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* QC; Grays Inn Tax Chambers, London. Visiting Professorial Fellow, Centre for Commercial Law Studies, Queen Mary University of London

** BA, LL.M, PhD, Senior Visiting Fellow at the Centre for Commercial Law Studies at Queen Mary University of London. Barrister, partner specialising in financial services tax, PricewaterhouseCoopers, London

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This is a shortened version of the General Report. A full version is included on the CD-Rom for the IFA Congress. The full version includes footnotes, further background material and further examples drawn from the branch reports.

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Abbreviations

AOA	authorised OECD approach
BIAC	Business and Industry Advisory Committee to the OECD
BIS	Bank for International Settlement
CFA	Committee on Fiscal Affairs (OECD)
DAPE	dependent agent PE
DD	discussion draft (OECD)
DTC	double taxation convention
FSE	functionally separate entity
GAAP	generally accepted accounting principles
The guidelines	<i>The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</i>
JDG	joint drafting group between WP1 and WP6
KERT	key entrepreneurial risk-taking (functions)
MTC	OECD model tax convention on income and capital
NFTC	National Foreign Trade Council, Washington DC
NT	new thinking (i.e. the thinking underlying the AOA) – see section 1.2.5
OT	old thinking (i.e. the thinking reflected in the existing OECD commentary) – see section 1.2.5
PE	permanent establishment
State H	host state (in which the PE is situated)
State R	residence state (the state in which the enterprise is resident for DTC purposes)
UN MTC	United Nations model double taxation convention between developed and developing countries
WH	working hypothesis
WP1	Working Party no. 1 of the OECD Committee on Fiscal Affairs
WP6	Working Party no. 6 of the OECD Committee on Fiscal Affairs

1. Background

1.1. Introduction

1.1.1. Introduction to the IFA discussion of this topic

The publication of this volume of the *Cahiers*, and the discussion of this topic at the IFA Congress, take place at an important – almost unique – point in time. The OECD has been working on this topic for more than six years, and that work is now approaching its completion: the OECD has announced its hope to complete the work by January 2007. The OECD has now published four discussion drafts (DDs) which seek to develop an authorised OECD approach (the AOA) to the attribution of profits to permanent establishments (PEs). The IFA discussion is an opportunity to have an input into that work before it is completed.

Though these developments have taken place in the context of the OECD, their impact will be much broader since the work focuses on the interpretation and application of provisions in the business profits articles of double taxation conventions (DTCs) which are common to both the OECD model (the MTC) and the United Nations model (the UN MTC), and which have also influenced domestic law provisions of many countries around the world. The issue has relevance for every one of the jurisdictions concerned.

The general reporters would like to thank all those who have contributed to the preparation of this report. In particular, they would like to thank the branch reporters and Raffa Russo who has acted as assistant. Finally, many thanks to the IFA general secretariat for its assistance.

This report uses a number of abbreviations and a table of abbreviations is attached. This report uses the term “dealings” to refer to “transfers”, “payments”, etc., between different parts of the same enterprise (e.g. PE to head office) to distinguish them from “transactions” which take place between separate enterprises. In general, this report focuses on dealings between the head office and its PE, though occasionally inter-PE dealings are discussed explicitly.

The views expressed in the report are entirely those of the general reporters and are personal views, not reflecting any organisation with which either is associated.

1.1.2. The problem in outline

The attribution of profits to PEs is necessary for two main purposes:

- the primary issue: the attribution of profits to the PE in the state where the PE is situated (state H) for purposes of taxation of those profits by that state; and
- the relief issue: attribution of profits to the PE by the state of residence of the enterprise of which the PE is part (state R) for the purposes of determining double taxation relief.

The focus of this general report is chiefly on the primary issue.

1.1.2.1. The separate enterprise concept

Since at least the 1930s, the international consensus has been that the profits should be attributed to a PE on the basis of the “separate enterprise” concept, and the application of the arm’s length principle. This is currently encapsulated in article 7(2) MTC:

“(2) Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make *if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment*” (emphasis added).

The words emphasised represent the separate enterprise concept and the arm’s length principle.

The key problem, in outline, is the correct interpretation and application of this wording in DTCs, and in domestic legislation which draws on this wording or on the separate enterprise concept.

Subject to one change, this wording has remained the same since the 1963 OECD draft convention. Identical wording appears in the vast majority of DTCs.

There is an inherent tension in article 7(2). On the one hand, the PE is to be treated as a distinct and separate enterprise – which it is not. On the other hand, the enterprise is engaged in activities “under the same or similar conditions”, which must involve conditions arising from the fact that it is a PE of a larger enterprise.

This is where the fundamental problem arises. The international consensus is to attribute those profits applying the separate enterprise concept and the arm’s length principle. However, a PE is not a separate legal person. Thus, in legal terms:

- there can be no legally binding contracts between a PE and other parts of the enterprise;
- there can be no separate ownership of assets by the PE or by its head office;
- no payments can be made between the PE and its head office since the funds paid belong in law at all times to the same person; and
- strictly speaking, no profit can be realised on any dealings between a PE and its head office.

There is, therefore, a fundamental tension between the legal position of a PE and the separate enterprise concept. On the one hand there is the “legal fact” that the PE is a part of the same enterprise; on the other hand, there is the “fiscal fiction” that the PE is a separate enterprise.

The resolution of this tension in article 7(2) requires that the PE must be treated as if it were a separate enterprise, which it is not. This is the “separate enterprise fiction” which attempts to treat the PE as if it were independent from the enterprise of which it is part.

As will be seen, different theories exist, and very divergent practices exist, as to the extent to which a PE is to be treated as if it were a separate enterprise or a separate entity (“separate entity” meaning a legally separate person). These theories include a theory of absolute independence under which the PE is treated as if it were a legally separate entity. On the other hand, there are theories of restricted independence under which some recognition is given to the fact that the PE is not a separate entity and is part of the enterprise as a whole.

In a very simplified fashion, one can say that the recent work of the OECD has been to move away from a more restricted concept of independence towards the theory of absolute independence, whereby the PE is hypothesised as a “functionally separate entity”.

1.1.3. The UN model

While much of the focus of this general report is on the work of the OECD, and on DTCs based upon the MTC, it should not be forgotten that a number of the jurisdictions surveyed are not member countries of the OECD, and a number of DTCs follow the UN MTC.

There are two significant differences between article 7(1)–(3) of the MTC and the UN MTC, only one of which is directly relevant for this general report. These differences are:

- the UN MTC in article 7(1) recognises a limited force of attraction – that is not discussed further in this general report;
- article 7(3) is expanded in the UN MTC with regard to the deduction of certain expenses.

The UN MTC follows the underlying separate enterprise concept and arm’s length principle which are found in the MTC. Article 7(2) UN MTC – which contains the “central directive” on the allocation of profits to a PE – is identical to article 7(2) MTC.

Article 7(3) UN MTC differs, however, in adding the words emphasised in the following text:

“(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of *the business of* the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. *However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment and the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payment in return for the use of patents or other rights, or by way of commission, for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on monies lent to the permanent establishment*” [there is similar wording for sums charged by the PE].

These additional words clearly conflict with the AOA, and raise the issue as to how far, if at all, states which follow the UN MTC might be willing to adopt the AOA.

1.1.4. Domestic law and treaty law

The recent work of the OECD is concerned only with the interpretation and application of DTCs. As a strict matter, the domestic law in each jurisdiction need not comply with the separate enterprise concept or the arm's length principle. It is for each jurisdiction to decide for itself how it determines the taxable profits of an enterprise, and how, for domestic law purposes, it attributes profits to a PE (if the domestic law even uses that concept).

The role of the business profits article in a DTC is to provide a limit to the consequences of applying domestic law, and to ensure that, in state H, only those profits attributable to the PE – as properly interpreted and applied – are taxed. As a number of the branch reports mention, a taxpayer cannot be worse off as a result of the operation of a DTC than it would be under domestic law: for those jurisdictions a DTC cannot impose a tax charge if there is none under domestic law.

While this is the strict position, the reality is somewhat different. As will be seen from the survey of the branch reports, in the majority of jurisdictions surveyed the domestic law on the attribution of profits to PEs is closely tied – often entirely linked – to the same attribution rules as would apply under a DTC. For many of the jurisdictions there is little, if any, distinction in practice between the attribution of profits to a PE under domestic law and under treaty law.

What this means, of course, is that the OECD's work on this topic, whilst strictly being concerned only with the interpretation and application of the MTC, has a much broader impact in practice. For some jurisdictions, a change to the MTC commentary might directly impact on the interpretation of domestic law. For others, the adoption of the AOA might be expected to lead to new legislation or a change in the practice of the relevant tax authorities.

1.2. The development of the authorised OECD approach (AOA)

1.2.1. The pre-2000 history

The issue of the attribution of profits to PEs is not a new one, and the origins of the underlying principles date back to work in the League of Nations in the late 1920s. In 1933, the Fiscal Committee of the League approved a draft convention on the allocation of business profits, based upon a report prepared by Mitchell Carroll. This convention was based on the principle that PEs must be treated in the same fashion as independent enterprises operating under the same or similar conditions.

The separate enterprise concept was adopted in the 1963 OECD draft convention. With minor amendments, the wording of article 7 of the 1963 draft is now found in article 7 MTC.

The commentary to article 7 was substantially amended in 1994 following the report on *Attribution of Income to Permanent Establishments*. With the exception of amendments in 2000 consequent upon the deletion of article 14, the commentary has remained largely unchanged since 1994.

Apart from the 1993 report, mention should also be made of the 1984 OECD report on *The Taxation of Multinational Banking Enterprises*. In the present context, that OECD report is of particular relevance for its discussion of the attribu-

tion of income to branches carrying on banking operations. The report specifically considered the basis on which loans might be attributed to bank branches: particular weight seemed to be attached to the approach of asking whether the relevant asset could be regarded as having been “substantially generated” by the activities of the PE and this in turn would be determined by “the extent to which the negotiation and conclusion of the transaction has been the work of the PE”. The report went on to look at the activities that would normally be involved in the negotiation and conclusion of a transaction, such as obtaining the offer of new business; negotiating the terms of the loan, etc.

1.2.2. *The recent work of OECD Working Party 6 (WP6)*

As well as the more distant link to the 1984 OECD work on banks, the recent work of WP6 seems also to have grown from the work on the global trading of financial instruments in the late 1990s. That work noted the acute difficulties that arise for the taxation of financial sector activities from dealing with the concept of risk, and particularly whether the right approach ought to focus on the bearing of risk (i.e. mere exposure to financial loss) or the management of risk (i.e. people activities). The report recorded the lack of consensus and called for more work on these difficult issues.

The recent work of WP6 was also prompted by concerns that the development of e-commerce would place strains on the application of the separate enterprise concept. The difficulties being encountered with the application of the separate enterprise concept to branches of foreign banks, and particularly the *NatWest* litigation in the United States, also seem to have prompted WP6 to concentrate on this issue.

