrences. General example would be seasonal business such as operating a ski resort. Thirdly, should a company carry out certain business activity solely in a foreign country, hence having a stronger connection to that country than its domicile.

---

[43] Malmgren 2017, p. 108.
[44] 2014 OECD MTC commentary article 5.6.

3.1.3. Business is carried on through fixed place of business

The enterprise shall carry on the business wholly or partly through a fixed place of business, in order to create a PE. Ordinarily carrying on business activities requires some extent of labor utilized. It is essential to note that this labor does not have to be employed directly by the principal, rather than being dependent on the foreign company, i.e. also leased labor could very well lead to creating a PE. On the other hand, if the business activities consist of leasing labor or movables PE is not deemed to be created in Finland if these activities are carried on by a foreign principal.[45]

Whether the company carries the business through the fixed place of business is usually rather distinctive, and it has not caused lots of controversy in tax practice. However, to account for new kinds of business models and ways to carry on business, the 2014 MTC commentary recognizes[46] a situation where a telecommunications operator enters into a "roaming" agreement with a foreign operator. The goal of the arrangement is that the operator is then able to "lease" the network to its customers travelling to that foreign country typically with additional fee. In this setup, it would need to be considered whether the income that the telecommunication operator sources from the foreign country would be deemed to be from the communication network as a fixed place of business. However, the network cannot be considered to be at the disposal of the home network operator and cannot, therefore, constitute a permanent establishment of that operator. Nevertheless, it creates an interesting opening for more varying ways to carry on a business through new kinds of fixed places of business which might lead into increase in controversy between taxpayers and tax authorities in this regard.

3.2. Building sites or construction or installation projects – Paragraph 3

According to the OECD MTC "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. " The same clause is included in most of Finland's bilateral tax treaties as well. While evaluating the duration of the project undertaken, different forms of subcontracting are included in the scope of the

[45] See KHO 1986/1679 II 501.
[46] 2014 OECD MTC Commentary Article 5.9.1.

project. Also it bears mentioning that pauses in the commissioning of the work do not stop the tracking of the construction duration.[47]

In terms of this study, the PE created by the aforementioned and described building sites or construction or installation projects are not of the most relevant nature. They are quite different by nature to other PE types, and the evaluation in determining such PEs in vastly different to the evaluation used to determine PEs created by fixed place of business or personnel. In addition, the BEPS project did not suggest or cause any changes to the PE regulations regarding the matter. Therefore, it is considered reasonable to exclude a further analysis of the landmarks of Paragraph 3 PEs from the scope of this study.

3.3. Preparatory and auxiliary activities and the negative list – Paragraph 4

As already mentioned in this study, the OECD methodology utilizes a concept of the negative list in its PE regulation. The negative list can be seen as a counterpart to the positive list of factors contributing towards a creation of a PE found in paragraph 2 of the OECD MTC and recognized also in national legislation[48]. As mentioned earlier in this study, the national approach laid out in TVL does not include such list.[49] Therefore, it is crucial to grasp that in a relation without tax treaty the negative list does not apply and thus the negative list only reduces Finland's power to levy tax on activities in a situation where the activities are carried out in Finland by a resident of a tax treaty country.[50]

The impact of activities falling under the negative list is that they do not create a PE even if they are consistent with paragraphs 1-3 of the tax treaties and the activities would otherwise create a PE in Finland. According to OECD, it is recognized that such a place of business that falls under the paragraph 4 may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question.[51]

According to 2014 OECD MTC paragraph 5.4:

---

[47] FTA A70/200/2018.
[48] See chapter 2.1.1.
[49] Malmgren 2014, p. 324.
[50] This is, of course, assuming that the particular tax treaty relation has included the OECD MTC Paragraph 5.4 in the treaty text. This is the case in all of Finland's current bilateral tax treaties.
[51] 2014 MTC Commentary, 5.21.

> *4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*
>
> *a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
>
> *b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
>
> *c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
>
> *d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
>
> *e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
>
> *f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

The main test to distinguish preparatory and auxiliary activities is to identify whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.[52] However, a fixed place of business with a general purpose identical to the general purpose of the whole enterprise, instead, may constitute a permanent establishment.[53] This is rather obvious. It would not suit the general concept that a company could operate its main business tax exempt as "preparatory and auxiliary" due to it would not support any major business rather than being the business.

Other typical factors associated with the preparatory activities it that they precede some other activities, and are carried out in a rather short period of time. This is not of course always the case but is often common in determining the activities in question. In terms of auxiliary activities, they often have a relation to an activity they are supporting without being a part of the essential and significant part of the activity of the enterprise as a whole. Another remark vastly associated with the auxiliary activities would be that they rarely demand a remarkable share of resources.

---

[52] 2014 MTC Commentary, 5.24.
[53] Helminen 2018: Preparatory or Auxiliary Activities.

In Finnish tax practice has shed some light onto what kind of activities are considered auxiliary and preparatory. In its ruling KHO 2013:42 the Supreme Administrative Court ruled that a foreign university that offered MBA-degrees offered some courses, exams etc. in Finland through its Finnish branch. It was deemed that these activities were highly similar to the activities carried out by the principal entity in its home country and could not thus be considered as auxiliary. Alas, PE was created in Finland and income had to be allocated to be taxed in Finland. In practice, even a fixed place of business carry out various combinations of preparatory and auxiliary activities and is not considered to constitute a PE provided that the overall activity of the fixed place of business due to this combination is of auxiliary or preparatory character.[54]

In another case KHO 42437/3/91, the Supreme Administrative Court ruled in a case where a Danish company that marketed computer programs developed by its parent company had utilized a 12 square meter office space and hence a fixed place of business in Finland. They also had two employees that were tasked to prepare and promote the sales, while all of the contracting was done in Denmark. Considering the tasks of the employees, court ruled that the office was not only used in supervision and advisory activities and deemed for a PE to exist.

In general the Finnish tax practice regarding the matter appears quite strict in granting exemptions from the principal PE rule based on the auxiliary and preparatory nature.

3.4. Agency PE – Paragraphs 5 and 6

In addition to fixed places of businesses and construction projects, also the personnel of an enterprise may create a PE. When a person creates the taxable presence in another country, this is commonly referred to as an Agency PE. As mentioned in the beginning of this study, the business model setups are nowadays very various. For many business functions it is beneficial to use light and flexible business structures, such as an agent.

2014 OECD MTC paragraphs 5 provides regulation concerning agents, by stating the following:

> *5. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 6 applies is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in*

[54] Helminen 2018: Auxiliary and Preparatory Activities.

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

The aforementioned lays the requirements for a person and his activities to constitute a PE. Thus it is important to realize that carrying on a business through an agent does not create a PE as there are further things to consider in the relationship. In order to dissect the aforementioned r let us analyze the requirements for an agency PE set by paragraph 5.

As will become evident in the following chapter discussing the BEPS project, the "ability to conclude contracts" was the dominant factor in determining whether the activities of the agent formed a PE in the previous OECD regime. However, the changes brought by BEPS have also modified the national approach. The FTA's guidance states the following "Agent does must not have the ability to formally sign contracts binding the principal. It is deemed sufficient that agent e.g. receives orders and mediates them to the principal, if the principal agrees the orders routinely".[55]

However, the 2014 OECD MTC also includes a restriction on what kind of agency relationship could create a PE in paragraph 6:

> *6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.*

The structure described in the aforementioned paragraph 6 is referred to as "independent agent". On the contrary, other agency arrangements described above would qualify as dependent agents. The agent must be independent of the enterprise both legally and economically. For example, if the agent's activities are subject to detailed instructions or to comprehensive control by the enterprise, the agent is not independent. The agent is not independent, if the agent does not bear any entrepreneurial risk of its own.[56]

In Tax board's decision 1996/68 a Dutch company was entering into a sales commissionnaire arrangement with its subsidiary in Finland. Commissionaire has the power to enter into deals

[55] FTA A70/200/2018.
[56] Helminen 2018: Agent.

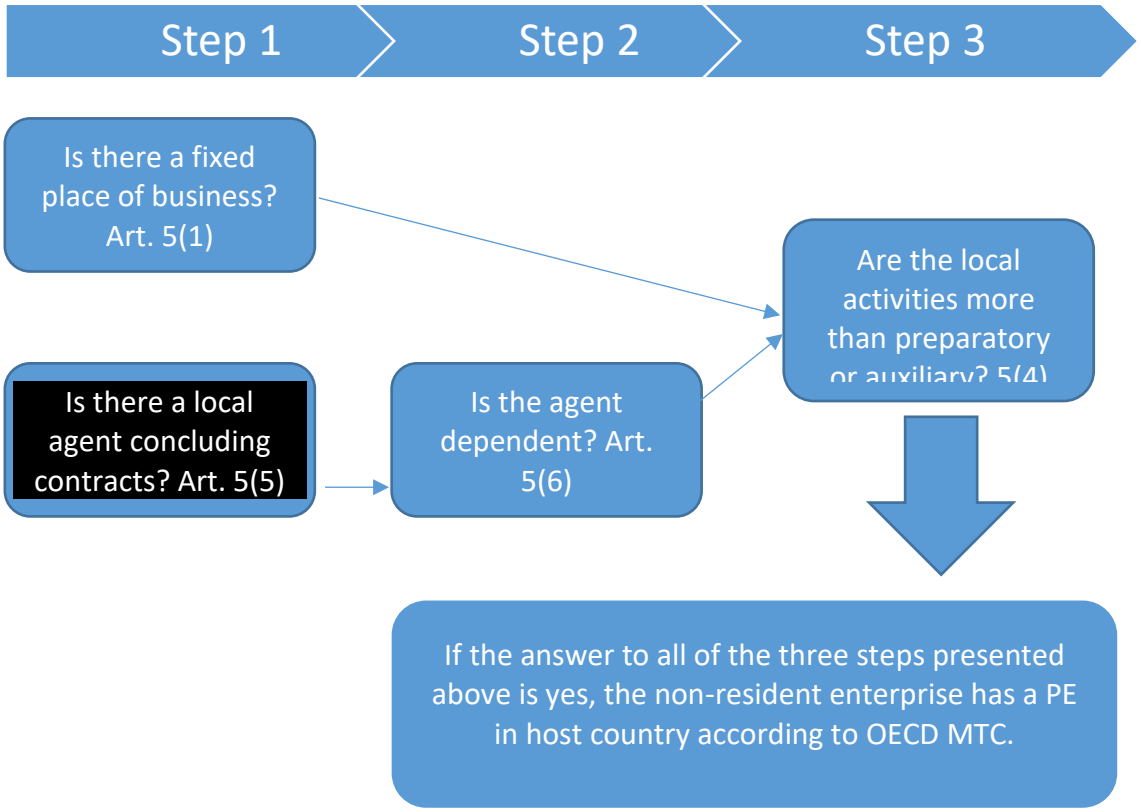
in the scope of the agreement without consent of the principal, it invoices its own sales and takes care of the negotiations without instructions from the principal. Tax board deemed that this would not create a PE, as the subsidiary is an independent agent. The interpretation was later withheld in Supreme administrative court.[57] It is also vital to note that in this case the agent was a related party, a subsidiary. The relationship between two group companies does not imply a dependent nature as such, as established by the court.[58] This is also explicitly stated in the paragraph 7 of the Article 5:

> *"7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."*

National guidance follows the OECD approach also in this aspect, stating that PE is not formed should the enterprise carry out the activities through an independent agent or a commissionnaire. Independent agent has to be independent in economical and juridical sense from the principal, and that independent agent should act within the ordinary course of its business. The FTA also adds the following, very important notion from a transfer pricing perspective: "Independent agent typically bears the entrepreneurial risk for the business it carries out". This is a clear indicator to the OECD Transfer Pricing Guidelines that regulate the transfer pricing and profit attribution to the PE. As will later be demonstrated, the risk the PE bears is the very basis for the compensation of the agent.[59] The constitution of a PE can be formulated in a flow chart as follows:

[57] KHO 7.6.96 T 1928.
[58] The aforementioned independent nature is also recognized in the council directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (later referred to as the "subsidiary directive"), see Articles 1-3 of Council Directive 2011/96/EU.
[59] FTA A70/200/2018.