One point should be emphasised about the recent work of the OECD: the objective was to establish a consensus position as to the preferred approach for attributing profits to a PE under article 7. This approach was *not* constrained by either the original intent or by the historical practice and interpretation of article 7. This point is sufficiently important to bear quoting in full:

“6. The discussion in the Report relating to the ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the discussion will focus on formulating the most preferable approach to attributing profits to a PE under Article 7 given modern-day multi-national operations and trade. It will be a separate question whether that approach is adequately authorised under the existing language of Article 7 and in the Commentary. It may be that clarifying amendments, either to the Article or its Commentary, would be necessary to validate the proposed interpretation.”

The chronology of WP6’s work is broadly as follows:

- February 2001: publication of DDI (general considerations) and DDII (banks): these DDs first set out the working hypothesis (WH);
- March 2003: publication of revised DDII (banks) and DDIII (global trading). These DDs first considered the application of the concept of key entrepreneurial risk-taking (KERT) functions;

- August 2004: the publication of revised DDI (general considerations). This version of DDI explained that sufficient progress had been made in the development of the WH so that it had now become the AOA;
- In January 2005 a joint drafting group (JDG) was established between WP6 and WP1;
- In August 2005 DDIV (insurance) was released for public comment.

1.2.3. The working hypothesis (WH) and the AOA, and the different interpretations of article 7(1) to (3) MTC

DDI (2001) began by explaining that a WH had been developed as to the preferred approach for attributing profits to a PE.

The underlying approach of the WH is very easy to comprehend. In 1995 the OECD had published the *Transfer Pricing Guidelines*. These applied to transactions between associated but separate enterprises. The proposition was that if it were possible to create, through a functional and factual analysis of the PE, a hypothesised separate enterprise, then the guidelines could be applied by analogy.

The testing of the WH was completed by August 2004, and the WH became the AOA.

Before considering the AOA, however, it is useful to understand that WP6 identified two different interpretations of article 7(1) to (3).

1.2.3.1. The “relevant business activity” approach

The first interpretation was referred to as the “relevant business activity” approach. In fact, this approach is perhaps better referred to as the “single enterprise” approach.

This approach begins with article 7(1) and identifies the “profits of an enterprise” as those of the business activities of the single enterprise of which the PE is part. The profits of the single enterprise are earned from transactions with third parties and with associated enterprises. Once the profits of this single enterprise have been determined, a share of those profits would be allocated to the PE by application of the central directive in article 7(2) or some other basis of apportionment (which would be authorised under article 7(4)).

The key feature of the relevant business activity (or single enterprise) approach is that profits are earned only from transactions with third parties (or with associated enterprises): no profit is earned from a transaction between the PE and the enterprise of which it is part.

1.2.3.2. The “functionally separate entity” approach

The second interpretation identified by WP6 is the “functionally separate entity” approach, but which may be better referred to as the “separate enterprise” approach. This approach does not limit the profit attributed to the PE by reference to the profits of the enterprise as a whole. Thus, under this approach, article 7(1) does not determine the quantum of the profits that are to be attributed to the PE: all it confirms is that the right of state H is to tax only the profits attributable to the PE (and hence is a rejection of the force of attraction approach).

Article 7(2) is then crucial to this approach.

Article 7(3) simply ensures that expenses are taken into account in attributing profits to the PE, wherever the expense is incurred, or whether it is incurred exclusively for the PE.

Under this approach article 7(4) is not needed to determine the profits attributable to a PE and may be deleted. Article 7(5) may also be deleted.

It is fundamental to the functionally separate entity approach that a profit can be attributed to a PE even though no profit has yet been realised by the enterprise as a whole.

As has been explained, the WH and, subsequently, the AOA, adopted the functionally separate entity approach.

1.2.4. *A summary of the AOA*

The AOA is now elaborated in DDI to DDIV (which run to slightly over 139,000 words). Perhaps the best summary comes from the NFTC:

“The authorised OECD approach seeks to attribute to a permanent establishment the profits that it would have earned at arm’s length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions. The authorised OECD approach begins by ‘hypothesising’ the permanent establishment as a distinct and separate enterprise, to which it attributes functions, assets and risks, based on factual and functional analysis focusing on ‘key entrepreneurial risk-taking functions’. Capital and funding costs are attributed to the permanent establishment based on its functions, assets and risks. A comparability analysis is then performed, and, finally, transfer pricing methods are used for attributing profits between related legal enterprises applied ‘by analogy’ to determine the portion of the profits of a single legal enterprise attributable to its permanent establishment.”

The AOA then applies the guidance given in the *Transfer Pricing Guidelines* (following an article 9 type approach) not directly but by analogy.

1.2.5. *Old thinking and new thinking*

It is important to recognise that the AOA represents a significant departure from the interpretation of article 7 as set out in the current commentary. One can say that the current commentary represents old thinking (OT), while the AOA represents new thinking (NT).

1.2.5.1. *The AOA and the NT*

The NT postulates a more unrestricted independence for the PE, requiring not merely the attribution of profits but also the attribution of assets and income, the recognition or derecognition of dealings, etc. as an incident of determining those profits. As the DDs recognise, this is not consistent with the OT, and will require amendments to the commentary at least.

For example, with respect to interest, DDI (2004) states:

“Under the authorised OECD approach the attribution can include, in appropriate circumstances, the recognition of internal ‘interest’ dealings ... The recognition of internal dealings represents a departure from the existing Commentary on Article 7(3), which only recognises internal dealings in financial enterprises.”

Similarly, with regard to internal dealings relating to the use of an intangible, an “internal royalty” is a possible way of rewarding part of the enterprise to which the ownership of intangible property is attributed.

Similarly, with regard to internal services, the NT differs from the OT:

“261. One area where there is a difference between the authorised OECD approach and the existing position in the Commentary arises from the fact that under the authorised OECD approach, the arm’s length principle is applied to determine the reward for performing that service.”

It is clear that, at the very least, the adoption of the AOA would require significant amendments to the current commentary to article 7.

1.2.6. The issue of dependent agent PEs

Two further issues from WP6’s work require explanation. The first of these is the issue of dependent agent PEs (DAPEs). The second issue, relating to the symmetrical application of the attribution principles, is considered in the following section.

With regard to the dependent agent PE issue, under article 5(5) MTC

“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 ...”

This deemed form of PE is referred to as a DAPE.

With regard to the DAPE issue, there are in turn two matters raised by the work of WP6. First, the circumstances in which a DAPE may be found to exist under article 5(5). Second, whether the approach to allocation in the case of an existing DAPE is the same as that applying in the normal case of a PE under article 5(1). These two issues have to a significant extent been run together in the discussions by WP6. Financial sector taxpayers make significant use of service provider arrangements (often using related party entities to provide the services concerned) and there has been widespread concern that WP6 is seeking to promote a wider application of article 5(5), and possibly even seeking to re-draw the test in article 5(5) by reference to the KERT analysis. Anecdotal evidence of

actions taken by individual tax authorities in recent months suggests fears in relation to article 5(5) are not unfounded.

The view taken by WP6 is that, applying the AOA, there may be a profit attributable to the DAPE in excess of the arm's length remuneration paid to the dependent agent enterprise.

DDI (2004) identifies an alternative to the WP6 approach put forward by some commentators, which is referred to as the "single taxpayer" approach. Under this approach, the payment of an arm's length reward to the dependent agent enterprise fully extinguishes the profit attributable to the DAPE. The underlying reasoning is that, if the dependent agent enterprise is fully rewarded at arm's length for all the functions it performs, assets used and risks assumed, then there can be no further profit to attribute to the DAPE.

DDI (2004) rejects the "single taxpayer" approach on several grounds. The arguments put forward in DDI (2004) are less than convincing, the wording of article 5(5) – specifically the wording which deems the enterprise to have a PE "in respect of any activities which that person [the dependent agent enterprise] undertakes" would not seem to support WP6's view. From a practical point of view it is extremely difficult to calculate what, if any, profit should be attributed to the DAPE in excess of the arm's length reward to the dependent agent enterprise. There are serious implementation difficulties, particularly when documentation may be required of a relationship with a DAPE which an enterprise was not even aware existed. One also wonders what point, if any, there is in pursuing this issue: since the dependent agent enterprise is resident within the host state, if that state considers that there are further risks or assets to be attributed to the functions of that dependent agent, that state always has the option to challenge the arm's length remuneration paid to the dependent agent enterprise.

The DDI (2004) approach also fails to note that there may be different types of dependent agent enterprise. At least three situations should be distinguished:

- the dependent agent enterprise which is wholly independent of its principal but is not an agent of independent status;
- the dependent agent enterprise which is a separate enterprise, but is associated with its principal. This may arise, for example, where one company in a corporate group acts as agent for another: article 9 MTC clearly applies to this situation;
- where the dependent agent is within the same enterprise which is the principal in respect of any agency transactions. The most common example of this would be where employees of an enterprise are sent to another country and habitually conclude contracts on behalf of the enterprise (but do not operate through a fixed base PE).

The latter situation would be one where article 5(5) and article 7 were clearly applicable, but not article 9.

1.2.7. The symmetrical application of the attribution principle

The second issue raised by the work of WP6 is the symmetrical application of the attribution principle.

Article 7(2) states, as part of the “central directive”, that “there shall *in each Contracting State* be attributed to that permanent establishment”. The words emphasised indicate that the attribution rules are intended to apply in state R and state H.

While the symmetrical application of the profit attribution rules did not feature particularly prominently in DDI (2001), the issue was discussed more fully in DDI (2004). The proposal put forward in the 2004 revision is to adopt a solution which is already found in the commentary to article 23 under the heading “Conflicts of qualification”. Under that approach, state R would adopt the same approach as that adopted by state H for the purposes of computing double taxation relief.

The difficulty remains, however, whether the existing wording of articles 7 and 23 sufficiently mandate this symmetrical approach. One might note in this context that article 7 has no equivalent to article 9(2) MTC which expressly requires a corresponding adjustment.

2. The current position

This section discusses the current position as set out in the branch reports. It is divided into two subsections. The first contains certain general comments based on the branch reports. The practice with regard to certain points of detail is considered in the second.

2.1. The general approach to the attribution of profits to PEs

2.1.1. *Variation in domestic laws and lack of consensus in interpretation*

DDI (2004) states:

“2. There is considerable variation in the domestic laws of the Member countries regarding the taxation of PEs. Currently, there is also not a consensus amongst the Member countries as to the correct interpretation of Article 7.”

This statement is borne out – with a vengeance – by the branch reports. While every branch report makes some reference to the separate enterprise concept, there is hardly a single point, be it in the application of domestic law or in the interpretation of article 7, on which every branch report agrees. Perhaps the only points on which there is agreement in virtually every one of the jurisdictions are the importance of using proper accounts maintained by the branch as a starting point; and the acceptance of some form of presumptive taxation where inadequate accounts are maintained.

2.1.2. *The absence of guidance and of litigated disputes*

One point which comes out clearly from a large number of the branch reports (though by no means all of them) is that there is little guidance from the revenue authority on the attribution of profits, particularly on many of the more detailed issues. In most jurisdictions there are few, if any, reported decisions of the courts on this issue.

The majority of jurisdictions report little or no guidance from the revenue authorities. There are exceptions, particularly where new legislation has been adopted recently. An example is Australia, where the Australian Taxation Office has issued two lengthy taxation rulings relating to this issue.

If one adds up the total number of decided cases and rulings on this topic in all the branch reports, the number does not exceed 150. Given that one is looking at more than 30 jurisdictions, and the separate enterprise concept has been adopted for almost 100 years, the lack of jurisprudence is significant. It would seem to suggest two things.

First, the problem of attribution of profits to PEs may not be a major issue in most jurisdictions. Not a single one of the branch reports stated that this was a major issue in practice, or that frequent and significant disputes arose between taxpayers and the revenue authorities.

Secondly, one may wonder whether the existing guidance in the OECD commentary – defective as it may be – may be adequate to deal with the vast majority of problems.

Applying the old but wise adage, “If it ain’t broke, don’t fix it”, none of the branch reports provides clear evidence that the existing principles are “broke”. Even in the financial sector, where some of the issues relevant to the approach under article 7(2) raise acute conceptual difficulties, the broad picture seems to be that most problems are dealt with either as a result of domestic approaches or by the application of the OECD’s 1984 guidance on banks.

This is not to say that there are no disputes at all. There are a small number of high-profile cases. High on the list are the *North-West Life Assurance* case and the ongoing *NatWest* litigation in the United States, and the *Cudd Pressure* case in Canada.

2.1.3. *An issue for financial institutions only?*

As a general impression, in a small number of jurisdictions this issue is seen as a problem primarily for financial institutions. A good example is the United Kingdom where the adoption of recent legislation seems to have been driven in large part by issues relating to the allocation of free capital to bank branches. The *NatWest* litigation in the United States has highlighted the attribution of capital as an issue.

For the majority of jurisdictions, however, the branch reports do not identify any particular issue relating to the taxation of financial institutions. It is hard to avoid the general comment that this issue is primarily one for financial institutions operating through branches in a small number of jurisdictions. For the majority of jurisdictions surveyed, it is simply not an issue and the local legislation and

guidance – such as it is – is generally coping with the limited problems that have arisen with respect to both the financial and non-financial sectors.

2.1.4. The abundance of theories

There is no shortage of theories and principles operating in this area. Some of them are general principles of taxation, such as the “ability to pay” principle and the “realisation principle”. Some of the theories, however, have been developed specifically with the attribution of profits to PEs in mind. The reports from Switzerland, Germany, Italy and the Netherlands are particularly rich on this aspect.

The distinction between the single enterprise approach and the separate enterprise approach has already been noted.

In some jurisdictions the adoption of the single entity approach arises because of the existence of certain general principles of taxation under which no profit can be realised for taxation purposes unless there is a transaction with a third party.

In some jurisdictions the dominant impact of the civil law determination of property rights also affects this issue and pushes towards the single enterprise concept on the grounds that there can be no separate legal ownership of an asset by a part of an enterprise.

2.1.4.1. Absolute versus restricted independence

For those jurisdictions which apply the separate enterprise approach, it is clear that the degree of independence accorded to the separate enterprise varies greatly. This difference, more than any other, explains the variation in practice between different jurisdictions.

German theory distinguishes absolute (hypothetical) independence and restricted independence. In the case of absolute independence the PE is treated for the purposes of profit attribution in no way different from a legally independent subsidiary. In the full version of absolute independence, dealings between a PE and other parts of the enterprise are treated as binding contractual arrangements, property is regarded as owned by parts of the same enterprise, and, as a result, interest on loans, royalties, rents and commission in respect of services are recognised for tax purposes.

By contrast, where the restricted independence approach applies, some recognition at least is given to the fact that the PE is no more than a part of the enterprise as a whole. Thus, no recognition is given to dealings which could not take place between the PE and other parts of the enterprise. For example, if it is accepted that an asset cannot be owned separately by different parts of the same enterprise, it follows that royalties or rental payments between one part of the enterprise and another should not be recognised for tax purposes.

One might say that there is a spectrum between the absolute independence approach on the one hand and the restricted notion of independence at the other extreme.

The existing OECD commentary adopts a relatively restricted independence approach: an internal royalty is not usually appropriate, and (except in the case of banks) internal interest charges should be disregarded.

By comparison, the AOA shifts dramatically in the direction of absolute independence. The functionally separate enterprise (FSE) is regarded as capable of owning assets separately from the remainder of the enterprise, and as a consequence notional rents and royalties should be charged and internal interest would normally be recognised.

Even then, it is fair to say that the AOA does not go to the absolute extreme of independence – what one might call the “full monty” separate enterprise. On that approach, if one were to attribute assets, risks and capital to the FSE, there seems no reason in principle why a separate credit rating should not be awarded to the FSE. Equally, under the absolute approach there seems no reason why the FSE should not be regarded as a resident of state H, capable of taking the benefit of the DTCs entered into by state H, and, if domestic law requires, operating a withholding of tax on the payment of (notional) royalties, rents, interest (and possibly technical service fees) deemed to be paid to the other parts of the enterprise.

2.1.4.2. Direct versus indirect approaches

A number of the branch reports refer to the recognition of both direct and indirect attribution approaches: most emphasise the preference for direct over indirect approaches.

In a sense this is foreshadowed in the OECD commentary to article 7 MTC which emphasises that adequate accounts usually exist (or can readily be constructed) for each part of an enterprise so that income and expenditure can be allocated to the particular parts with a considerable degree of precision and consistency. This is the preferred method.

The commentary recognises that there are circumstances where this may not be the case and other methods may be adopted to arrive at the profits of the PE on a separate enterprise basis. The commentary mentions insurance enterprises, or relatively new enterprises where there may be no proper accounts. In those situations it may be possible to estimate the arm’s length profit of the PE by reference to suitable criteria (in the case of insurance enterprises, for example, the application of appropriate coefficients to gross premiums received from policyholders in the country concerned). The essence of this second approach, however, is nevertheless to seek to estimate the arm’s length profit on a separate enterprise basis.

German theory recognises direct and indirect allocation methods, the direct method being preferred by the Bundesfinanzhof. Under the direct method the PE receives a share of the company’s profits determined on the basis of accounts maintained following German principles of bookkeeping. The indirect method allocates the total income of the company to its head office and its PE on the basis of an allocation formula which may depend on turnover, premiums, capital or cost of wages and material.

The Swiss theory in this area is particularly rich, recognising first the indirect method (where the enterprise’s total profits are apportioned to the PE in the ratio of certain auxiliary factors). Under the proportional-direct method, the enterprise’s total profits are apportioned to the various PEs in the ratio of their separate profits (as determined in accordance with commercial law). This proportional-direct method builds on the “total profit allocation” concept (*Gesamtgewinnzerlegung*). The proportional-direct method means that internal dealings

are relevant for profit attribution but normally irrelevant for profit determination. Finally, under the objective-direct method the PE's profit is determined directly on the basis of the separate PE's accounts and is viewed distinctly from the total profit of the enterprise. Strict application of the objective-direct method means that internal dealings between the head office and the PE have to be considered (usually at arm's length prices for the determination of the taxable profit).

2.1.5. The existence of a wide variation in the extent to which a PE is treated as a separate enterprise

There is a wide variation in the extent to which different jurisdictions recognise a PE as a separate enterprise or even as a separate entity.

At the one extreme are jurisdictions which treat a PE as a fully separate entity and a separate taxpayer.

At the other extreme there are those jurisdictions which consider that there is only ever one taxable entity, so that taxable income cannot flow from dealings between the PE and the enterprise of which it is part.

Between these two extremes there is a wide band of jurisdictions which attribute varying degrees of independence to the PE.

Starting at one end of the spectrum, Argentina, Chile and Peru all treat a permanent establishment in their country as an entity independent from the remainder of the enterprise. In Peru, for example, a local PE of a foreign enterprise is treated as a separate taxpayer.

At the other extreme of the spectrum, there are those jurisdictions which regard the enterprise as a whole as the only possible taxpayer. This is the case in the United States where income is not generally realised on a transfer between a US and non-US office of a single legal entity as they are considered to be part of one taxpayer.

In a few jurisdictions there are court cases where priority has been given to the legal fact that the PE and its head office are part of the same entity. In Australia, in the *Max Factor* case, the Supreme Court of New South Wales took the view that an entity cannot make a profit in dealings with itself. Similarly, in India, the courts have ruled that a branch and its head office are part of one legal entity and cannot earn profits from each other.

These cases are interesting, partly because any dispute over the attribution of profits to a PE will ultimately come to a court which, almost instinctively, will tend to give predominance to the legal fact over the fiscal fiction (or, put another way, the court will be drawn to interpret the deemed separateness of the PE in the context of it carrying on the same and similar activities under the same and similar conditions, following the mandated approach of article 7(2)).

Between the extremes under which a PE is recognised as a separate entity on the one hand and the disregard of internal dealings for tax purposes on the other, a wide band of jurisdictions recognise a degree of independence for the PE, but in most jurisdictions this is a limited independence.

In Belgium, for example, it is a limited independence so no recognition is given to internal interest, royalties or rent. In Canada, only limited independence is recognised. In Denmark, the independence is limited with regard to internal dealings. More examples can be seen in the detailed discussion below.

2.1.6. Domestic law and treaty law are in conformity with one another

One point which comes out very clearly from the branch reports is that, for the vast majority of jurisdictions, domestic law and treaty law are either completely, or very largely, in conformity. This arises for a number of reasons.

First, in certain jurisdictions the domestic legislation relating to the attribution of profits to PEs is modelled on, or identical to, the wording found in article 7 MTC. This is the case in the Netherlands, New Zealand and the United Kingdom.

In many jurisdictions, though the wording may not be identical, the separate enterprise concept and the approach in article 7 MTC is found in domestic law. In France, for example, domestic law adopts an approach similar to article 7(2) and (3).

In some jurisdictions the courts interpret domestic legislation consistently with the commentary. In Norway, for example, the Supreme Court has held that domestic laws should be interpreted consistently with tax treaties based on the MTC.

In some jurisdictions the revenue authorities expressly follow the approach set out in the commentary. In Russia, the relevant guidance issued by the federal tax authorities states that the attribution of profits to a PE should be based on the principles contained in tax treaties.

In many jurisdictions the domestic law is also based on the separate enterprise fiction. In Denmark, for example, there is conformity between the fiction of independence of a PE in DTCs and the fiction of independence in Danish domestic tax law.