Figure 4: OECD MTC PE Flowchart



3.5. New forms of PEs – a Server PE

Above there has been a quite extensive look into the traditional comprehension of a PE, someone in form of an agent or something in form of fixed place of business carries on such significant activities that income should be allocated to be taxed in that jurisdiction. As the business infrastructure has remained rather tangible in the past, this has satisfied the needs of tax authorities and countries globally and granted a just distribution of taxation power between the relevant countries. As the megatrends of internet of things[60] and widespread digitalization is swooping over the world and economy, taxation has to adapt to completely new constructions and ways to carry on a business for profit.

The tax authorities around the world face new challenges in determining the taxation for business operations such as the AirBnB, Spotify, Uber and Lyft, which fit to the mold of a traditional corporation fairly badly. They all derive profit for the end user's utilization of a platform, through which they purchase or lease products without any tangible presence of the

[60] Internet of Thing or IoT's dictionary definition is "the interconnection via the Internet of computing devices embedded in everyday objects, enabling them to send and receive data." For more information regarding the matter, see for reference Goldman Sachs 2014: The Internet of Things: Making sense of the next mega-trend.

service provider. The common nominator for all of the aforementioned enterprises, is that they all utilize cloud technology, and data stored therein. Therefore, a brief look into what is a whole new ordeal of "digital PE" or a "server PE" follows to provide an interesting outlook into PEs further the ones we have discussed above.

One of the more intriguing aspects of BEPS was its Action 1, "*Addressing the challenges of digital economy",* that discussed the tax implications of the more business models that are highly dependent on digital infrastructure. This study does not provide an in depth look into digital economy and its taxation, but it is necessary to give the reader an understanding of the comprehensive change that is taking place in economy, and therefore, in taxation. Especially when discussing the PE threshold's future, it is quite possible for an entity to create a taxable presence in a state due to its digital presence in such country, i.e. in form of a server. This does not fit in to the systematic set forth by the traditional PE regulation presented in OECD MTC article 5. Even though the Action 1 of BEPS did not give clear new legislation, as e.g. action 7, the discussion and attention it generated led into a suggestion by EU Commission in late March to implement a directive tackling the matter by expanding the PE definition.[61] The development of the legislative process following falls outside the scope of this study. The directive is a product of a more broad initiative Common Consolidated Corporate Tax Base that aims to tighten and uniform the corporate taxation in EU to halt tax arbitration within the internal market.[62]

As mentioned above, the new PE regulation would be relevant for MNE's creating value through cloud services and platform e.g. Apple Music or Netflix, who do not own tangible property in a country, but may generate significant revenues due to service payments. As in many cases the withholding tax regimes offer a quite limited toolbox for tax authorities to tax the outbound royalty payments between related parties.[63] A model structure of a company offering digital content i.e. music or movies via subscription is presented in below chart:

[61] European commission 2016a.
[62] For more information see. Verotus 3/2017, Rapo et als p.338.
[63] The EU's subsidiary directive and Article 12 of OECD MTC prohibit or significantly limit the power of a source country from levying withholding tax on royalty payments between related entities.

Figure 5: Example of potential server PE setup

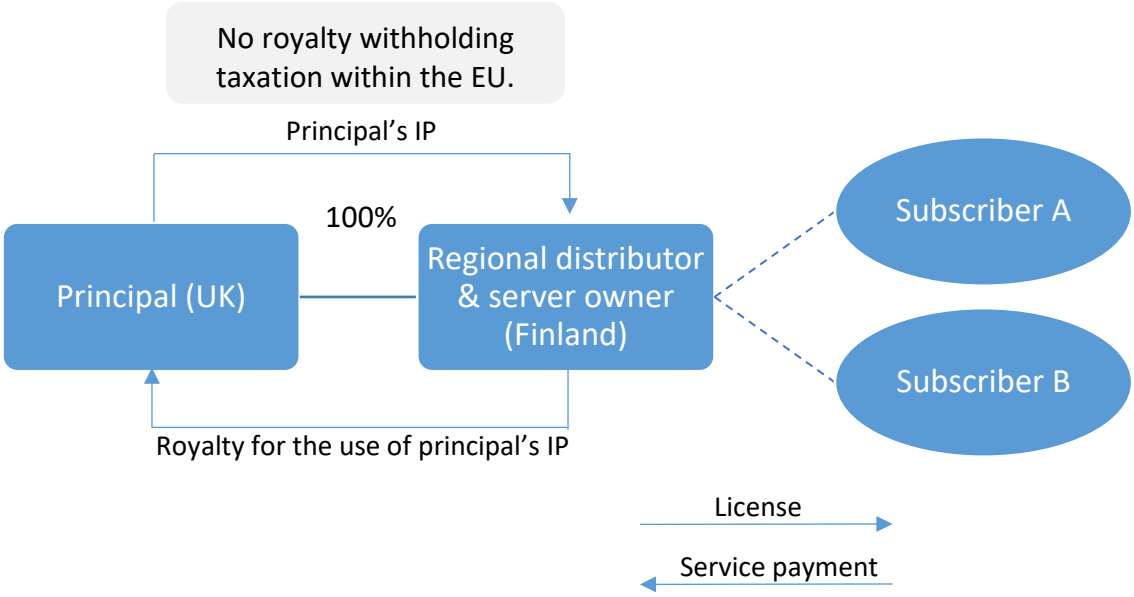


Table 1 Simplified typical P/L example for Principal.

Net sales (IP licensing to Finland)	70
OPEX (Operating expenses)	20
EBIT (Earnings Before Interests and Taxes)	50
CIT Paid in UK (19% rate)	9,5

Table 2 Simplified typical P/L example for Finnish Branch.

Net sales (Service payments)	100
OPEX (Operating expenses)	10
Royalty to UK	90
EBIT (Earnings Before Interests and Taxes)	0
CIT Paid in Finland (20% rate)	0

In the aforementioned model the UK based principal owns, develops, maintains and manages the IP in question. Finnish regional distributor is a branch of the principal, who licenses the IP for local distribution. The Finnish branch then places the product available for the customers through its server located in Finland on a cloud platform. Subscribers in Finland access and utilize the product, and pay a service payment to the Finnish branch. Finnish branch pays a

royalty to the principal. As there is no withholding tax for royalty payments from Finland to UK according to the tax treaty and EU legislation[64], the tax paid in this structure is in practice merely the UK corporate income tax.

This is a text book example of what new MTC Article 4 introduced by BEPS is aiming to prevent. As for the regional distributor, the auxiliary activity of server leasing actually forms its core business, it cannot be considered auxiliary according to the post BEPS model. Therefore, it should create a PE in Finland through which Finland could levy tax on its business profits in order to align taxation with value creation.

Finnish subscribes generate quite significant revenue in Finland, but the company has no presence based on which a PE could be created according to current legislation. Therefore, the profits are shifted outside of Finland and there is little to be done from Finnish Tax Authorities' point of view. As discussed above, one of the primary aims of BEPS was to align the profits with value creation. In the example, the value is created in Finland, but there is no basis for the profits to be taxed. This is just one of the many problems taxation faces in the fast evolving digital economy, and is addressed here to illustrate the complexity of PE and definitions in general in modern international taxation.

[64] Article 13 of the Finland-United Kingdom tax treaty and EU Subsidiary directive.

4. OECD BEPS Action 7

As discussed in Chapter 1.2, the BEPS project was initiated especially due to concerns from the G20 countries. The BEPS package consisting of 15 Actions was seen necessary whilst international tax issues kept climbing in the political agendas globally.[65] The 15-point Action Plan was adopted by the OECD and G20 countries soon after the release of *Addressing Base Erosion and Profit Shifting* (BEPS report) in February 2013.[66] The following statement from the BEPS report states the concern particularly well:

> *In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere.*

Action 7 was created after a review of the previous definitions in the BEPS *Action Plan on Base Erosion and Profit Shifting* conducted by OECD. After the review, drafting of Action 7 begun to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition. These include arrangements where taxpayers replace subsidiaries that traditionally acted as distributors by commissionnaire arrangements or similar strategies, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country. Another detected issue was misuse of the OECD MTC exemption Article 5:4, where the specific exceptions were an issue particularly relevant in the digital economy.[67]

OECD managed to release the Final Report on Action 7 in October 2015. The report is divided into four sections, each tackling an issue connected to BEPS through artificial avoidance of PE status:

A. Artificial avoidance of PE status through commissionnaire arrangements and similar strategies
B. Artificial avoidance of PE status through the specific activity exemptions
C. Other strategies for the artificial avoidance of PE status
D. Profit attribution to PEs and interaction with action points on transfer pricing

---

[65] OECD 2013, p. 61.
[66] Malmgren 2014, p.229.
[67] See OECD 2015d.

In terms of this study the section D discussing the profit attribution and transfer pricing bears the most significance. However, in order to analyze the profit attribution we shall dissect the section A as well, since for attributing the profits and understanding the transfer pricing considerations it is vital to understand the functions and profiles on the PE entities.

Actually OECD decided to postpone the section D, releasing it as an additional guidance separate of the Action 7 final report. OECD it was necessary to carry out some other Actions of BEPS project in order to successfully implement new transfer pricing guidance, i.e. it had to wait for the Actions 8-10 to step into force. The section D is therefore discussed in more detail in Chapter 6.[68]

As mentioned above, the primary weapon for OECD was to modify the OECD MTC Article 5 in order to change the PE regulation through tax treaties. It shall be notified, that Action 7 Final Report is not the tool by which this is done, rather than the MLI. MLI is the juridical instrument which embeds the changes into the tax treaties, and acts as the implementation method to the BEPS project. Specifics in terms of MLI are further discussed later in Chapter 4.1.

4.1. Preparing the Action 7

Preparing such vast project has naturally not been a simple process. OECD's work has been concluded in steps, frequently consulting the representatives of the member countries and tax administrations. Hence, the provisions now included to the MLI are a product of several drafts and amendments. The First Discussion Draft was released for discussion in October 2014.[69]

First discussion draft included several options for the possible alterations of the OECD MTC wording. The main focus areas were already quite similar to the Action 7 final report, as both the commissionaire arrangements and use of paragraph 4 exemptions were highlighted together with profit attribution concerns. Interested parties were allowed the opportunity to

[68] Paragraph D.20: "Realistically, however, work on attribution of profit issues related to Action 7 could not be undertaken before the work on Action 7 and Actions 8-10 had been completed. For that reason, and based on the many comments that have stressed the need for additional guidance on the issue of attribution of profits to PEs, follow-up work on attribution of profits issues related to Action 7 will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan."

[69] See OECD 2014b.

give their take on OECD's work. They did indeed receive a handsome amount of feedback from consulting firms, governments, MNEs and other relevant parties in the late 2014.

Another OECD body, Working Party 1 on Tax Conventions and Related Questions continued the drafting process. The work led to "a Revised Discussion Draft" that was published the following May, 2015.[70] Of the options presented in First Discussion Draft, option B prevailed, and was adopted as the working file going forward.[71] Once again the Working Party 1 invited comments of the interested parties to the report.

Some four months later, the Revised Discussion Draft was updated with the received comments and the Action 7 Final Report was published. At this point, the working assumption assumed in previous stage was not amended in great extent, alas some clarifications and concerns risen of the comments were added.

4.2. Action 7 Final Report

As described above, Action 7 brought multiple report includes the changes that will be made to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties, as a result of the work on Action 7 of the BEPS Action Plan.[72]

The key relevance in terms of this study lays in the section A discussing the agency arrangements, as this is the aspect of OECD MTC that went through the most turmoil. Therefore, there lays the greatest need for new profit attribution and transfer pricing which is the key interest of this study. Also the Anti-fragmentation rule shall be addressed, however given that due to the various nature of PEs created by its introduction the transfer pricing considerations are less relevant.