The only area where there seems to be scope for conflict between the provisions of domestic law and DTCs is where the domestic law limits in some way the deduction of head office expenses in determining the profits attributable to the PE. In those circumstances, appropriately worded DTCs based on article 7(3) may override the domestic law restrictions.

The only country where there is clear evidence of a conflict between domestic law provisions and DTC provisions is the United States. Though the Treasury and the IRS take the position that the domestic law of the United States is normally followed under a DTC, the courts have disagreed with this general rule in two specific circumstances. In the *North-West Life* and the *NatWest* litigation, the court held that the provisions of domestic law were not compatible with the provisions in the relevant DTC and the DTC should prevail.

With the exception of this point in the United States, and the issue of the deduction of expenses, no branch report indicated a substantial conflict between the provisions of domestic law and of DTCs.

There are a number of consequences which one can draw from this conformity between domestic law and the approach in DTCs.

First, the reporters were asked to consider certain situations both under domestic law and under DTCs. In all but a small number of situations the reporters noted that the position under domestic law and where a DTC applied were identical. For that reason, the position under domestic law and under DTCs is not considered separately in this report.

Secondly, because domestic law is closely aligned with the approach in DTCs, any discussion of the interpretation and application of article 7 goes beyond the realm of DTCs and is directly related to the domestic law of many jurisdictions.

Thirdly, and as a direct corollary, changes to the OECD commentary on article 7 might have a direct impact on the interpretation and application of domestic law in many jurisdictions. Many jurisdictions adopt the approach set out in the existing commentary – the OT. Were the OECD to adopt the AOA and the NT, it would be an issue for many of these jurisdictions whether that change was also to be followed in their domestic law.

2.1.7. An increase in legislative activity

A substantial minority of the branches report that there has been new legislation on this topic in recent years; in certain other countries there has been new administrative guidance. This is true, for example, in Australia (detailed guidance in 2001 and 2005), Austria (in 2005), Belgium (in 2004), France (in 2005), Germany (in 1999), Russia (in 2003), Spain (in 1999) and the United Kingdom (in 2003).

It is hard to resist the conclusion that some if not all of this legislation has been prompted by the discussions in the OECD. This is most clearly evident in the case of the United Kingdom where the legislation is consciously modelled on the wording of article 7 MTC, and detailed guidance was issued by the revenue authorities which covers many of the issues under consideration in WP6.

2.1.8. The application of the arm's length principle in domestic legislation to PEs

In a number of the jurisdictions, transfer pricing legislation containing the arm's length principle applies to PEs. This is the case in Argentina, Austria, Belgium, France, Italy and Spain.

It is worth noting that the European Union Arbitration Convention contains wording equivalent to articles 9 and 7(2) MTC. The convention expressly applies the arm's length principle to PEs.

In a few jurisdictions the transfer pricing legislation applies to a PE in one direction only. That is, it applies to dealings between a local PE and its non-resident head office; it does not apply to a locally-resident enterprise and its foreign PE. This is the case in India where the legislation does not apply to dealings between an Indian head office and its PE outside India.

In a few jurisdictions, by contrast, the domestic transfer pricing legislation does not apply to PEs. This is the situation in South Africa where statutory transfer pricing provisions presuppose a legally recognisable transaction between two separate persons, and are therefore not applicable to dealings between a head office and its PE. Similarly, in the United States the main transfer pricing provision – section 482 of the Internal Revenue Code – does not apply to dealings between a PE and its head office.

2.1.9. The emphasis on accounts maintained by the PE

Virtually all of the branch reports emphasise that the starting point for the attribution of profits to a PE is the separate accounts maintained by it. This reflects the preference for the direct method of attribution, and also reflects the importance given to properly maintained accounts by the commentary to article 7 MTC.

A number of branch reports note a legal requirement for a PE to keep separate accounts. This is the situation in Argentina, Chile, Greece and in Spain since 1964 (when there was a change in the law from a previous position under which there was a proportional allocation of the total profits of the enterprise).

2.1.10. The widespread acceptance of presumptive taxation

Despite the emphasis on accounts prepared for the PE, almost half the branch reports mention the acceptance of some form of presumptive taxation.

In a number of jurisdictions the revenue authorities have an alternative of assessing tax on a presumptive basis where inadequate records are maintained for the PE: this is the situation in Argentina, Luxembourg, Spain, Sri Lanka, Sweden and Uruguay. In Belgium, the taxable profits of a PE can be computed either by a comparison with three similar taxpayers, or there can be a flat rate assessment agreed with the revenue authorities. In France, there are two forfait methods: one determines the taxable profits based upon the proportion of turnover in the PE to the turnover of the enterprise; the other operates by a comparison with other similar taxpayers.

A further group of jurisdictions permit a presumptive form of taxation for certain sectors. In Greece, this applies to shipping and aircraft enterprises, as well as those involved in the processing and packaging of raw materials, in India, to shipping, oil extraction, aircraft and turnkey power projects.

The relatively widespread practice of taxation on a presumptive basis, or by the apportionment of total profits or income, may be one explanation why the attribution of profits to PEs seems not to represent a major issue in many jurisdictions.

2.2. Specific issues considered in the branch reports

The branch reporters were asked to consider a number of specific situations from the point of view of their jurisdiction. This section discusses some of the responses.

This summary focuses on the primary issue – the attribution of profits in State H from that state’s perspective – and generally looks at the more common situation where the goods or services are supplied by the head office to the PE.

2.2.1. The use of the PE concept in domestic law

A majority of the jurisdictions use the PE concept both in domestic law and in DTCs. However, a significant minority do not use the PE concept in their domestic law, though all employ the term in their DTCs.

Those jurisdictions that do not employ the PE concept in their domestic law nevertheless tax businesses carried on in their jurisdiction, and have equivalent rules for the determination of the profit attributable to that business.

Perhaps the best example of a country that does not employ the PE concept is the United States, which taxes the income from the conduct of a trade or business within the United States. There is a process by which gross income is treated as effectively connected with a US trade or business; this involves determining the taxable gross income and allowable deductions of that trade or business.

Thus, even for those jurisdictions that do not employ the PE concept in domestic law, there is nevertheless a process of identifying either the gross income and allowable deductions which relate to the business carried on in their country, or an allocation of the net profit that arises from the conduct of the business in that country. Some form of attribution process and the arm's length principle is employed by all these jurisdictions: it is still appropriate to talk about an "attribution of profits" even though the attribution is to the local business rather than to a PE.

2.2.2. Whether the PE is taxable on its worldwide income

An issue which is not discussed extensively by the OECD or in the literature is the question whether the PE is taxable in State H only on local source income or on its worldwide income. The PE concept is often regarded as a threshold for source-state taxation. However, once a PE is established, its activities may not be restricted to sales only in the host jurisdiction, but it may make sales, supply services and hold income-producing assets either in third jurisdictions or in state R.

State practice varies on this point. In at least five jurisdictions (Argentina, Brazil, the Czech Republic, Spain and the United Kingdom) a PE is taxable in state H on attributable profits, wherever those profits arise: that is, the PE is taxed on its worldwide income. On the other hand, in a number of other jurisdictions – examples include Chile, France, Luxembourg, Peru and the United States – a PE is taxed on its local source income only (though occasionally local source income is defined to include some income arising outside the jurisdiction).

The scope of a PE's liability may have an impact on the process of attribution of profits.

2.2.3. Transfers of inventory

Branch reporters were asked to discuss the tax treatment of transfers of inventory – raw materials or finished goods – between the head office and PE.

For transfers of inventory a geographical approach based upon the physical location of the inventory can quite easily be applied: it is clear to see that the inventory has left the head office and arrived at the PE.

Two particular issues were identified.

First, where inventory is transferred to the PE, the value to be attributed to the inventory in computing the profit of the PE on a subsequent sale.

Secondly, if the PE transfers inventory to its head office, does the PE immediately recognise a profit on the internal transfer or is there no realisation of profit until the inventory is subsequently sold by the head office? This second issue

neatly illustrates the difference between the single enterprise approach and the separate enterprise approach.

2.2.3.1. The cost of inventory transferred to the PE

If there is any issue on which one would expect a uniform view, it is that inventory should normally be regarded as transferred to the PE at its fair market value (i.e. its arm's length price, including costs and a profit mark-up for the head office). In fact, even on this point there is no unanimity.

The vast majority of branch reports indicate that inventory is to be regarded as transferred to the PE at fair market value.

However, there are exceptions. In Sweden, for example, the acquisition value for the Swedish PE is either the cost paid by the head office or the fair market value at the time of transfer, whichever is the lower. If the transfer of the inventory was a taxable event in state R, and exit taxation was imposed, then the acquisition value is the fair market value. In Switzerland, the acquisition price is either the fair market value or the transfer price determined by the foreign revenue authorities.

2.2.3.2. The timing of profit realisation on a transfer from the PE

Three different positions can be identified.

First, there are those jurisdictions which recognise an immediate profit in the PE on the transfer of inventory to the head office. This is the case in Denmark, for example, where the transfer of goods may most likely be considered to be a transfer at arm's length value, including a fictitious mark-up. This is supported by a 1905 circular according to which a Danish PE should attribute a price which includes a fictitious mark-up.

At the other extreme are jurisdictions where no profit is realised until the inventory is sold to an outside third party. This includes the Czech Republic, Mexico, Norway, Peru, Uruguay and, on one view, the Netherlands. These jurisdictions are, to a certain extent, all reflecting underlying principles – such as the realisation principle – that no taxable profit should be recognised until there is a commercial profit generated by a sale to an outside third party.

Finally, there are some jurisdictions where there is normally an immediate recognition of profit but there can be a deferral in certain circumstances. In Austria, since 2005, it has been possible to defer profit realisation on sales if the head office is located in the European Union or the European Economic Area.

2.2.4. *Transfers of machinery*

Branch reporters were asked to comment on the tax treatment of transfers of capital items such as machinery from a head office to a PE.

In the case of transfers of machinery, it is relatively easy to enquire as to the physical location of the machinery to determine whether it has been transferred to the PE or not. In some cases, the arrival of substantial machinery in a jurisdiction will constitute the creation of the PE.

A number of issues arise:

- Whether the transfer should be regarded as a sale or a lease? In the latter situation, the subsidiary question arises whether a notional rent may be deductible in computing the profits of the PE.
- Secondly, if the machinery is regarded as sold to the PE, and a depreciation allowance is subsequently given, what is the base for that depreciation allowance?

2.2.4.1. The form of the transfer

This issue is nicely illustrated by the *Cudd Pressure* case in Canada where a US-resident corporation carried on business through a PE in Canada. The corporation provided two snubbing units for use by the PE. The taxpayer deducted a charge for a notional rent to the head office. The Tax Court questioned whether an independent enterprise would have rented rather than purchasing the snubbing units. It further held that notional rents were not deductible.

The three judges of the Federal Court of Appeal all agreed that a third party would not have rented the units but would have purchased them instead. Two of the judges did not find it necessary to decide whether a notional rent would have been deductible; McDonald JA thought that an amount of notional rent might be deducted in an appropriate case.

On the characterisation of the transfer as a sale or a leasing, several branch reports point to the issue whether the transfer is temporary or permanent. In Australia, the revenue authorities acknowledge that a transfer may be characterised as a sale, a lease or something else. The issue must be determined on the basis of surrounding facts and circumstances, and a number of factors are identified including the history of the acquisition and use of the asset, whether the use by the PE is expected to be temporary or permanent, and whether the PE has assumed the risks associated with the use and ownership of the asset.

2.2.4.2. The deduction of a notional rent

Where the transfer to the PE is characterised as a lease, jurisdictions display virtually every possible treatment which might be accorded to the notional rent.

First, there are those jurisdictions, such as New Zealand, where internal leases are not recognised and there is consequently no deduction for an internal rent.

On the other hand, in some jurisdictions a notional rent is deductible. In Canada one of the judges of the Court of Appeal in *Cudd Pressure* would allow the deduction of a notional rent in appropriate circumstances.

In some jurisdictions, a notional rent is not deductible but the depreciation allowance on the machinery may be deducted in computing the profit attributable to the PE: this is the case in Spain where legislation establishes that payments by a PE to its head office for the use of capital assets are non-deductible, but a tax depreciation allowance can be taken by the PE for wear and tear during the period it is used.

Finally, in the case of some jurisdictions, of which Chile is an example, a withholding tax is imposed on rental payments to the head office for the use of equipment.

2.2.4.3. The value in the PE for depreciation purposes

In a number of the jurisdictions a depreciation allowance is granted based upon the fair market value of the machinery at the time it is transferred to the PE. This is the situation in Belgium, Canada, Denmark (probably), Luxembourg and Sri Lanka.

In a few jurisdictions, however, the depreciation charge in the PE is based upon the original cost of the machinery when acquired by the head office, adjusted for depreciation for the period of ownership prior to the transfer to the PE. In Greece, the original cost is depreciated according to Greek depreciation rates for the period of ownership prior to the transfer.

2.2.5. *Supplies of intangibles*

Branch reporters were asked to comment on the tax treatment of the supply of intangible property from a head office to a PE. The answers show a wide range of different treatments.

2.2.5.1. The deduction of royalties or costs

The existing commentary to article 7 MTC states that there should be no deduction for notional royalties but that it may be appropriate to allocate the actual costs of creation of intangible rights between the various parts of the enterprise without any mark-up for profit.

The branch reports indicate no uniformity in treatment. Broadly, the positions identified fall into three groups: jurisdictions where no deduction is allowed at all; jurisdictions where no deduction is allowed for a notional royalty, but actual costs incurred to third parties are allocated (without any mark-up); and jurisdictions where a deduction is allowed for royalties and costs (subject to various limitations).

There are certain jurisdictions where no deduction is allowed in respect of intangible rights provided by the head office. This is the case in Indonesia where specific legislation provides that any royalty or other consideration for the use of assets, patents or other rights is not deductible. In Brazil, royalty payments from a Brazilian PE to its head office are non-deductible.

There is a second, large group of jurisdictions which follow a practice close to the existing OECD commentary: notional royalties are disallowed, but actual costs incurred are deductible, without a profit mark-up. This is the case, for example, in France where the tax administration does not recognise the payment of royalties between a PE and its head office (on the basis of the unity of the single legal entity). In Australia, the revenue authorities' view is that a notional royalty is recognised only if there is actual expenditure incurred by the enterprise in the form of royalties to third parties. In the case of internally generated intangibles, it is appropriate to allocate the actual costs of creating such property. Where, however, intangible property has already been created, an internal charge for the subsequent use of the intangible is not recognised for tax purposes (under the single entity concept).

In a third group of jurisdictions there is a limit placed on the deduction of expenses in connection with the provision of an intangible asset to a PE. There are various types of restriction, and in some cases they are similar to the restrictions on payments for head office services. For example, in Argentina only 80 per cent of the expenses may be deducted and the intangible asset has to be registered in connection with legislation on technology transfers. Whether these limits to the deduction of expenses are compatible with DTC provisions is discussed in connection with the deduction of head office expenses generally.

2.2.5.2. Withholding tax on internal royalties

A small number of jurisdictions require a withholding of tax by a PE on the payment of royalties to its head office. This is the case in Argentina (where withholding tax is 28 per cent), Brazil (15 per cent), Chile (30 per cent), Sri Lanka (15 per cent, but where a DTC applies 10 per cent) and Uruguay.

One can contrast with this the situation in Canada where in the *Twentieth Century Fox Film* case the court held that a withholding tax could not be imposed on notional royalties paid by a Canadian PE to its US head office in respect of the use of films and videotapes.

2.2.6. Interest charges

Branch reporters were asked to comment on the tax treatment of interest on loans provided between a head office and a PE. The special situation of banks is dealt with below.

The commentary to article 7 MTC was substantially amended in 1994. The amended commentary records that an approach previously suggested – the direct and indirect apportionment of actual debt charges – did not prove to be a practical solution. Instead, the commentary proposes a ban on deductions for internal debts and receivables (subject to the special problems of banks).

There is again a wide variation in practice between the different jurisdictions. However, a large block of jurisdictions deny any deduction for notional interest, but permit a deduction as an actual expense for interest on loans raised by the head office from a third party, where it can be demonstrated that the proceeds of these loans have been applied in the business of the PE.

2.2.6.1. The allocation of “free” capital to non-bank PEs

As a preliminary point, a small number of jurisdictions expect that a PE will have allocated to it a certain amount of “free” or “equity” capital – that is capital on which no deductible interest charge arises. This is the case in Germany, for example, where an amount of “endowment capital” (*Dotationskapital*) is to be treated as the PE’s equity capital. In principle, the amount of this capital is determined in a direct way by the decision of the entrepreneur; that decision will usually be respected provided that the capitalisation does not amount to abuse. If necessary, however, an amount of equity capital will be allocated using a methodology such as the “capital mirror method” or based on a ratio where the company’s entire capital is attributed to the PE according to the functions performed.

2.2.6.2. The application of thin capitalisation rules to non-bank PEs

In some jurisdictions, thin capitalisation rules do not apply to non-bank PEs. This is the case in Austria (which is rather surprising since Austria, as will be seen, allows a deduction for notional interest), Belgium and France. On the other hand, in Argentina and New Zealand the thin capitalisation rules apply. In the latter country, for example, deduction for interest of a branch is limited where the branch's interest-bearing debt–asset ratio is greater than 75 per cent.

2.2.6.3. The deduction of interest

There are, broadly, three positions taken by the jurisdictions surveyed:

- first, those jurisdictions which disallow the deduction of any interest to the head office;
- secondly, those which allow a deduction for interest, including notional interest charged on loans from the head office;
- thirdly, those jurisdictions which disallow notional interest on internal loans, but permit a deduction for interest on loans taken out from a third party where the proceeds of the loan are applied in the business of the PE.

In the first group are Indonesia (where specific legislation disallows the deduction of interest on loans from a head office except in the case of banks), Mexico, and Spain (where there is again specific legislation providing for non-deduction of interest from the Spanish PE to its foreign head office).

At the other extreme are jurisdictions such as Austria and Italy which allow a deduction even for notional interest. Austria is particularly interesting in this respect since, as a result of legislation in 2005, intra-company loans are recognised provided the interest rate is set on market terms. The deduction does not apply to “free” capital, but thin capitalisation rules do not apply to Austrian PEs and the Austrian tax authorities have not expressed a view on the appropriate capital base for PEs.

Between the two extreme positions there is a broad swathe of jurisdictions – the majority – where no deduction is allowed for notional interest, but only for interest actually incurred by the head office on loans from third parties. Broadly, this is the situation in Australia, Belgium, Canada, the Czech Republic, Denmark, France, Germany, Greece, the Netherlands, New Zealand, Russia, South Africa, Sweden and Switzerland.

For example, in France, interest on funds placed at the disposal of the PE is non-deductible. However, if the head office contracts a loan specifically for the PE and it appears in the accounts of the PE, the interest is deductible. Also, interest on loans taken out by the head office for its general activities is deductible to the extent that it can be objectively attributed to the activities of the PE in France.

2.2.6.4. The identification of funds provided for the business activities of the PE

Where a jurisdiction allows a deduction for interest on loans from third parties, it is necessary to identify that the funds have been employed in the business of the PE. For example, in Australia a tracing approach or a fungibility approach is

employed. In New Zealand the taxpayer must trace or prove through a form of allocation approach the extent to which third party borrowings have been used by the PE.

2.2.7. Supplies of services, and head office expenses

Branch reporters were asked to comment on the tax treatment of charges made for supplies of services between a PE and its head office, and specifically with regard to head office expenses. This topic covers a wide range of different expenses.

One can distinguish a number of types of services and charges made between a head office and a PE:

- a head office may pay for specific services supplied by third parties which benefit the PE's business directly. For example, the head office may pay an accounting firm which maintains separate accounts for the PE;
- secondly, the head office may supply services to the PE – for example, there may be centralised accounting carried out at the head office for the benefit of the PE; and
- thirdly, there may be general services provided by the head office for the enterprise as a whole, which benefit the PE, but for which no direct advantage to the PE can be identified. This may include, for example, general management services carried out by the head office for the enterprise as a whole.

In some cases, the supplies of these services will have an identifiable cost which can be directly linked with a benefit to the PE: for example, if an external accountancy firm invoices for its services in providing separate accounts for the PE. In many cases, however, it would not be possible to make this direct link with the benefit to the PE.

The existing commentary deals briefly with these different services. The commentary asks whether a service should be charged at cost, or at cost plus mark-up to represent a profit: where it is part of the trade of the enterprise to supply that service, it may be appropriate to charge at an arm's length rate. Where the services are part of the general management activity of the company, it will be usual to provide it at cost. The commentary also indicates that no profit should be attributed to the exercise of good management of the enterprise as a whole.

This is an issue where there may be more scope for conflict between the provisions of domestic law and the provisions contained in DTCs. In most branch reports it is only in connection with the deduction of head office expenses that a significant difference is recorded between the position under domestic law and the position where a DTC applies.

The variations in the wording of article 7(3) may be significant. Whereas virtually all DTCs referred to in the branch reports follow the wording of article 7(1) and (2) MTC, when it comes to the equivalent of article 7(3) a substantial number of DTCs adopt variant forms of wording.

2.2.7.1. The wording of article 7(3) of the relevant DTCs

A minority of the jurisdictions surveyed adopt the wording of article 7(3) UN MTC. This is the case for India and Sri Lanka.