4.3. New Agency PE regulation

4.3.1. Revised MTC Article 5.5

The new wording of Article 5.5 reads as follows:

[70] OECD 2015b
[71] OECD 2015b, p. 4.
[72] OECD 2015d, p. 9.

> *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 through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.*

In order to make sense of the previous, let us extract the conditions of the new agency rule. According to Article 5.5 PE is formed, in a situation when the agent's activities meet the following criteria:

1) Acts on behalf of an enterprise, and
2) In doing so
   a) habitually concludes contracts, or
   b) plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
3) these contracts are
   a) in the name of the enterprise, or
   b) for the transfer of the ownership of, or
   c) for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
   d) for the provision of services by that enterprise

Acting on behalf of the enterprise

Company is deemed to have a PE if an agent is acting on behalf of the enterprise and has, and habitually exercises, an authority to conclude contracts in the name of the enterprise. A permanent establishment is deemed to exist in respect of any activities, which that person undertakes for the enterprise, unless the activities are only preparatory or auxiliary.[73] It is

[73] Helminen 2018: Agent.

worth noting that the same outlet of auxiliary or preparatory nature also applies to agents as well as to fixed places of businesses. Additionally, these contracts are either in the name of the enterprise or 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 for the provision of services by that enterprise.[74]

For a person to be considered acting on behalf of an enterprise that person has to involve the enterprise to a particular extent in business activities in a certain state, i.e. agent acting for a principal. A person in this context has to be understood widely, i.e. juridical person such as a company can act as an agent as well in this sense.[75] Also included in the general definition of an agent is the prerequisite that he pursues to benefit his principal, not himself.[76] It also bears mentioning that even though the agent has to involve the business to activities in certain state, the agent does not have to be a resident in that particular state.[77]

Habitually concludes contracts, or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise

Agent has to have and habitually exercise an ability to conclude contracts in the name of the enterprise. It should be noted that even if the agent must conclude contracts in the name of the enterprise in order to constitute a permanent establishment, signing the contracts is not a decisive circumstance if the agent factually concludes the contracts and the signing is only a formality.[78] Also certain substance over form interpretation is utilized here – an agent may be considered to conclude contracts on behalf on the principal if it negotiates the contracts on behalf of the principal and principal merely signs the contracts.[79] This is widely regarded as "concluding a contract".[80] The phrase "*or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*" is aimed at situations where the conclusion of a contract directly results from the actions of the Agent further solidifies the substance over matter approach.[81]

---

[74] 2017 OECD MTC Commentary, 5.84.
[75] 2017 OECD MTC Commentary, 5.86.
[76] Hemmo: 2006, chapter 5.
[77] Malmgren 2011: p.223.
[78] Helminen 2018: Agent.
[79] Malmgren 2011: p.223.
[80] 2017 OECD MTC Commentary, 5.87.
[81] 2017 OECD MTC Commentary, 5.88.

In the name of the enterprise, or 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 for the provision of services by that enterprise

The wording of subparagraphs *a*), *b*) and *c*) ensures that paragraph 5 applies not only to contracts that create rights and obligations that are legally enforceable between the enterprise on behalf of which the person is acting and the third parties with which these contracts are concluded but also to contracts that create obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.[82] However, "in the name of" requirement should not be taken literally, as if a contract is done unanimously without disclosing the name of the principal, the Article still applies.[83]

In terms of subparagraphs b) and c), the main consideration is that the person i.e. the agent who habitually concludes the contract is acting on behalf of an enterprise in such a way that the parts of the contracts that relate to the transfer of the ownership or use of property, or the provision of services, will be performed by the enterprise as opposed to the person that acts on the enterprise's behalf.[84] This is rather, as otherwise the situation would be evaluated under subparagraph a).

It is important to note that the contracts the paragraph 5 refers to, are to relate to operations that are of core nature to the enterprise. It would not be reasonable for a person to create a taxable presence merely by concluding minor agreement for internal purposes. Where, for example, a company acts as a distributor of products in a particular market and, in doing so, sells to customers products that it buys from an enterprise (including an associated enterprise), it is neither acting on behalf of that enterprise nor selling property that is owned by that enterprise since the property that is sold to the customers is owned by the distributor.[85]

From a transfer pricing perspective, it is even more important what OECD states in the immediately preceding example:

> *This would still be the case if that distributor acted as a so-called "low-risk distributor" (and not, for example, as an agent) but only if the transfer of the title to property sold by that "low-risk" distributor passed from the enterprise to the*

[82] 2017 OECD MTC Commentary, 5.91.
[83] 2017 OECD MTC Commentary, 5.93.
[84] 2017 OECD MTC Commentary, 5.94.
[85] 2017 OECD MTC Commentary, 5.97.

> *distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold) so that the distributor would derive a profit from the sale as opposed to a remuneration in the form, for example, of a commission.*

This is a direct notion that promotes the use of "a low risk distributor", also often referred to as "a limited risk distributor", a related party that distributes the goods with minimal function profile. For more in depth analysis of the LRDs and their transfer pricing, see Chapters 5 and 7.

To summarize the new provisions of Article 5.5, it is clear that the scope of the arrangement that may fall under its scope shall widen. There is, of course, no way of knowing how strictly the tax administrations shall apply the new regulation but at the very least the new OECD model gives them more firepower in order to prevent agency structures that were at least on the gray area prior to BEPS.

4.3.2. Revised MTC Article 5.6

Just like in the previous OECD model, in post-BEPS MTC Article 5 the outlet of independent agency is quite as important. The basic function is the same, to limit the applicability of the general provision of paragraph 5. As was stated above, the lowered threshold of paragraph 5 will swallow more structures into its scope. This will, at least in tax planners' minds, increase the relevance of independent agency exception.

Article 5.6 went under a full reconstruction in Action 7. It reads as follows:

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

The method that is to be derived from this rule is rather straightforward. An agency PE is not created by the person, even if the Article 5.5 would apply in the situation, where the agent:

1. is an independent agent and;
2. acts for the enterprise in the ordinary course of that business.

At the first glance the requirements look rather similar to the ones included in the previous OECD model. What was previously referred to as "an agent of independent status" is replaced with "independent agent". In addition, the mention that agent shall be "economically independent" is not included in the commentary.[86] It should also be noted that the control principal might exercise over the agent in the case agent is a related party as a shareholder is not relevant in consideration of the dependence of the agent.[87] This is in line with the rule presented in paragraph 7[88].

Whether a person acting as an agent is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise.[89] The implication of this is, that if the activities undertaken by the person are subject to thorough and detailed guidance from the principal he can hardly be taken as independent. As mentioned above, the economic independence is no longer a requirement. In the previous model the consideration was that the business operation carried out by the independent agent had to be sustainable in economic sense for it to be justified.[90] Even though the requirement has been removed from the commentary, there are still opinion supporting that independent agent has to remain its independence also economically.[91] Very much like in the previous model, entrepreneurial risk remains one of the key consideration points,[92] which should be emphasized in the dealings between related parties and their transfer pricing.

Another addition to the independent agent rule was the last sentence "*Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise."* This is an additional negative requirement that was not included in the previous model. The effect is quite clear – the

---

[86] 2017 OECD MTC Commentary, Paragraph 6.
[87] 2017 OECD MTC Commentary, Paragraph 6.105.
[88] Paragraph 7: "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."
[89] 2017 OECD MTC Commentary, Paragraph 6.104.
[90] See Helminen 2018, Agent and Skaar 2000 p. 193.
[91] See Helminen 2018, Agent. Also, interesting enough, FTA has remained on the stance that the economical and juridical independence is required. Otherwise the FTA's guidance appears to be a mere translation of the OECD model. This is hardly a surprise, thus as mentioned earlier in this study the agency PE does not appear written in TVL specifically.
[92] 2017 OECD MTC Commentary, Paragraph 6.104.

sentence renders that all persons acting as an agents are categorically deprived of the exception.

Due to new paragraph 6 numbers of principals becomes one of the key points of consideration in granting the paragraph 6 exception. However, the commentary states that "this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge".[93] Hence, however challenging it may seem for a related party subsidiary to maintain its independence it is not closed out in the new model. It shall very interesting to see, if tax administrations will have any lenience for these arrangements as the wording of the paragraph 6, especially when read without the commentary, seems to take a strict stance towards related party arrangements with just one principal. The commentary also notes that acting on behalf of several group companies is considered as working for one principal[94], which makes perfect sense at least from a transfer pricing perspective.

The second condition "acts for the enterprise in the ordinary course of that business" is familiar also from the previous model. The commentary states that an independent agent cannot be said to act in the ordinary course of its business as agent when it performs activities that are unrelated to that agency business.[95] This aims to tackle arrangements where an entity typically acts e.g. as a limited risk or full risk distributor of goods, would assume the role of an agent in relation to a certain principal. Then it would not be considered acting "in the ordinary course of its business.

An additional rule regarding paragraph 6's "*closely related*" requirement is included in the paragraph 8, which reads as follows[96]:

> *8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the*

[93] 2017 OECD MTC Commentary, Paragraph 6.109.
[94] 2017 OECD MTC Commentary, Paragraph 6.111.
[95] 2017 OECD MTC Commentary, Paragraph 6.110.
[96] The discussion draft of Action 7 used broader terms "associated enterprise" and "person connected to an enterprise" but these faced significant friction in the comments received and they were excluded from the final version.

> *beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.*

The paragraph sets out the following rules. Firstly, agent is closely related to an enterprise if principal has control over the agent, they are under mutual control e.g. in the same subgroup or agent has control over the principal. This evaluation is based on all the relevant facts and circumstances. The first part is rather obvious.

The second part provides some alternative cases which would cause a person to be "closely related":

1. One possesses directly or indirectly more than 50 per cent of the
    a. beneficial interest in the counterpart; or
    b. aggregate vote and value of the company's shares or of the beneficial equity interest in the counterpart's company, or if
2. another person possesses directly or indirectly more than 50 per cent of the
    a. beneficial interest in the agent and the principal; or
    b. beneficial equity interest in both companies

To conclude, the aforementioned circumstances would prevent a closely related person that is included in the scope of Article 5.5 to utilize the independent agent exception. It is important to mention that merely by being related according to the aforementioned criteria an agency PE is not formed, the closely related party shall first fall be included in the scope of Article 5.5.

4.4. The Anti-Fragmentation Rule

Also OECD deemed it necessary to tackle the artificial avoidance of the PE status through the negative list, and amended the 2017 MTC with the following additions that include the so called "Anti-fragmentation-rule":

> *4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State*
>
> *and*

> *a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or*
>
> *b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,*
>
> *provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.*

These latter provisions aim to fulfill the goals of BEPS action 7. The underlining goal is to prevent a company or a group of companies from avoiding its PE status by fragmenting the activities in a target country, so that several entities would benefit from the paragraph 4 exemption arguing that they are engaged in a separate preparatory or auxiliary activity. The additional provisions of article 4.1 sort of consolidate the preparatory and auxiliary activities, thus making it impossible to gain benefit for fragmenting different auxiliary and preparatory activities to different locations. At least one of the places where these activities are exercised must constitute a permanent establishment or, if that is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.[97] In order to determine whether the enterprise is "closely related", the same test of paragraph 8 introduced in Chapter 3.3.2 above is used.

In addition, BEPS made an addition to the "negative list" subparagraphs e-f emphasizing that the "overall activity of the fixed place of business, is of a preparatory or auxiliary character". This slight change helps prevent the artificial avoidance of PE status in operations such as server maintenance discussed above in Chapter 3.5, where originally auxiliary or preparatory activity has become the core business of the related party.[98]

[97] 2017 OECD MTC Commentary, Paragraph 4.1.79.
[98] OECD 2015d, p. 10.

5. Implementation

5.1. Multilateral instrument

In November 2016, some 100 countries and jurisdictions concluded negotiations on the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("Multilateral Instrument" or "MLI"). The MLI is used to efficiently implement the changes introduced by BEPS project. It entered into force on July 1 2018.

The roots of MLI are in the BEPS Action Plan, developed by the OECD Committee on Fiscal Affairs (CFA), discussed earlier in this study. Action 15 of the BEPS Action Plan was to analyze the possibility to develop a contractual "multilateral instrument" that would implements the BEPS measures that related to amending the tax treaties. The need for MLI kind of instrument was dire, as the number of bilateral treaties[99] in scope of the change was too much for an effective bilateral updating.[100]

The Action 15 Final report "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties" came into a conclusion that there really was a need for such instrument. The functionality of MLI was quite extraordinary: it would not amend the language of existing tax treaties but rather operate alongside the bilateral tax treaties that were covered by the changes ("covered tax treaties") and modify their application. However, this makes it hard in practice to determine which Articles of each tax treaty apply in each bilateral relation as they are not visible in the treaty text.[101] This was however considered necessary in order to implement the changes in reasonable time.[102]

An ad hoc Group was formed of the interested participating countries, and was tasked to develop the MLI instrument for signatures by 31 December of 2016. The Chair of the ad hoc Group was Mr. Mike Williams of the United Kingdom. The ad hoc Group agreed on the substance of the tax-treaty related BEPS measures to be included in the instrument. Of the final package, actions on hybrid mismatches (Action 2), treaty abuse (Action 6), permanent

---

[99] It was estimated by the CFA that over 3000 individual treaties were in the scope of changes that would be implemented due to BEPS.
[100] MLIb Art. 4.
[101] Malmgren – Myrsky 2017: p. 82. See also MLI b Art. 13
[102] To mitigate the inconvenience, OECD as the coordinator created a MLI matching database that analyzes the changes to different tax treaties. The tool can be accessed through: http://www.oecd.org/tax/treaties/mli-matching-database.htm

establishments (Action 7) and dispute resolution mechanisms (Action 14) were included. As mentioned, MLI merely implements the changes introduced by BEPS. However, as an exception the arbitration procedure of Action 14 was implemented directly via MLI.[103]

The MLI has been open for signatures from the beginning of 2017, and a ceremonial signing was organized in Paris on 5 June 2017 where representatives of 68 jurisdictions including Finland signed the MLI. Ten more jurisdictions signed in the spring 2018, and currently 84 jurisdictions have signed the MLI while six others have expressed their intent to sign the MLI in the near future.[104]

5.1.1. Contractual structure and the minimum standard

The minimum standard regarding the MLI signing refers to the minimum requirement of the provisions each country shall agree to in order to sign the MLI[105]. The ad hoc Group considered that the Convention should enable all Parties to meet the treaty-related minimum standards that were agreed as part of the Final BEPS package, which are the minimum standard for the prevention of treaty abuse under Action 6 and the minimum standard for the improvement of dispute resolution under Action 14.[106] Therefore, the MLI is basically split into a minimum standard and voluntary part of which the parties may cherry pick Actions they desire. As is evident, the Action 7 and PE regulations are not part of the minimum standard. The ad hoc group came into a conclusion that including too much controversial content to the minimum standard would affect the general willingness to sign the MLI. This naturally limits the impact of new PE regulation. However, it should be noted that the changes were implemented to OECD's 2017 MTC which will cause change at least indirectly.

The underlining feature of the MLI is its flexibility. In addition to minimum standard, this is visible in the excessive modifications the signing jurisdictions are able to make to their respective MLIs ("MLI position"). Firstly, jurisdictions may specify the "covered tax agreements" ("CTAs") to which the MLI applies. They may even specify that some CTAs are only partly in the scope of the MLI. Secondly, if certain CTAs already meet the minimum

---

[103] See MLIb Art. 9 and 14.
[104] Situation per October 24 2018. OECD follows the signees at: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.
[105] Actually, even the minimum standard is as so called"soft law legal instrument", and not binding rather than a recommendation. See Ojala 2017, p. 217.
[106] See MLIb Art. 14.

requirement, jurisdiction may restrain from applying even the minimum standard in term of these contracts. Thirdly, some BEPS Actions produced multiple ways to address a certain issue. MLI grants jurisdictions freedom to choose their approach in these cases.

5.1.2. Finland's MLI approach and Action 7

The Finland's take on MLI was explained in Ministry of Finance's memorandum "The reservations and notifications of the Republic of Finland for the purposes of the signature of the Multilateral Convention on Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on 7 June 2017".

The memorandum starts by listing Finland's CTAs. The list includes all but tax treaty with Bulgaria and multi-lateral Nordic tax treaty. In terms of Bulgaria, the treaty was seen to be too inconsistent with the BEPS model, bilateral update was considered the best option. In terms of the Nordic treaty, common and comprehensive amending with other countries was seen as best practice.[107]

Then the memorandum proceeds to the reservations made by Finland to the MLI. Memorandum states that Finland opted for the minimum standard, implementing Action 6 and Action 14 and made reservations to all the other Articles of MLI. Therefore, the new PE regulations in Finland were not changed due to the MLI.

Article 12 of MLI aimed to implement the core of BEPS Action 7. Its wording is identical to BEPS Action 7 Final Report, naturally including some provisions regarding the reservations and technicalities.[108] Finland reserved not to implement the Article 12 in its entirety. Article 12(3a) states which provisions the proposed PE rule with its exceptions would replace. It reads as follows:

> *Paragraph 1 shall apply in place of provisions of a Covered Tax Agreement 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 for the enterprise, but only to the extent that such provisions address the situation in which such person has, and habitually exercises, in that*

[107] See VM 5/2017.
[108] See Art. 12 of MLIa.

> *Contracting Jurisdiction an authority to conclude contracts in the name of the enterprise.*

Thus, Article 12(1) would replace the DTT treaty articles consistent with the OECD MTC Article 5.5. Article 12(3b) reads as follows:

> *Paragraph 2 shall apply in place of provisions of a Covered Tax Agreement that provide that an enterprise shall not be deemed to have a permanent establishment in a Contracting Jurisdiction in respect of an activity which an agent of an independent status undertakes for the enterprise.*

Hence, Article 12(2) would replace the DTT articles consistent with the OECD MTC Article 5.6. As mentioned above, some MLI articles include alternative approaches to implement the changes. This is not the case with Article 12, as country may choose to implement the new rules of Articles 12(1-2) or opt to exercise the reservation on both. Partial implementation is not an option.

The new specific exemption regulation is included in the Article 13, of which two options are offered. They read as follows:

> *1. A Party may choose to apply paragraph 2 (Option A) or paragraph 3 (Option B) or to apply neither Option.*
>
> *Option A*
>
> *2. Notwithstanding the provisions of a Covered Tax Agreement that define the term "permanent establishment", the term "permanent establishment" shall be deemed not to include:*
>
> *a) the activities specifically listed in the Covered Tax Agreement (prior to modification by this Convention) as activities deemed not to constitute a permanent establishment, whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character;*
>
> *b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a);*
>
> *c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b),*
>
> *provided that such activity or, in the case of subparagraph c), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.*
>
> *Option B*

> *3. Notwithstanding the provisions of a Covered Tax Agreement that define the term "permanent establishment", the term "permanent establishment" shall be deemed not to include:*
>
> *a) the activities specifically listed in the Covered Tax Agreement (prior to modification by this Convention) as activities deemed not to constitute a permanent establishment, whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character, except to the extent that the relevant provision of the Covered Tax Agreement provides explicitly that a specific activity shall be deemed not to constitute a permanent establishment provided that the activity is of a preparatory or auxiliary character;*
>
> *b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a), provided that this activity is of a preparatory or auxiliary character;*
>
> *c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

As a concluding remark, the built in feature in MLI that new PE regulation shall become part of the bilateral tax treaty if both parties to the agreement agree to implement without reservations to the PE provisions. Such unanimity has been very hard to come by. So far Norway, South Africa and Australia in some extent have decided to implement the new PE regulations to their tax treaties.[109] Hence, it could be said that the implementation of new PE regulations through MLI has not yet been very successful. It would appear that the more effective way of implementing is through bilateral tax treaties and OECD MTC 2017, but that will take more time.

Simultaneously with the OECD, EU Member States have voiced their concern in battling base erosion and profit shifting together with aggressive tax planning. Possibly the most tangible method has been passing of the Anti-Tax Avoidance Directive (ATAD)[110]. However, PE related issues have not been in the focus of the Commission and are excluded from ATAD. Commission has stated that they should be dealt with utilizing the tax treaties.[111] Therefore, commission

[109] Deloitte 2018.
[110] Council Directive (EU) 2016/1164 of 12 July 2016 .
[111] Commission 2016b, p.6.

has only made recommendations to member states about updating the PE regulation bilaterally.

6. Transfer pricing analysis

6.1. PEs constituted by anti-fragmentation rule

As mentioned earlier in this study, changes to paragraph 4 of the OECD MTC are less comprehensive, and the functions that the new PEs constituted by the new rule are often very miscellaneous. Therefore their transfer pricing relates to traditional, low value-adding intra-group services addressed in the OECD 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("2017 TPG").

2017 TPG provides guidance regarding services provided by related parties that produce relatively low value add. Therefore, the transfer pricing documentation and compliance regarding these services has its own, simplified approach.[112] Services qualifying as low value-adding may be documented in a simple process, where the related party producing the services is compensated using comparable uncontrolled price method[113], the mark-up shall be equal to 5% of the relevant cost as determined in section D.2.2 of the 2017 TPG.

In order for a service to qualify as low value-adding, it must meet the requirements set in the 2017 TPG[114]. They are described as services performed by one member or more than one member of the MNE group on behalf of one or more other group members which:

A. *are of a supportive nature,*

B. *are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group),*

C. *do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and*

D. *do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.*

It is interesting to see that the requirements have a lot in common with the description of *preparatory or auxiliary* activities on OECD MTC paragraph 4. Especially the distinction from

---

[112] 2017 TPG 7.43.
[113] For more information regarding transfer pricing methods, see 2017 TPG Chapter II and FTA's guidance A68/200/2018 5.7.
[114] See section 7 D.1.

principal's core business and general supportive nature adhere to this conclusion. This is not, of course, to say that all activities described in paragraph 4 could be remunerated as low value-adding but in many cases that appears to be a feasible approach. Therefore we will not analyze the transfer pricing of a service provider described in paragraph any further in this chapter.

6.2. PEs constituted by dependent agents

As became evident in the Chapter 3, most of the new PEs potentially created in the post-BEPS environment are born due to the lowered agency PE threshold. In order to gain a grasp of the remuneration of a related party agent, this subchapter will present and analyze the applicable OECD transfer pricing guidance.

6.2.1. Arm's length principle

All transfer pricing is based on the following of the arm's length principle. In national legislation, it is included in the Act on taxation procedure's Article 31:

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

The latter part of the statute states that the same rule is enforced in dealings between a principal and its permanent establishment. The same principle is included in the OECD MTC paragraph 1 of Article 9. As the statutes regarding transfer pricing nationally are very few and far between, additional guidance provided by other bodies is essential in carrying out relevant transfer pricing. The main provider of such guidance is OECD, as FTA's national guidance is often a mere translation of the OECD TPG currently in force.[115]

The essence of arm's length principle is that in the trade between two associated enterprises, the transfer prices have to comparable to the prices that independent enterprises would use in a similar situation in a free market. Arm's length principle derives from a principle of separate entities, according to which associated enterprises should be analyzed as separate entities rather than as a part of a group of companies.[116] This is also acknowledged in the

[115] See FTA A72/200/2018 and FTA A68/200/2018.
[116] Raunio 2018, p. 46.