Even for those jurisdictions that normally follow the OECD wording, a significant number of their DTCs follow the UN wording. In France, for example, it is estimated that two-thirds of its DTCs follow the OECD wording and one-third the UN MTC wording. In South Africa around one-fifth of DTCs adopt the wording of article 7(3) UN MTC.

A number of specific DTCs adopt wording which states that expenses are only deductible if they are deductible in accordance with domestic law. This is the case with some of the DTCs entered into by Canada, India, and Spain. This is particularly important where domestic law places a limit on the deduction of head office expenses.

2.2.7.2. The deduction of charges for services and head office expenses

There is a wide variety of practice between the jurisdictions. A number of jurisdictions note that restrictions under domestic law will not apply where a DTC with appropriate wording is in place.

One can identify three approaches in domestic law:

- first, jurisdictions which have a complete ban on the deduction of head office expenses, or at least certain categories of head office expenses;
- secondly, jurisdictions which permit a deduction for head office expenses, but then impose a limit on the amount of deductible expenses;
- thirdly, jurisdictions which permit the deduction of expenses but subject to certain conditions (which vary from jurisdiction to jurisdiction).

In the first group is, for example, Brazil, which does not allow the deduction of expenses for head office services supplied to a Brazilian PE. In Indonesia there is specific legislation which denies a deduction for fees for management services and other services paid to the head office.

One is tempted to comment that, for businesses operating in countries which adopt this approach, a change in practice to allow the deduction of head office expenses would be of greater interest than adoption of the AOA.

In the second group are jurisdictions which limit the quantum of the deduction for head office expenses. An example is India, whose domestic legislation limits deductions to 5 per cent of the total income of the PE.

Somewhat controversially, in Greece there is domestic legislation which limits the deduction of foreign head office expenses to 5 per cent of the total administrative and operating expenses incurred in Greece by the PE. However, where a DTC containing article 7(3) applies, the quantitative limit in domestic law is overridden.

The third and largest group of jurisdictions permits the deduction of head office expenses without a quantitative limit but subject to various conditions. Sad to say, these conditions are not uniform.

In Belgium, there is a “specificity rule” which requires that the enterprise demonstrates that the expenses have been made or borne for the sole purpose of the Belgian PE. A proportionate part of overhead expenses is not deductible because of the specificity rule. The head office cannot allocate part of the fee it pays its directors unless it relates to activities performed exclusively for the purposes of the PE. The Belgian authorities will not allow the deduction of a

praecipuum, i.e. a share of the PE's profit in return for good management. Where, however, a DTC applies, a proportionate share of the overhead costs may be deducted if it is proved that these costs benefited the PE. (To labour the point, this is one of the few specific situations where it is expressly stated that domestic law and DTC provisions diverge.)

In Spain, under specific legislation, a reasonable part of the management and general administration expenses may be allocated to the PE provided that: the expenses have been disclosed in the financial statements of the PE; the PE attaches an explanatory report with the amounts paid, distribution criteria and allocation modules used; the PE demonstrates the reasonableness and continuity of the imputation criteria adopted.

2.2.7.3. Deduction at cost or with a profit mark-up?

The branch reports do not disclose a consistent practice, though most indicate a tendency to allow deduction only for costs incurred, and for a profit mark-up to be exceptional.

A number of jurisdictions report that, where the service is provided to outside customers, a profit mark-up should be added. Canada, for example, is likely to follow the commentary under which services must be accounted for at cost unless the enterprise provides similar services to third parties. In France, services have generally been allocated without a margin. However, more recently the revenue authorities have tended to request the inclusion of a margin.

There is a tendency to follow the existing commentary and charge head office expenses at cost, with the profit element only being added where the service is part of the core business activity of the head office. However, this is by no means a uniform approach.

2.2.7.4. Withholding taxes on fees paid to the head office

In a small number of jurisdictions a PE is required to withhold tax on payment of certain fees to its foreign head office. A withholding tax is imposed in Argentina, if the payment is regarded as a technical service fee (at 21 per cent). It is also the case in Chile (where the rate is 30 per cent, 35 per cent, or 20 per cent on fees for technical assistance).

2.2.8. *Dependent agents*

Branch reporters were asked to speculate as to whether they thought the DDI (2004) contention (that there might be a profit attributed to the DAPE over and above the arm's length agency fee paid) would be accepted in their jurisdiction. Not all branch reporters responded to this question. A few indicated that the issue was highly controversial.

Of the reporters who responded, five indicated that there might be a profit attributed to the DAPE. These were Australia, Austria, Denmark, Norway and Switzerland.

By contrast, six reporters indicated that in their jurisdiction no profit would be allocated to the DAPE. These were the Czech Republic, Germany, Italy, Mexico, the Netherlands and New Zealand.

Finally, three reporters stated that the issue was unclear: Canada, India, and the United Kingdom.

What one can say is that this is not a rousing show of support for the DDI (2004) contentions with regard to the DAPE or, put another way, that the adoption of the WP6 approach to the DAPE issue seems unlikely to achieve the “broad consensus regarding the interpretation and practical application of Article 7” that it seeks.

2.2.9. Special rules for banks and insurance companies

Branch reporters were asked whether there were any special rules in their jurisdiction for the attribution of profits to PEs of banks and insurance companies. A significant number of reporters answered this question in the negative.

The commentary has always recognised that special considerations might apply to banks and insurance companies. With regard to banks, it recognises that special considerations apply to payments of interest between different parts of financial enterprises in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. For insurance companies, the commentary explains that it may be appropriate to make an apportionment of total profits by reference to premiums received.

2.2.9.1. Banks

In a number of jurisdictions where there is a general prohibition on the deduction of interest, or at least notional interest, an exception is made for banks. To take Spain as an example: legislation disallows the deduction of interest charged between different parts of the same enterprise, but a second paragraph states that the non-deductibility is not applicable to banks. Similarly, in the United Kingdom a general prohibition on the deduction of interest does not apply if the PE is engaged in financial business, which includes banking, deposit taking and dealing in commodity or financial futures.

Once the deduction of internal interest is allowed, the issue arises as to how the deduction can be computed. In particular, issues arise as to the correct amount of “free” capital (i.e. capital on which the return is not deductible in computing profits).

For some jurisdictions this is dealt with under general thin capitalisation legislation, though often with different rules for banks as for non-financial enterprises. In Canada, for example, a debt:equity ratio of 19:1 is applied as a limit to the amount of interest deductible in computing the profits of a Canadian branch of a bank.

In a small number of jurisdictions there are detailed rules on the determination of the free capital of a PE: this is so in Australia, France, Germany, the Netherlands, Switzerland and the UK. However, these jurisdictions do not display unanimity in the method employed.

In Australia, detailed guidance in a 2005 Taxation Ruling requires a functional and comparability analysis to determine attributable capital. The actual amount of equity capital allocated to an Australian PE must be taken into account. The safe harbour tests in Australia's thin capitalisation provision, if satisfied, should ensure that the interest deduction is not adjusted.

In France, branches are not directly subject to thin capitalisation legislation. However, on audit by the revenue authorities a 2005 Instruction is generally followed on thin capitalisation. This Instruction refers to the dotation of capital which an independent enterprise would have required. The revenue authorities generally follow the regulatory approach (based on the BIS ratio).

In Germany, new guidance issued by the Federal Finance Ministry in September 2004 deals with the dotation capital for German PEs of non-residents. This adopts the function- and risk-related capitalisation method (the BIS ratio method) and the regulatory minimum capitalisation method (the quasi-thin capitalisation method). These methods are not at the discretion of the taxpayer, rather they must be applied in order with different priority depending on the case involved. It is accepted that these methods lead to a range of acceptable dotation capital amounts.

In the Netherlands, a 2004 decision of the Amsterdam Court adopted the capital-adequacy ratio (the BIS ratio) to determine the free capital of a Dutch PE of a Belgian bank. The Court applied the BIS ratio of the overall enterprise to the branch (which had been funded entirely, on its books, by loan capital).

In Switzerland, the three capital attribution alternatives in DDII are accepted.

Finally, in the United Kingdom there is extensive guidance on the process of attributing free capital to a PE. A thin capitalisation approach is adopted: a branch is taken to have the free capital which would support its functions, assets and risks.

The United States is a particularly interesting case. Treasury Regulation §1.882-5 provided an explicit formula for the allocation of interest expense to the conduct of a US trade. This was challenged in *NatWest I* where it was held that the formulary approach was incompatible with the business profits article of the 1975 UK-US DTC. This left open the amount of interest deduction which was permitted to the US branches. In *NatWest II* an attempt to compute the interest on the basis of the capital which the branches would have required if they had been separate entities, regulated in the US, was rejected. Most recently, in *NatWest III* the Tax Court upheld the interest deduction based upon the books and records of the US branches without any substantial adjustment.

These recent developments in a number of countries have clearly been prompted and influenced by the discussion in WP6. They reflect the fact that the DDs have not identified a single approach to capital attribution around which there is consensus.

2.2.9.2. Insurance companies

A small number of branch reports refer to indirect methods of determining the profits attributable to the PE of a foreign insurance company.

For example, in Australia, a non-resident insurer is deemed to have taxable income equal to 10 per cent of the total premiums relating to its Australian business, unless it can satisfy the Commissioner as to its actual profit or loss. Sim-

ilarly, in Belgium, in the absence of sufficient evidentiary information to make a direct assessment, profits are assessed at 10 per cent of premiums collected. There is also a flat rate basis of assessment, based on a comparison with other similar enterprises.

In Germany, a dotation of free capital is required for an insurance company. In the case of PEs subject to regulatory supervision, this is the minimum equity capitalisation laid down by the regulatory authorities. Interestingly, for overseas PEs of German insurance companies the capital allocation in accordance with the foreign regulatory supervision is generally recognised as long as the capital is not withdrawn.

2.2.10. The relief issue and the symmetrical application of profit attribution methods

Most of the issues considered above relate to the primary issue. By contrast, relatively little has been said about the relief issue. In connection with the specific situations considered – transfers of inventory, transfers of capital equipment, etc. – the branch reports have considered both the state H and the state R situation, and those reports can be examined for the detail.

In terms of general issues of principle, it is of particular interest whether state R might accept state H's method of attribution of profits to the PE, or the actual attribution of profits, when state R eliminates double taxation. That is, would there be symmetrical operation of the profit attribution, as WP6 suggests?

In particular, this issue arises from the lack of a consensus on a single method for the attribution of free capital to a PE, and the adoption of three alternatives. The concern of business is that this will lead to a different determination of the profit attributable to PEs (bank branches in particular) in State H and State R, and, consequently, an amount of unrelieved double taxation.

A few branch reports deal specifically with this issue.

In the case of a foreign PE of a German insurance company which was subject to regulatory supervision in the host state, it is likely that the minimum capital required by the regulator in the host state would be regarded as adequate.