OECD TPG "the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business."[117]

Arm's length principle seems rather simple in theory, but in practice its application may prove to be difficult. As the products sold are very seldom identical to any comparables, it is very hard to gather all the data necessary to achieve result perfectly in line with the arm's length principle. Also 2017 TPG acknowledges this by stating that the objective of transfer pricing is rather to "find a reasonable estimate of an arm's length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer."[118] Often the dealing between the associated enterprises might include a unique product that simply cannot be found in the open market. Therefore, there is a need for transfer pricing analysis that provides a reasonable estimate of the correct transfer price. The main steps of the OECD guided approach to this analysis are presented below, in the context of a dependent agent PE. In practice this information and analysis would be included in the transfer pricing documentation of the company.[119]

6.2.2. Comparability analysis

As described in the previous Chapter, it is often essentially impossible to find perfect comparisons to the transactions in order to gain information of the pricing between independent parties. These transactions are often referred to as the "comparable uncontrolled transactions" in transfer pricing context and OECD TPG. Essentially, transfer pricing seeks to adjust the profits realized between the associated enterprises by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, i.e. in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's length principle.[120]

---

[117] 2017 TPG 1.6.
[118] 2017 TPG 1.13.
[119] For more information regarding the transfer pricing documentation requirements see FTA A68/200/2018 and 2017 TPG Chapter 5. National requirements are in VML 14b §. It should be noted, however, that enterprises are liable to document their dealings with their Finnish PE's.
[120] 2017 TPG 1.6.

The comparability analysis to be conducted between the associated enterprises is regulated in OECD TPG Chapter I D and Chapter III. Comparability analysis consists essentially of two parts: first step is to identify the commercial relations between the associated enterprises and the condition and economically relevant circumstances of these relations. Second step is to compare the conditions and economically relevant circumstances of the controlled transaction with the conditions and economically relevant circumstances of the comparable uncontrolled transactions.[121]

The two general, and most important, steps of the comparability analysis are identifying the contractual terms of the transaction, and to identify the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.[122] The latter part is well in line with the key objective of BEPS project transfer pricing wise – to align the Transfer Pricing Outcomes with value creation.[123] The essence of the concept is that the more value is created in a certain country, the more profit should be taxed in that jurisdiction.

In order to address the first step of the aforementioned analysis, we shall identify the contractual terms of the transaction. As is evident, the relationship under review is one between a principal company and its foreign agent. As it is one of the specific aims of BEPS Action 7 to address PE avoidance through sales commissionaire arrangements and similar strategies[124] we shall use sales agent as an example setup.

Below is illustrated a typical business setup for a business model that uses agent in another jurisdiction to provide sales services. From supply chain point of view, the tangible goods flow directly from *SalesCo* to customer, and the service flow is from *AgentCo* to *SalesCo*.

---

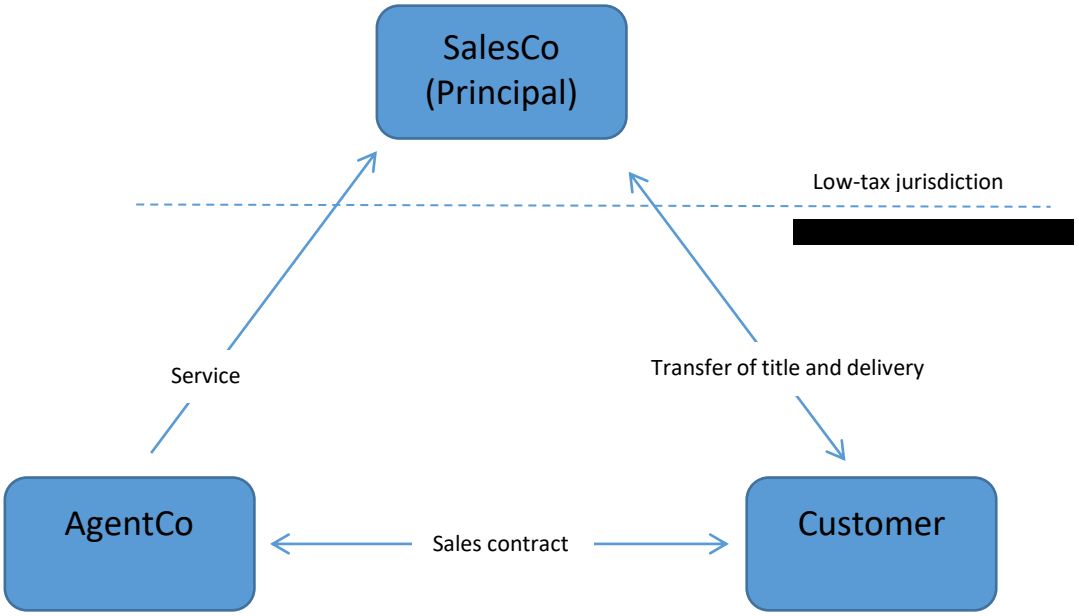
[121] 2017 TPG 1.33.

[122] In practice, transfer pricing teams are including value chain analyses to the transfer pricing documentations of MNEs in order to demonstrate where the value is created in the group.

[123] See BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation Final Report, also Raunio 2018, p.64-66.

[124] See BEPS Action 7 Final Report, Section A.

Figure 6: Sales agent PE setup



a) The principal company, hereafter *SalesCo,* is a legal entity based in a jurisdiction with a lower corporate income tax (CIT). Hence it is beneficial for the group's effective tax rate to tax as big of a share of the profit as possible in this jurisdiction.

b) The Agent, *AgentCo*, is a subsidiary of the principal company.

c) *AgentCo* acts as a sales agent in the customer jurisdiction and enters into sales contracts with customers. Hence it provides sales and marketing services for the *SalesCo* and receives an arm's length compensation calculated typically with comparable uncontrolled price (CUP) method. Invoicing is done in the name of the agent, but the sales receivables are owned by the *SalesCo.*

d) Legal title to the product is transferred directly to the end customer, product is delivered directly to the customer. It is noteworthy that hence the agent never owns the product, or the corresponding sales receivable.

e) Agent is compensated for its functions and activities with a commission based on the sales, calculated with some of the OECD's transfer pricing methods to ensure arm's length remuneration level. In this exercise we use CUP method for its simplicity. It is vital to understand, that due to the low risk, limited functions and very little assets employed the arm's length rate for the transfer price, in this case the agent's compensation, is very low. This is of course very positive for the company, and the tax savings increase as the revenue, paid agent commission, in the high-tax jurisdiction decreases. As mentioned above, when the remuneration is determined on a CUP basis,

AgentCo receives an arm's length commission. Consequently, the residual profit flows to SalesCo.

Table 3 Simplified typical P/L example for SalesCo

Net sales (of sold goods)	110
COGS (Cost of goods sold)	70
OPEX (Operating expenses)	30
Agent's service fee	5
EBIT (Earnings Before Interests and Taxes)	5
CIT Paid in SalesCo jurisdiction (15% rate)	0,75

Table 4 Simplified typical P/L example for AgentCo

Net sales (service income)	5
COGS (Cost of goods sold)	0
OPEX (Operating expenses)	3
EBIT (Earnings Before Interests and Taxes)	2
CIT Paid in customer jurisdiction (20% rate)	0,4

6.2.3. Functional analysis

Once the transaction has been identified and the parties to the transaction analyzed, a functional analysis shall be prepared. According to the 2017 TPG "In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed."[125] Functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed and risks that are assumed by the parties to complete the transaction.[126]

Functional analysis in other words aims to identify the functional profile of the parties to a transaction under review. In practice functional analysis is used to limit the comparables in the second stage of the analysis – only companies with a similar functional profiles can be

[125] 2017 TPG 1.51.
[126] Raunio 2018, p. 60.

compared to determine the arm's length remuneration. In practice, the functional analyses included in the transfer pricing documentations of MNEs are often formatted in tables that illustrate the functions entities carry out, assets they utilize and risks they assume. This study has assumed a similar approach.

To gain better understanding of the range of functional profiles of different entities in the setup described in the previous Chapter, the following functional analysis table includes the functions, risks and assets of an agent PE but additionally for reference the functional profiles of a limited risk distributor and a full-fledged distributor. For clarity's sake, a limited risk distributor ("LRD") is a distributing entity in a structure where the manufacturing entity or other principal entity has assumed some risk for its behalf.[127] Typically this could include market risk, when principal makes the sales, and merely distributes the goods through the LRD. Full-fledged distributor refers to a full risk enterprise that operates like a third party, assuming full risk. The working assumption is similar to the *Figure 4* above, the distributing entity (AgentCo) purchases tangible goods from a principal (*SalesCo*) that manufactures the goods.

Table 5 Functional analysis of different distributors

Functions	Full-fledged	LRD[128]	Agent
Research & development	Might carry out limited local R&D, usually included in the product pricing.	Usually no R&D, principal conducts the R&D and includes the costs in the product price.	No R&D activities, R&D costs are embedded in the product price.
Logistics and warehousing	Usually responsible for warehousing the finished goods before title is passed to the end customer.	Usually carries out warehousing function, at least in some extent.	Typically no warehousing activities.[129]
Marketing and sales	Carries out all necessary marketing and sales functions to conclude its sales.	Usually little to none marketing activities, just conducts the sales that are caused by principal.	Carries out all necessary marketing and sales functions to conclude its sales.

[127] 2017 TPG 9.15. For more information regarding LRD models, see Raunio 2018, p. 81.
[128] It should be taken into account that LRD arrangements are always unique. In this setting principal does the sales, and merely flows the goods through the LRD.
[129] Anti-fragmentation rule introduced by BEPS might affect this in the future.

Administration, Finance and Legal	Dependent on Group size and structure. MNEs tend to use more centralized administration to achieve cost savings.	Dependent on Group size and structure. MNEs tend to use more centralized administration to achieve cost savings.	Carries out necessary administrative functions to support its business.
Risks			
Market risk	Assumes full market risk.	Market risk is limited due to the LRD arrangement, i.e. its limited risk profile.	Shared market risk with the principal, assumes limited market risk.
Inventory risk	Assumes inventory risk due to warehousing.	Usually assumes at least some inventory risk.	No, except when warehousing.
Customer credit risk	Yes	Yes	Usually no, as the SalesCo invoices the customer.
Product liability risk	Yes	Yes	No
Assets			
Tangible assets	Full ownership of goods.	Flash title[130]	Does not own the sold products.
Intangible assets	Yes, marketing intangibles, subcontracting relations and customer relations.	Limited risk profile does not enable it to develop significant marketing intangibles.	Limited intangibles regarding local marketing intangibles and relations.

Table 6: Functional analysis of the manufacturing principal

Functions	Principal
Research & development	Usually responsible for principally all R&D and other high level corporate services due to value creation.[131]
Logistics and warehousing	Usually responsible for warehousing of the semi-finished and finished goods before title is passed to the end customer or distributor.
Marketing and sales	Carries out all necessary marketing and sales functions to conclude its direct sales. In addition, usually responsible for group's marketing strategy.
Administration, Finance and Legal	Highly dependent on group size and structure. Big multinationals tend to use more centralized administration to achieve cost savings.
Risks	
Market risk	Assumes full market risk.

[130] Flash title refers to assuming the title to the product only momentarily before passing it to the customer.
[131] For transfer pricing purposes it is more defendable to allocate more of the residual income to the Principal's home country if it carries out high value add functions for group companies. This is in line with BEPS' main goal to align profits with value creation.

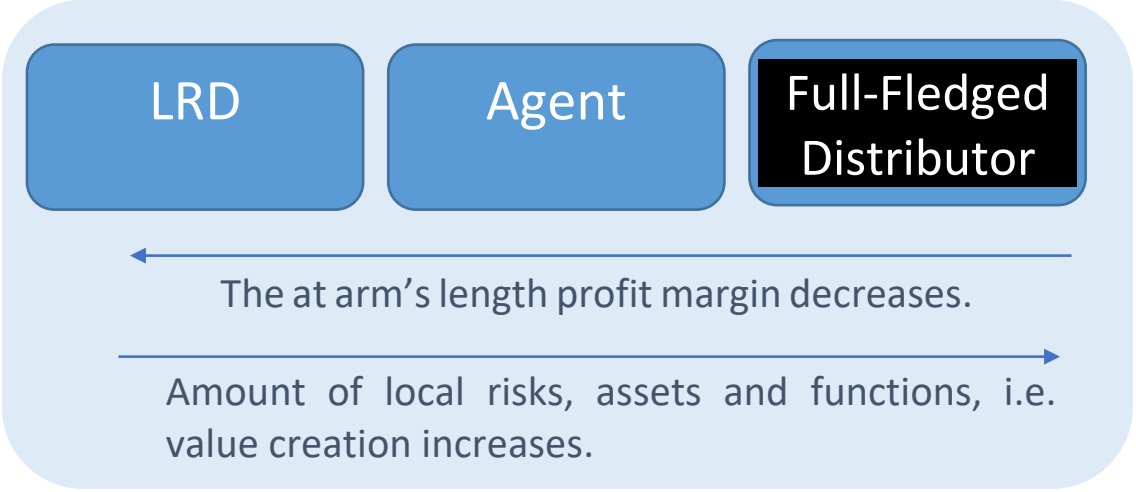
Inventory risk	Assumes inventory risk due to warehousing.
Customer credit risk	Yes, in relation to its own sales.
Product liability risk	Yes, fully also for reputation reasons.
Assets	
Tangible assets	Full ownership of goods. Owns also all necessary Plants, property and equipment to produce products.
Intangible assets	All relevant intangibles.

As is visible from *Table 1* the functional profile of the Agent is very limited. It practically merely promotes the products and closes the sales, and carries out its own supportive functions such as bookkeeping. The only risk associated with the Agent's business is the market risk, i.e. its income depends on the market situation and its ability to close sales. Accordingly, the Agent owns practically no assets neither does it take title to the product it sells. Therefore we can conclude, that the overall functional profile of an agent in very slim, especially compared to its counterparty the Principal.

As mentioned above, the BEPS' goal to align transfer pricing outcomes with value creation is of an essential importance in modern transfer pricing. It is a generally known principle of economics that value creation follows risk.[132] Hence, the amount of risk assumed by certain entity correlates strongly to the income expectations it has. Therefore, the Principal is naturally entitled to a significantly larger share of the profit. This is also supported by the value creation standpoint, even though value creation has more consideration than mere risk. The general principle on risk and value creation correlating with profit could be formalized as follows:

[132] Raunio 2018, p. 80.

Figure 7: Arm's length profit margin and entity functions.



7. Allocation of profits to new PE's

7.1. Attribution of profits to PE before the BEPS final report

Prior to the BEPS project the main sources of regulation discussing the attribution of profit to PEs were OECD's 2010 Report on Attribution of Profits to Permanent Establishments ("2010 Report"), the OECD TPG and FTA's guidance.[133] The legislative foundation in included in TLV 9.1 §, according to which "Foreign enterprise is liable to pay tax for the income derived from Finland" this is often referred to as the *limited tax liability.* TVL 10.1 § specifies that income derived from Finland includes income received from a Finnish enterprise. TVL 9.3 § supplements the aforementioned as follows:"if a foreign enterprise has a permanent establishment in Finland through which the business in carried on, it is liable to pay tax on all income attributable to that permanent establishment". The position of OECD's Profit Attribution Report as a source of regulation has been confirmed in tax practice of Supreme Administrative Court.[134]

In practice, bilateral tax treaties are very important in determining the taxation power. Article 7 of the OECD MTC also included in Finland's tax treaties reads as follows:

> *1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.*
>
> *2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.*

To conclude, business profits of an enterprise of a state may be taxed only in that state, unless the enterprise carries on business in another state through a permanent establishment

---

[133] FTA A72/200/2018.
[134] KHO 2016:72

situated therein.[135] It is important to note, however, that the taxing right only exceeds to profits attributable to the PE. On the other hand, in a tax treaty situation Finland is not allowed to tax non-residents for their business concluded in Finland if the business is not carried on through a PE. Finland's right in non-tax treaty situation is therefore broader.

The 2010 Report relies heavily on the standard principles discussed in chapter 5.2. For purposes on the attribution analysis, the PE should be regarded as a *functionally separate entity*. This means that PE might be attributed profit when the enterprise as a whole has not been profitable, and vice versa.[136] The report includes the basic premise of *the authorized OECD approach* ("AOA"), identical to the OECD MTC Article 7.2 above, which is widely used in attributing profits to PEs. It essentially sets the limit on the amount of attributable profit that may be taxed in PE's jurisdiction.[137]

The interpretation of OECD MTC Article 7.2 together with AOA relies on the similar two step method used previously in Chapter 5.2 in determining the arm's length remuneration. In the first stage, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE's activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE.[138] In attribution of especially the risks and assets, the *significant people functions* are essential to determine the correct distribution. This will be a case-by-case evaluation, as the significant people functions vary between different industries.[139]

In the second stage OECD TPG is applied with analogy using the hypothesis, by which a PE is treated as functionally separate and independent enterprise, and arm's length compensation is determined based on comparables.[140] At this stage, also necessary capital attributions are made.[141] This is more relevant in terms of e.g. a branch because it needs capital to function.

---

[135] Helminen 2018: A Permanent Establishment of a Non-resident in Finland.
[136] OECD 2010: pp. 12-13.
[137] It is of vital importance to grasp that AOA is not binding, and it does not apply if the country has opted for an alternative approach. However, as it is nearly identical to the OECD MTC Art. 7 majority of states including Finland apply it as such.
[138] OECD 2010, p. 13.
[139] OECD 2010, B-3.16.
[140] FTA A72/200/2018, Chapter 4.
[141] OECD 2010: pp. 18-20.

As agent is a rather independent unit, further analysis of attributing capital and financing costs such as interests to the PE's books is left outside the scope of this study.

There are some special considerations in terms of dependent agent PEs. In case a PE is created by a dependent agent, there are actually two taxable entities in the host country – the dependent agent enterprise (usually a resident of the enterprise) and the dependent agent PE (which is a non-resident). In terms of the associated enterprises (the dependent agent enterprise and the non-resident principal) Article 9 will determine the arm's length nature of the transaction, usually the compensation i.e. commission.[142] Additionally, in terms of the PE the issue is to determine the amount of profit of the non-resident principal to be attributed to the PE in the host country. In this relation, Article 7 is the relevant source of regulation.

When determining the profits attributable to the dependent agent PE it is essential to determine and deduct the arm's length remuneration to the dependent agent enterprise for the services it provides to the non-resident principal. Otherwise there would be double taxation for the profits. Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. That is subject to the facts and circumstances in each scenario, but it can't be ruled out that also profit exceeding the dependent agent's reward should be attributed to the dependent agent enterprise.[143]

To conclude, the attribution of profits to PE process is largely similar to transfer pricing between a principal and its subsidiary. Only as PE is not its own legal entity, it is not possible to conduct the legal and contract structure analysis and the hypothesis of functionally separate entity must be utilized.[144] Also it is noteworthy, that in the functional analysis of a PE risks and assets usually follow the functions rather when in regard of independent enterprises the intra-group agreements usually determine the split of functions, assets and risks.[145]

7.2. Attribution of Profits to PE post-BEPS

When OECD published the BEPS Action 7 Final Report, it stated that realistically work on attribution of profit issues related to Action 7 had to wait to be addressed before Action 7 and

[142] OECD 2010, p. 59.
[143] OECD 2010, p. 60.
[144] OECD 2010: p. 14.
[145] Raunio 2018, pp. 40-41.

the work on Actions 8-10 had been completed. This, and on the other hand extensive comments in the drafting stage emphasizing the need for additional guidance on this matter led to a decision to prepare a follow up report on the attribution of profit to PEs. This work commenced after September 2015, aiming to produce the report prior to the launch of MLI in the beginning of 2017.[146] Therefore, it is natural that the new guidance reflects also the outcomes of BEPS Action 8-10 Final Report *Aligning Transfer Pricing Outcomes with Value Creation*.

Thus, Committee on Fiscal Affairs begun its work and published two discussion drafts of the 2018 Additional Guidance on the Attribution of Profits to Permanent Establishment report ("2018 Report"), first in July 2016 and second in June 2017 for interested parties to provide comments to. As the result, countries have agreed that the principles presented in the 2018 Report are relevant and applicable in attributing profits to permanent establishments.[147] The key content of Action 7 Final Report and 2018 Report is that no substantial changes to the AOA are required. Rather the key relevance is how the rules will apply to the PEs resulting from the changes presented by BEPS Action 7, and how the changes to transfer pricing related matters in general affect the profit attribution going forward.[148]

7.2.1. Attribution of profit to PE resulting from changes to Article 5(4) and the Commentary

The 2018 Report recognizes the AOA approach as the starting point to post-BEPS attribution also in case of a PE that has been established due to activities specified in Article 5(4) that are not preparatory or auxiliary in nature, the attribution of profits to the PE should be determined under an analysis of the amounts of revenue and expense that the PE would have recognized if it were a separate and independent enterprise.[149] The same applies, naturally, to a PE deemed to exist due to infringement of the anti-fragmentation rule when the combined activities "constitute complementary functions that are part of a cohesive business operation".[150]

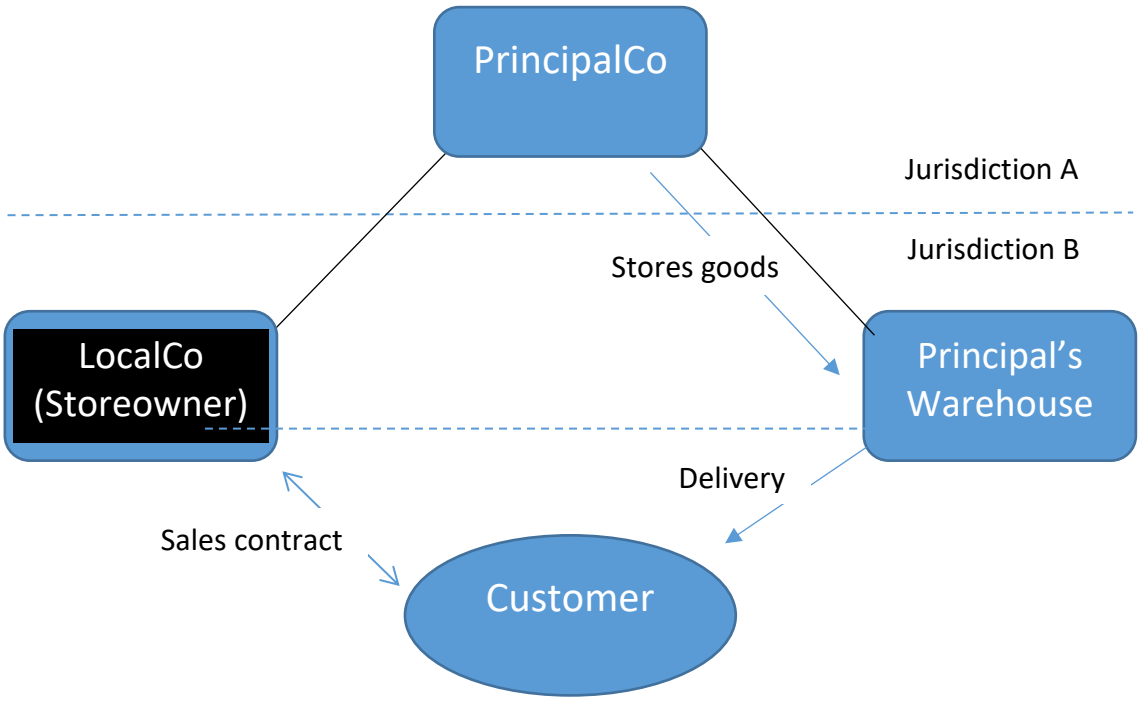
---

[146] OECD 2015d, D.20.
[147] OECD 2018: p. 7.
[148] OECD 2015d D.19. and OECD 2018 Paragraph 2.
[149] OECD 2018, para. 6.
[150] OECD 2018, para. 7. For more detailed revision of the fact patterns associated with the anti-fragmentation rule, see para. 81 of the 2017 OECD MTC Commentary.