The branch report indicates that Spain should accept the profits of the PE calculated by the host country with which it has a DTC. This would suggest a symmetrical application is accepted in Spain.

The Swiss report states that Switzerland would be willing to adopt the method applied in the host state of the PE as long as it is consistent with the principles of Swiss law and the relevant DTC.

By contrast, the UK report notes that case law has now established that UK principles must be used to establish the level of profits of overseas PEs. This would indicate that UK principles should also determine the capital attributed to the overseas PE.

A KPMG survey in 2005 reported that Australia accepts the symmetry principle, but that it is not accepted in Belgium, Canada, Germany or the UK. Whether the Netherlands would adopt the symmetry principle remains to be seen. The Norwegian tax authorities do not seem to apply the symmetry principle in practice, and acceptance of the symmetry principle in Spain should not be regarded as inevitable.

At this stage it seems unlikely that all countries will accept the symmetry principle.

3. The future

This section looks to the future and leads towards some recommendations for consideration at the IFA Congress. It begins by recording some criticisms of the OECD's recent work, then considers what constraints exist on future developments. Branch reporters were asked to speculate as to future reaction in their jurisdiction, and their responses are summarised. Finally, there is an examination of some options for future action and recommendations.

3.1. Criticisms of the OECD's recent work

It is not the purpose of this report to heap up criticisms of the OECD's recent work. However, it would not be appropriate to look to the future without recording that there have been some quite strong criticisms of this work, both from academics and, in particular, from business.

While this is not a criticism, some writers fear that the adoption of the AOA would lead to a shift towards source taxation (i.e. taxation in state H), while others fear that it would lead to a shift to greater residence taxation (i.e. taxation in state R).

One important issue in determining the potential impact on source state taxation is whether or not tax should be withheld on notional payments of interest, royalties and rents to the head office in state R. If these notional payments are deductible without any withholding of tax, this could have a negative impact on taxation in state H.

3.1.1. *The lack of clear underlying principles*

A criticism made by a number of writers is that WP6 did not adequately state the underlying principles which underpin its work, and which could be used to test whether or not the AOA achieves what the OECD set out to do. DDI (2001) stated that: "The first step in establishing a consensus position is for the Member Countries to develop a working hypothesis (WH) as to the preferred approach for attributing profit to a PE under Article 7 in terms of simplicity, administerability, and sound tax policy." This is the only express reference to any underlying principles, and requires further explanation of the criteria by which "sound" tax policy is judged in the context of the project.

The NFTC notes that global businesses have as their primary concern that the attribution of profits to PEs requires:

- a consistent approach to be applied internationally;
- adequate certainty in advance regarding the interpretation and implementation of the agreed approach; and
- associated compliance burdens do not exceed an administrable level.

3.1.2. The use of KERT functions

Particular criticism has been directed at the all-encompassing use of the concept of KERT functions as a way of attributing assets and risks within an enterprise. KERT functions are essentially key people functions, and the identification of those functions is an important element in functional analysis. However, the AOA goes further in using KERT functions as a means of allocation. Even in the financial sector where the KERT approach is more familiar, there are concerns that comments in the DDs on the KERT approach are over-prescriptive and may lead to allocation of assets on a split basis across multiple locations.

3.1.3. Failure to agree a consensus, especially on the methods of capital allocation

WP6 set out to establish a consensus position: they failed. Most significantly, they failed to achieve this with regard to the methods of allocating free capital to bank branches.

By reversing the previous position in the existing commentary, under which internal, notional interest is generally not deductible outside of the banking sector, the AOA makes the allocation of free capital a matter of concern for all businesses, including those outside the banking sector. Thus, failure to reach consensus has potential implications for all sectors of the economy. This is all the more striking when it is considered that WP6 itself recognised that, as a general matter, the lack of a common interpretation of article 7 can lead to double taxation, and it is axiomatic that: “the establishment of a broad consensus regarding the interpretation and practical application of Article 7 ... is essential to achieve the goal of eliminating the risk of double, or less than single, taxation”.

3.1.4. Failure to give prominence to branch books and records: an assumption of manipulation

The NFTC and others point to the failure of the AOA to give sufficient respect to a branch’s own books and records. Many critics point out that WP6 is all too ready to assume that internal dealings will be manipulated for tax purposes, so that internally-maintained records must be viewed with a degree of scepticism. The US report records the criticism by business that properly maintained records should generally be respected, and transactions should not be shammed or disregarded too readily.

3.1.5. Failure to address the consequences of the AOA

The DDs would, if adopted, lead to significant changes to the current approach and practice. While there has been a considerable effort expended upon the nature and operation of the new approach, discussion of the consequences of the AOA has been limited. Two examples illustrate the difficulties.

First, where a bank PE funds itself exclusively by borrowing in the market, it follows from the application of the AOA that a portion of the real interest paid by

the PE to third parties will be disallowed for tax purposes. There is no discussion in any of the DDs as to what adjustments should be made, and how they should be effected, in relation to such disallowed interest.

Second, in the context of discussions on capital attribution, there has been much business comment during the consultative process as to how double taxation can be avoided where states use different capital attribution methodologies. This could occur, for example, where state R applies a simple allocation approach and state H applies a thin capitalisation approach. If this leads to more tax being paid in state H than would have been paid if a capital allocation method had been used, the question is how relief will be secured by the head office in state R.

3.1.6. Criticisms by the business community

The business community has been particularly critical of DDI (2004). Some of the criticisms are identified in the US and Swedish branch reports in particular.

Particular criticisms have been made of the consequential application of documentation requirements to dealings within a single enterprise. While one might expect appropriate documentation to exist to support transfer pricing between independent enterprises, for PEs much of this documentation will need to be generated specifically for this purpose.

3.2. Constraints on future approaches

WP6 expressly approached the development of a WH without being constrained by either the original intent or the historical practice and interpretation of article 7. Some have praised the OECD for adopting this approach.

In many jurisdictions there are existing constraints on the ability to adopt certain approaches to the attribution of profits to PEs, at least in their domestic law. Some of the constraints are identified in the branch reports, and are summarised here.

3.2.1. Constitutional principles and general rules of tax law

A few jurisdictions indicate that there are constitutional principles or general principles of tax law which would restrict that jurisdiction from adopting aspects of the AOA in its domestic law. The AOA requires a PE to recognise notional payments as a deduction or as a basis for attributing profits. Also, there may be an allocation of profit to a PE where either the enterprise as a whole has made a loss or there has been no profit realised by a transaction with a third party.

A good example here is Greece where the Constitution enshrines the “ability to pay principle” and the “principle of legality” which requires that all taxes or tax exemptions are provided for in a statute. The “realisation principle” is also part of Greek tax law under which no earnings may be accounted for unless they have been realised. There is also a strong principle that the civil law position on ownership of assets must be respected by tax law.

Some of the jurisdictions that have constraints on the ability to recognise a profit for a PE on an internal dealing have previously followed the single enter-

prise approach. DDI states that some of those jurisdictions that have adopted the relevant business activity approach thought that they might be able to adopt the functionally separate entity approach if there were more support for it in the OECD commentary. An examination of the branch reports indicates that this may not be correct: constitutional rules and principles of tax law may mean that, at least in their internal law, no profit may be attributed to a PE on a purely notional, internal dealing.

This is probably the single most important conclusion of this general report: that in a small but significant number of jurisdictions, constitutional rules or principles of tax law may make the adoption of the AOA impossible, at least in domestic tax law.

3.2.2. Existing case law, guidance and the MTC commentary

Though there is not a huge body of case law, a fair part of the existing jurisprudence conflicts with the AOA. For example, there is case law from a number of jurisdictions – the *Max Factor* case in Australia; the *Imperial Oil* case from Canada – which emphasises that an enterprise cannot make a profit from dealing with itself. The *NatWest* litigation in the US rejected the idea of an attribution of free capital based upon a formula or based upon an allocation of capital.

In the UK, there is no jurisprudence, but there is the hugely influential opinion given by Lord Nolan (when he was a QC) on the application of the business profits article of the UK–US DTC to the attribution of capital to a bank branch. The UK branch report notes that it has already been suggested that the new approach to capital allocation adopted by legislation in 2003 is incompatible with the Nolan Opinion.

In all these cases, it will remain a matter of uncertainty whether a court will adopt the AOA or will follow the pre-existing jurisprudence, unless there is a clear change in the wording of DTCs themselves.

This may be the second important conclusion of this general report: that existing case law and guidance may make it very hard in a number of jurisdictions to adopt the AOA without an explicit change in the wording of article 7.

3.2.3. Non-discrimination provisions

It may seem a little strange to characterise non-discrimination provisions as a constraint on the attribution of profits to a PE. However, most DTCs contain a non-discrimination article with provisions relevant to PEs. It is important that any approach to the attribution of profits to PEs is consistent both with the provisions of the article and with the commentary.

The primary provision is the equivalent of article 24(3) MTC. The commentary to article 24(3) identifies a number of issues relating to PE taxation, and generally adopts an approach consistent with the separate enterprise concept. There may, however, be some difficulties between this existing commentary and the AOA.

For example, one issue which might arise in connection with article 24(3) is this. Assume a PE in state H transfers inventory to its head office in state R: the AOA would require that the PE recognises a profit for the purposes of attributing

profits to the PE. Suppose, however, that in the case of inventory transferred from a branch in state H to its head office *in the same state* no profit was to be realised. It seems arguable that to require the PE to recognise a profit where none would be recognised in a purely domestic situation results in taxation being less favourably levied on the PE. At the very least, there would need to be changes to the commentary to article 24 MTC to ensure that arguments could not be raised against the application of the AOA based on non-discrimination provisions.

3.2.4. *The position under European Community law*

The 25 Member States of the EU are subject to the constraints of Community law in regard both to the operation of their domestic tax rules and their DTCs. In addition, there are the three European Economic Area states which are subject to similar constraints, as well as states which are candidates to join the EU in the coming years. More than half of the OECD member countries are affected by Community law issues.

At present, the Community does not have a developed position on the attribution of profits to PEs. The current status of Community law is explained in a special report in this volume of the *Cahiers*.

The freedom of establishment in article 43 of the EC Treaty prohibits restrictions on the setting up of branches by nationals of one Member State in the territory of another Member State. This prohibits exit restrictions in Member State R which might tax the enterprise more heavily because it establishes a branch in Member State H. Equally, it prohibits entry restrictions in Member State H which might tax the branch more heavily than a branch of a state H enterprise. In both circumstances, the branch must be in an objectively comparable position to the domestic branch, and the restriction must be unjustified.

There is a general tendency to treat a PE in the same way as a local subsidiary under Community law. For example, the Arbitration Convention applies the arm's length principle to a PE of an enterprise of a Member State.