There would be essentially two cases where the new regulation could lead to a constitution of a PE due to the anti-fragmentation rule. Firstly, where a closely related enterprise has already had a PE in the source country of income and the activities under review constitute function complementing these activities, e.g. by warehousing goods, and these complementary functions *are a part of a cohesive business operation.* A consideration would have to take place whether this indicates the existence of one or several PEs in the source country. The profits attributable in this case according to the 2018 Report are:

> *the profits derived from the combined activities constituting complementary functions that are part of a cohesive business operation*
>
> *considering*
>
> *the profits each one of them would have derived if they were a separate and independent enterprise performing its corresponding activities, taking into account in particular the potential effect on those profits of the level of integration of these activities*

As indicated, the 2018 Report emphasizes two new aspects in the attribution, the combination of activities under the anti-fragmentation rule and the *level of integration* of these activities. Let us formalize this in form of an example used in this context to illustrate the integration of business activities.[151]



[151] See 2017 OECD MTC, 5.81.

The fact pattern is as follows:

a) PrincipalCo is a resident of A, and manufactures and sells large machines. It also owns a small warehouse in B, where it stores a few of the sizeable machines.
b) LocalCo, a resident of B, is a 100% subsidiary of PrincipalCo, and owns and operates a store in B where it sells and displays the machines, identical to the ones in the warehouse.
c) When customer makes the purchase from the store, employee of LocalCo goes to the warehouse to fetch the machine and delivers it to the customer.

In this case anti-fragmentation rule halts the paragraph 4 exception from the warehouse. PrincipalCo and LocalCo are *closely related enterprises* in the meaning of 2017 MTC 5(4.1), LocalCo forms a PE that exists outside the warehouse arrangement and the *combined business activities* of the parties involved constitute a cohesive business operation i.e. storing and delivering goods to the customer as a part of a sale. Therefore, the added value of the warehouse has to be taken into account in the profit attribution, and not seen as a separate auxiliary function from the "main PE" of LocalCo. Instead, the warehouse creates another PE in B.[152]

Under Article 7, the profits attributable to the warehouse PE of PrincipalCo are those that the PE would have derived if it were a separate and independent enterprise performing the same warehousing activities.[153] Step one of the AOA includes the recognition of the internal dealing. Here, it is hypothesized to be the provision of warehousing services to the economic owner of the warehouse, PrincipalCo.

Under step two of the AOA the OECD TPG is applied by analogy in order to estimate the arm's length remuneration between the PE and the principal. In the above case, the remuneration for the provision of the warehousing services would amount to the equal fee for warehousing services from an independent third party service provider, taking into account the scope of services and distribution of risks and assets between the related parties.[154]

In this case it leads to the increase of functions carried out by PEs in jurisdiction B as the warehousing activities are no longer in the scope of exception of paragraph four. Thus there is an increase the profit to be allocated to be taxed in jurisdiction B compared to the situation

[152] It does not make material difference whether the PE created by the warehouse is separate, or whether it is included as an extension of functions of LocalCo under the AOA. The consolidated profit stream would be identical.
[153] OECD 2018, para. 15.
[154] OECD 2018, para. 20.

prior to BEPS. This is a simple illustration how the BEPS Action 7 and the stricter interpretation of paragraph 4 helps to align the transfer pricing and taxation with value creation, which truly is the core of the whole project.

7.2.2. Attribution of profit to PE resulting from changes to Article 5(5) and Article 5(6) and the Commentary

As addressed earlier in this study, the Action 7 recommended that Articles 5(5-6) of the MTC would be changed to better reflect current needs of PE regulation and the split of taxation power between states. Especially in terms of agencies, the Acton 7 Final Report stated that "where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business."[155]. To achieve this effect, the amended articles were provided and implemented to the 2017 OECD MTC.

Whilst the Action 7 made quite extensive changes to the PE threshold, i.e. on what grounds a PE could be deemed to exist, it did not modify the core nature of the deemed PE.[156] Hence, the approach assumed in profit allocation to agency PEs prior to BEPS should be applicable also in the post-BEPS environment and Article 5(5). Therefore, once a PE has been determined to exist based on Article 5(5) the obligations resulting from the actions of the agent will be properly allocated to the PE.[157] The actual attribution is still based on the Article 7 of MTC, which remained unchanged in the BEPS project. In practice, Article 7 of the relevant tax treaty remains as the foundation for the profit attribution also in post-BEPS relation. It grounds to the familiar principle of "profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions" regardless whether the states in question have adopted the AOA as their approach.[158]

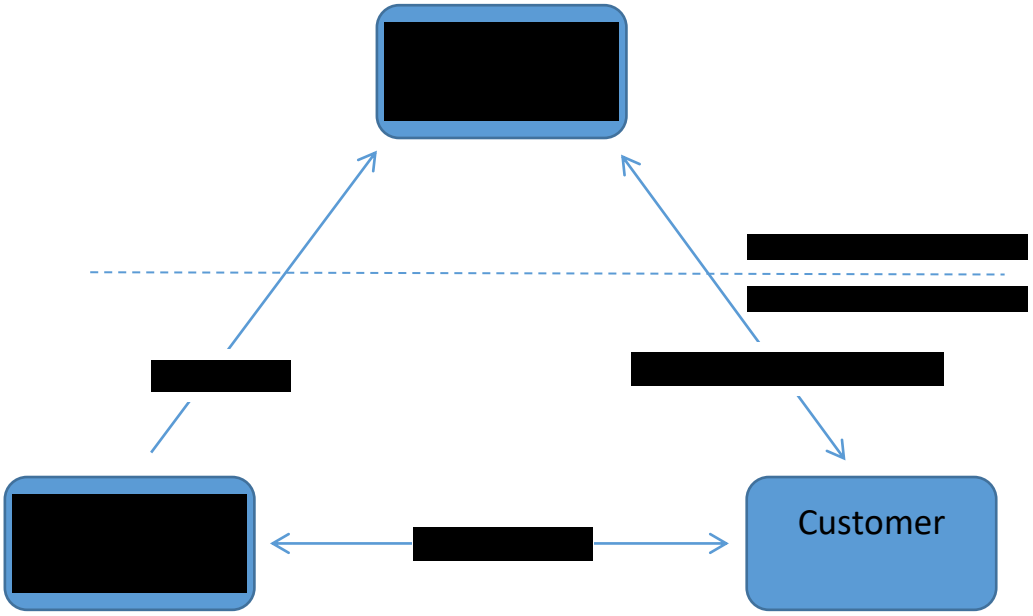
The 2018 Report makes a reference to the BEPS Actions 8-10 Final Report, in relation to the amount of remuneration payable to the PE. According to the guidance produced under BEPS

---

[155] OECD 2015d, p. 15.
[156] OECD 2018, para. 30.
[157] OECD 2018, para. 31.
[158] OECD 2018, para. 32.

actions 8-10 and incorporated in the 2017 TPG Chapter 1, the risk allocation by contracts between the parties is respected only to the extent there is actual control and capacity to carry the risk.[159] 2017 TPG establishes that if a related party, that has contractually assumed the risk, does not control the risk or does not have the financial capacity to control the risk the risk should be allocated to the enterprise who has the control and the financial capacity.[160] Thus, the risk cannot be distributed artificially with contractual arrangements. This does not alter the legal relationship between the parties that still remains as a significant part of the process of determining whether a PE exists according to Article 5(5).

Let us analyze the profit attribution in the sales agent structure, which has been discussed throughout this study, in the light of the 2018 Report. The already familiar structure is similar to the one presented in Chapter 5.2.2.[161]



Also the fact pattern remains similar.[162] It is also assumed that there is a tax treaty between the jurisdictions similar to 2017 OECD MTC. Under the revised Article 5(5) SalesCo has a PE in customer jurisdiction, due to the fact that AgentCo habitually concludes contracts there on behalf of the Principal and does not do that as an independent agent described in Article 5(6). The foundation for the profit allocation is embedded in the tax treaty:

[159] OECD 2018, para. 36 and 2017 TPG para. 1.60.
[160] 2017 TPG, Section D.1.2.
[161] Analysis of a similar structure is included in the 2018 Report. OECD 2018, pp. 18-19.
[162] For reference, see Chapter 5.2.2.

a) Under Article 9, the compensation to be paid by SalesCo to AgentCo has to be at arm's length, taking into account its functions performed, assets used and risks assumed.
b) Under Article 7, the profits attributable to dependent agent PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that AgentCo performs on behalf of SalesCo.

Following the first step of AOA, the functional and factual analysis indicates that sales are concluded by the personnel of AgentCo[163]. Therefore, by using the significant people functions as an allocation key for assets and risks we shall allocate the market risk for the sales to the AgentCo, due to in PE context, the legal and factual position is that there is no single part of an enterprise which legally owns the assets, assumes the risks, possesses the capital or contracts with separate enterprises..[164] This is a key justification for the remuneration. Hence, the hypothetical intra-group transaction or the *internal dealing* between the related parties is the sale of goods by the SalesCo to the PE.

The second step includes applying the TPG by analogy to the transaction in order to determine the arm's length pricing for the internal dealing between the PE and the Principal. In this case, the pricing would equal to the amount of commission SalesCo would have to pay for an independent third party distributor to carry out the similar activities in similar circumstances taking into account the relevant functions and distribution of assets and risks between the Principal and the PE.[165] The way of testing this in a comparability analysis would be to study the commission, or essentially profit margin, realized by third party distributors in similar setting.[166] This could be done using the CUT method, if the product was deemed general. For unique products, Transactional Net Margin Method (TNMM) would be a good option, using the operating margin as a profit level indicator.[167]

The above analysis creates the basis for the analysis according to the AOA, and taking into account the implication of 2018 Report. However, a similar problem of two simultaneous legal

---

[163] Bearing in mind the wide concept of concluding a sale as discussed in Chapter 3.3.1.
[164] OECD 2018, para.39.
[165] OECD 2018, para. 55.
[166] Alternatively, the seller could be used as the tested party. Then we would analyze the price SalesCo would have realized if it had sold the goods to an unrelated third party. The end result would be the same, the process is just reverse. However, the OECD TPG does not recommend this approach as the tested party should be the related party with more simple function, risk and asset profile. In this case that would be naturally AgentCo.
[167] For a detailed description of the transfer pricing methods and their application, see OECD TPG Chapter II.

entities is embedded in this setup as was introduced in the previous Chapter. As the activities carried out by the dependent agent constitute a PE, essentially representing an intangible, theoretical legal entity in the host state that exists parallel to the dependent agent enterprise. Both of these two entities are in the taxation power of host state, end their profit is to be calculated separately. This should also be taken into account in the function, risk and asset allocation between the legal entities to prevent double taxation.[168] This situation has been subject to great confusion in the past, as there has been very limited guidance regarding the matter.[169] 2018 Report sheds some light on the matter.[170]

As indicated previously due to the two entities both Articles 7 and 9 are applicable in n determining the total amount of profits to be taxed in the host country. This compensation is an important step in determining the profit that is attributable to the PE. This is, due to the actual profit attributable to the PE is based on the functions performed, risks assumed and assets utilized. Here the PE assumes the risks of the non-resident PE as the hypothesized associated enterprise, and therefore depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss).[171] In contrast, the dependent agent enterprise is remunerated based on the arm's length commission. It is essential to recognize, that might differ from the analysis presented above. Hence, the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary.[172] This is determined when the compensation paid to the dependent agent is deducted from the calculated profit to the PE. If the result is positive, the host country shall have a taxing right over the positive corporate income according to local compliance rules.

For this means, a "single taxpayer approach" has been presented. It contends that in all circumstances the payment of an arm's length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE.[173] The reasoning supporting the approach reckons that the remuneration paid by principal to the dependent agent

---

[168] OECD 2018, para. 41.
[169] OECD 2010, p. 59.
[170] Chapter *Administrative approaches to enhance simplification,* pp. 16-17.
[171] OECD 2018, para. 42.
[172] Further discussion regarding the possible gap in profit allocation, see Ernst & Young's comments at OECD 2015a, p. 237.
[173] See OECD 2010, pp. 60-61.

enterprise, given that it is at arm's length as indicated in Article 9, is considered to award it for its functions performed, assets used and risks assumed. Therefore, there are no activities performed in host country that require compensation, and the correct taxation has been carried out.[174]

The above approach is however, not considered to be flawless.[175] It fails to take into account the fact that risks legally belonging to one entity, may possibly be attributed to another legal entity. Therefore, a return may follow these risks without the legal ownership of them. It also puts different forms of PEs in different position when applying the AOA, as it would render the existence of the PE largely indifferent.[176]

[174] See OECD 2010, para 235.
[175] See OECD 2010, para 236.
[176] See OECD 2010, para. 237-239.

8. Concluding remarks

8.1. Finland's PE position – De Lege Ferenda

From a tax revenue standpoint, a host country usually benefits from a rather wide PE regulation that includes as many variations of business models within its scope. This is, of course, assuming that when the amount of PEs increases, the profit attributable to these PEs increases and therefore the corporate income tax revenue increases. This is naturally just a working assumption, due to the fact that corporations regularly asses their tax position, and alter their structures to avoid excessive tax exposure in countries e.g. introducing more strict PE regulation. Measures taken by MNEs in case of legislative changes might include exits from the jurisdiction, or conversions in their operating model, latter of which is discussed in the next chapter. All in all, it is essential to recognize that in the end all tax revenue is dependable of the actions of the taxpayers, and how they react to changes.

The national Finnish PE rule could be considered rather curious. As became evident in Chapters 2.1 and 2.2 of this study, the national approach varies quite much from the OECD model. This might be due to the fact that according to TVL PE is not required to tax the Finnish sourced income of a foreign enterprise. Therefore, there is less of a need to cover all the PE situations addressed in the OECD model. On the other hand, Finland's vast network of tax treaties allows it to transfer some of the regulation to the bilateral tax treaties as non-treaty relations are relatively uncommon. The disparity of the TVL approach and the OECD approach the tax treaties has not been seen as a major issue, as no changes have been made to the national legislation. This was also evident when Finland decided to opt for the minimum standard of the MLI, and disregard the proposed changes of BEPS Action 7.

However, at some point the disparities of the two models will begin to cause issues. The principle of legality in taxation is embedded in the statute 81 of the Finnish constitution, according to which the basis for taxation has to be in the written law. Therefore, it is suspect at least that in the minutes for the new TVL it was suggested that PE rules should be interpreted in the light of tax treaty provisions.[177] This does not obviously pose any issues as long as the two models are similar. However, as was noted in Chapter 2.1 of this study the TVL

[177] See HE 76/1995.

model is based on the concept of a fixed *place.* In addition, the TVL model does not specifically recognize agent PE. As the OECD model keeps evolving to tackle the ever changing tax avoidance schemes, the stagnant TVL from year 1995 statute appears badly outdated. As has been presented in this study, many modern business models do not require any tangible presence in the host country e.g. when server is utilized. If in this case the OECD MTC would be used by FTA to expand the meaning of the TVL PE definition, this could not be accepted.

Especially, when Finland expressly opted to not include the new BEPS measures to its tax treaties it would be extremely bad administration to lower the PE threshold through interpretation based on new OECD MTC and its Commentary. As expressed in the tax practice, the MTC and its Commentary are considered legitimate sources of interpretation.[178] Such disregard of the constitutional rights of the taxpayers should not be accepted under any circumstances. Even in the case Finland later decides to amend some tax treaties with BEPS Action 7 measures, this should not lead to change in domestic PE interpretation. Unfortunately such practice has already been discovered in European tax practice[179], and the threat of tax administrations undermining the principle of legality cannot be disregarded.[180]

Naturally, the correct way to tackle the issue would be to update the 1995 PE definition. It is hard to see arguments contradicting transfer to a new, more OECD coherent PE regulation, like e.g. Sweden where Swedish Income Tax Act includes PE definition identical to the OECD model.[181] This would not force Finland's hand into a package deal such as MLI, rather than having the opportunity to handpick the most feasible elements to a new PE regulation, and determine the threshold freely. This would not mean implementing the Article 5 as such, but structuring the new Finnish PE rule around similar elements: General rule 5(1) and the positive list 5(2), including the construction PE 5(3). In addition, negative list should be added 5(4) maybe most importantly together with written agency PE laws 5(5-6). Profit attribution and principle of separate entities are addressed in the current TVL in a satisfactory extent, and they do not seem to be in such dire need of an update.

---

[178] KHO 2002:26, KHO 2016:72.
[179] See Jiménez 2016 regarding Spanish tax practice.
[180] In KHO 2014:119 the Group tax office made the corresponding maneuver, and used a method not included in domestic law but which existed in OECD TPG.
[181] For reference, see Inkomstskattelag (1999:1229). Sweden did not opt to include the BEPS Action 7 changes to its tax treaties, thus its PE interpretation can assumed to be similar post-BEPS.

8.2. In practice implications for MNEs resulting from Action 7

It is necessary to note that PEs are just one aspect of the global operating models of MNEs. If changes are introduced to the PE legislation, threatening to increase the tax exposure and effective tax rate of a MNE it will act swiftly to change its operating model to maintain its competitive position. PEs and in particular agency PEs are often arrangements in place in order to maintain a light and agile presence with limited functions leading to very light or no corporate tax responsibility. If the local operations would constitute a PE in the host country due to the Action 7 changes, avoiding the PE status through other means would become a priority. It should be emphasized that maintaining a PE is rarely a goal of the MNE, as then operating through a local subsidiary would often be more efficient.

In case MNE would like to maintain a lean operation in host state post-BEPS with similar function profile, a LRD could be a feasible solution. A conversion to a LRD is simply done by re-allocation of functions, risks and assets i.e. by changing the intra-group agreement between the entities.[182] Compared to a dependent agent transfer flow wise LRD takes a short term title, often referred to as the *flash title,* before delivering it to the customer. This does not mean, however, that the delivery would not be arranged straight from the principal to the customer. LRD does not require significant PPE or financing, as the operation is very lean and it could reimburse the principal for the title transfer after it has received the payment from the customer. Similar to agent PE, LRD does not carry any risks associated with the business disregarding its own market risk. Therefore the arm's length compensation paid as a service fee would actually be quite well in line with the remuneration level of the dependent agent PE.[183]

In the BEPS project LRD was seen to fall outside the scope of "commissionaires and similar strategies" due to its buy-sell contracting function.[184] It was discussed to some extent in the process and e.g. US council for international business voiced its concerns regarding the matter in its comments on discussion draft.[185] However, it was decided not to include LRDs to the scope of the revised discussion draft and Action 7 Final Report. The 2017 MTC Commentary further reflects this, as a buy-sell distributor cannot be seen as acting on behalf of an

[182] See Chapter IX A1, 2017 OECD TPG.
[183] Raunio 2018, p. 168 and p. 269-270.
[184] OECD 2015d, p. 15.
[185] See OECD 2015b, p. 165-166.

enterprise rather than as an individual business unit.[186] As LRD sells goods it has purchased and it has the ownership on, according to the statute of separate enterprises set forth in Article 5(7) of the 2017 OECD MTC typical LRD arrangement should not constitute a PE.

To conclude, conversion to LRD would allow the MNE to carry out similar activities in host country with minimal changes in the operating model and avoid the PE status. Naturally this does not relieve MNE from tax liability in the host-country, as the LRD entity is CIT liable for its profit. It gives MNE, however, the possibility to control the ETR of the LRD by manipulating its functions and correspondingly its routine profit level. The 2017 TPG suggest a 2% operating margin level acceptable for a LRD annually, which should be very feasible for a MNE to surrender under the taxation power of a jurisdiction even with a CIT rate on the higher side.

8.3. Conclusion

If the success of the BEPS Action 7 would be estimated by its goal to stop base erosion and profit shifting through artificial avoidance of the PE status, the measures proposed in the Action 7 Final Report and included in the MLI are precisely what the doctor ordered. Especially the new agency PE regulations included in 2017 MTC are so strict, they practically rule out commissionaire like distribution structures that would not constitute a PE. However, this might have come at the price of an alarmingly low implementation rate.[187] The changes have not been accepted even by the world's key economies, which were involved in the drafting process through G20. Many large exporting countries are concerned that the expansion of the DAPE concept through the changes to Article 5(5) will result in too great a burden on their multinationals and do not plan to amend their treaties via the MLI, or otherwise, for the revisions to the Model Article 5.1.[188]

As indicated above, the PE status is not a mere issue of taxation for the MNE as it forces it to comply with different compliance requirements in the host country including but not limited to corporate income tax returns and country by country reporting[189], transfer pricing related filings and filings for corporate registers. As indicated previously, also the determination of profit to be allocated to the PE and its comparison to the remuneration already paid to the

---

[186] See OECD 2017: p. 20-21.
[187] See Deloitte 2018.
[188] EY 2017.
[189] For more information regarding CbC reorting see, Raunio 2018, p. 18 and FTA A71/200/2018.

dependent agent enterprise may prove to be a difficult process that creates uncertainty and administrative burden.

The de facto consequences of the BEPS action 7 and MLI may steer MNEs to opt for "treaty shopping" as in placing its foreign entities in countries with feasible countries with non-BEPS compliant PE regulation. This should not even prove to be difficult, taking into account the degree of implementation globally. In the jurisdictions where MLI does expand the PE regulation, MNEs would seem to be able to avoid the PE status going forward with relatively simple operating model conversions to LRDs. The actual damage suffered by MNEs is more likely to be caused by amendments to OECD TPGs and MTC Articles 7 and 9 going forward, as they are not dependent on the existence of PE or other legal structure rather than substance over form profit allocation towards alignment with vale creation. However, short-term view is that these structures and arrangements allow the MNEs to stream the profits to the principal companies with minimal tax exposure for their foreign activities.

Regardless of the outcome of the MLI, BEPS would seem like a new era in regulation of international taxation. In the future, 2017 MTC that was amended to correspond BEPS' suggestions will become the starting point in many bilateral relations steering the regulation towards BEPS. Simultaneously EU has waged war against aggressive tax planning with similar projects such as CCCTB[190] will continue to address and harmonize the direct taxation in member countries. While new countries are implementing the MLI and international tax practice keeps forming to post-BEPS state taxpayers are forced to live in at least temporary uncertainty. However, it would seem like a megatrend of cross-border co-operation in taxation is emerging through such projects, aiming to develop taxation to more coherent direction ensuring more justified taxation where the profits would be taxed where they are created.

In Finland an update of the PE regulation seems inevitable. The current TVL model is badly outdated, and is falling behind the international development fast. The Supreme Administrative Court has not given new precedents regarding PEs after the MLI. Ministry of Finance has stated that amendments to Finnish regulation wait for the EU driven actions, rather than implementing the BEPS measures. The Report evaluating the effects of BEPS does

[190] For more information regarding CCCTB, see Helminen 2018b and Viitala 2017b.

not provide further clarification on what is the expected timetable for changes in national PE regulation. Therefore, the developments in the near future in EU's CCCTB project shall be key in the direction Finland is taking in terms of this matter. As the EU commission recommended[191] the member countries to implement the Action 7 measures in the MLI without success, it would not be surprising if EU decided to force the member counties' hand using heavier measures putting the union in the forefront in the battle against global tax avoidance through base erosion and profit shifting.

On the other hand, the profit attribution matters between the principal entity and the PE appear to be rather clear considering the rate of turnover in the legislation. As the attribution process and setting of transfer prices relies on the same basic principles, and new 2017 OECD TPG addresses new forms of economic activities tax administrations and taxpayers are quite well equipped to tackle the attribution issues of new PEs. Naturally, it can prove to be difficult in practice to find comparable data on business activities such as certain cloud platforms et cetera but this will surely be just a temporary issue. However, it seems that correct transfer pricing and its administration are proving to be increasingly essential in international corporate income taxation and BEPS does nothing but emphasize this.

[191] See Ministry of Finance 26/2017, p. 100-101.