This tendency is also reflected in the jurisprudence of the European Court of Justice. In his recent opinion in the case of *CLT-UFA SA v. Tax Authority, Cologne West*, the Advocate General referred to article 7(2) MTC as support for the view that a PE and its head office were to be treated as legally distinct entities.

While there is this support in Community law for treating a PE as a separate enterprise, and even ascribing to that separate enterprise a high degree of independence, it is fair to say that many of the issues considered in the OECD's recent work have not yet arisen in the Community context.

Suppose, for example, that the AOA required a PE in Member State H to recognise a profit on the transfer of inventory to its head office in Member State R, but there would be no equivalent realisation of a profit if the head office was in the same Member State as the PE. A different rule is being applied merely because there is a transfer of inventory across a border. More to the point, an alternative – less restrictive route – could be adopted under which no profit is recognised until sale to an outside party.

At the current state of development of Community law, it is very hard to state categorically what the position is with regard to the attribution of profits to PEs.

This position may become clearer over the next decade. At best one can say that, at present, there is a risk that adopting the AOA may have aspects which prove to be incompatible with Community law.

3.2.5. A note on the constraints on future action

To an extent, the possibility that constraints would prevent a jurisdiction from adopting the AOA in its domestic law does not prevent the OECD from adopting the AOA as the correct interpretation of DTCs. DTCs operate to place a limit on the profits which may be attributed to a PE: they do not require a state to tax all those profits attributable to the PE.

It would, theoretically, be possible for a state which could not recognise a dealing between parts of the same enterprise to adopt the single enterprise approach in its domestic law. Domestically, therefore, the jurisdiction would only recognise a profit if there was a transaction with a third party: internal dealings would give rise to no taxable profit. The AOA would apply only in a DTC context.

This position is inherently unattractive. As has been seen from the branch reports, virtually all jurisdictions have aligned their domestic law rules completely or substantially with the position under DTCs. To accept a scenario where, for some jurisdictions, the domestic law could not be aligned with the authorised interpretation of DTCs is unattractive.

In the case of European Community states, it is not even clear whether they may enter into DTCs if the interpretation of those provisions is contrary to Community law.

The issue of constraints on future action is an important one which was deliberately set aside by WP6. One of the issues for the IFA Congress is how far these restrictions would prevent adoption of the AOA.

3.3. Possible reactions to the OECD's work

Branch reporters were asked to speculate as to the future. Not all branch reports dealt with these issues, but the responses of those that did are summarised below.

3.3.1. Acceptance of the AOA

Several of the existing OECD Member Countries were likely to adopt the AOA. This was the case in Austria where there is already legislation which applies aspects of the AOA. Branch reporters in Canada, Italy, Mexico and Norway all thought their jurisdiction would follow the AOA if adopted. In the UK, legislation has already introduced an approach based on the FSE concept.

The US branch reporter, however, thought it was unclear whether the OECD approach might be adopted; even if the AOA were adopted with regard to the interpretation of DTCs (and possibly only future DTCs), a taxpayer could elect out of the rules in any DTC which had an adverse impact on him.

The branch reporter for Switzerland thought that the AOA was unlikely to be implemented in Switzerland in the foreseeable future due to existing principles enshrined in Swiss law.

In non-OECD countries, there was a similar spread of reaction. The branch reporters for Argentina and Chile considered that their jurisdictions effectively adopted the AOA already because a PE was treated as a separate taxpayer.

The branch reporter for Russia thought that his jurisdiction would be likely to follow any solutions adopted by the OECD. The branch reporters for South Africa thought the position was not yet clear.

The position in India is particularly interesting as the branch reporter considered that the FSE approach was largely present under existing domestic law. However, DTCs signed by India are mainly based on the UN MTC which provides that expenses such as royalty payments can only be recognised to the extent of reimbursement of actual expenses. In cases of DTCs based on UN MTC it would not be possible to adopt the AOA.

The branch reporter for Sri Lanka indicated that there was no indication that the OECD proposals would be taken up for discussion in the near future.

At best this indicates sporadic support for the AOA, and the real prospect of conflict with DTCs based on the UN MTC.

3.3.2. The need for domestic legislation and the prospect of problems in implementation

Branch reporters were asked whether, if their jurisdiction adopted the AOA, there would be a need for a change to domestic law. Every branch report which addressed this issue thought that the answer was yes. It should also be recalled in this context that a number of jurisdictions have recently adopted legislation which may have been prompted by the OECD work.

In most jurisdictions the branch reporter thought that the revenue authorities would try, if it were possible, to ensure that domestic law was in line with the correct application of DTCs. To achieve this result would require domestic legislation in virtually every jurisdiction.

3.3.3. Would a change to the commentary suffice?

Branch reporters were asked to speculate whether – if the OECD were to adopt the AOA and to implement it by changes to the commentary, and not to change the wording of article 7 – this would be sufficient as a basis for the adoption of that approach in their jurisdiction.

Three OECD jurisdictions thought that a change to the commentary would suffice. These were Italy, Mexico and Switzerland (where, as mentioned, it was doubtful that the AOA would be adopted in any event). The Swiss reporter noted that a change to the commentary would probably apply to existing DTCs, but the point was controversial.

In three jurisdictions it was clear that a change in the commentary could not apply to pre-existing DTCs: this was the view taken in Belgium, the view (supported by jurisprudence) in France, and (though it was controversial) the view in the Netherlands.

The US reporter thought that changes to the commentary could not operate retrospectively but noted that in any event a taxpayer could elect against any adverse operation of a DTC.

The largest group of OECD countries took the view that a change in the commentary was probably sufficient, though the point was not clear in most jurisdictions. This was the situation in Denmark, Finland and Norway, for example.

For non-OECD countries, the South African branch reporters were very clear: a change to the commentary would not suffice. India, though not a member of the OECD, takes note of the commentary which has a persuasive value and has been relied upon by the judiciary. It was possible that a change to the commentary might suffice.

If one is seeking international consensus on the attribution of profits, the conclusion to which one is forced is that a change to the commentary, of itself, will not achieve that result. In a number of countries it is clear that the change would not apply to pre-existing DTCs, and in the largest group of OECD member countries, though it is probable that a change would suffice, the position was not certain.

In a sense, the conclusion has been clear since the first publication of DDI in 2001 – if one wants to achieve certainty based upon the WH/AOA, it will be necessary to change the wording of article 7.

3.4. Future options

This section considers some of the options now facing the OECD and individual jurisdictions. The section is divided into two parts: policy options and implementation options if it is decided to adopt the AOA. The purpose of this section is to highlight issues for discussion at the IFA Congress.

3.4.1. Policy options

First, one option which is not available is to do nothing: WP6 having published the DDs, countries have already begun to change their domestic law. In any event the DDs have highlighted defects in the existing commentary, even if the AOA were not adopted.

Second, if the OECD were to conclude that a number of countries were unlikely to adopt the AOA, then it might be preferable to retain the existing position, under which a limited degree of independence is ascribed to the separate enterprise. Some clarificatory changes to the commentary would be required, but no major change.

A third option would be to adopt the AOA only as it applies to banks, global trading and insurance companies. This approach could be based on the existing commentary which has always accepted that special considerations need to apply to banks and insurance companies and it would build on the earlier work of the OECD on banks. The AOA could then be applied in those sectors where it is likely to be of the greatest relevance. If this approach is adopted there would need to be adequate flexibility in the KERT approach to risk management and to avoid the problem of split assets. It would also be essential to deal with the outstanding issues resulting from the various methods for the attribution of capital and DAPes.

If this were the approach adopted, then DDII, III and IV could perhaps be published as additional chapters to the guidelines since, in essence, those DDs are primarily concerned with the application of a functional analysis to those sectors.

However, shorter versions of these DDs, with more emphasis on the underlying principles and less prescriptive detail, might be welcome. DDI could then become a short introduction to the “functionally separate and independent financial enterprise”, which would be the only enterprise to which the new approach would initially apply.

A fourth option would be to adopt the AOA itself, and apply it to all sectors, and not simply banks and insurance companies. Implementation of this approach is discussed below.

There is fifth option. This would be to go the whole hog and start to treat PEs as if they were separately incorporated entities, resident in their host jurisdictions. On this basis, there would be no reason why a PE would not have a credit-worthiness different from the enterprise of which it was part, and internal guarantees would be recognised. It would be treated as a resident of the host jurisdiction, and withholding taxes would be applied on notional payments. That is, we are told, already the position in a few jurisdictions. It would certainly require substantial changes to the MTC and lead to significant change in the application of domestic law.

There are two further options that should be mentioned.

The OECD might wish to defer the publication of any guidance on the DAPE issue. This issue has caused perhaps some of the greatest controversy and threatens to give rise to some of the most difficult implementation issues. It might be wise to defer this issue, whatever else is done.

Finally, all the discussion so far has focused on an approach which applies arm’s length, transactional transfer pricing to a PE. An alternative – never in fact considered so far – is to introduce some form of formulary apportionment between a PE and the enterprise of which it forms part. This would involve a major departure for the OECD and for many countries; it would require changes to the wording of the MTC. It is worth noting, however, that some commentators have recommended this.

3.4.2. Implementation options

This section considers implementation if the OECD were to adopt the AOA (for all sectors, and not just the financial services sector) as set out in the four DDs largely as they are presently drafted. At least four issues arise. First, whether it is sufficient to change the commentary and, secondly, if not, what changes might be made to the wording of article 7(1) to (3)? Thirdly, what of the OECD proposals for other parts of article 7? And, fourthly, how (if at all) to publish the DDs?

3.4.2.1. Changing the commentary

It is clear that adoption of the AOA will require changes to the commentary. Would changes to the commentary suffice? The answer from the branch reports appears to be no. In at least some jurisdictions changes would not apply to pre-existing DTCs; in others it is not clear whether they would apply.

If the commentary alone were changed, it would usher in a period of uncertainty and – in all probability – litigation, probably ending up with the position

that the new commentary applied to all DTCs in some jurisdictions, to no DTCs in others, and only to subsequently concluded DTCs in a third group.

3.4.2.2. Changing article 7

The alternative to implementing the AOA would be through adopting revised wording for article 7. What this would mean in practice is likely to be as follows.

For existing DTCs which adopted the current wording of article 7, the OT would apply (probably with some tidying up of the existing commentary). Over time, each jurisdiction would replace its existing DTCs with the new wording of article 7. With regard to these new DTCs, it would be very clear that the AOA applied. There would be certainty, but at the expense of two approaches operating side by side for a period of time. Ideally, some method may be developed for more rapidly amending the wording of a large number of DTCs. However, for a period of time the MTC would consist of article 7 (old version) with the current commentary (as amended), alongside article 7 (new version) and a new commentary.

If a new draft of article 7 were adopted, one simple approach would be for it to provide as follows:

“(1) [As present]

(2) Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a *functionally separate enterprise*.”

There would be no need for article 7(3) since expenses are clearly deductible in connection with such a functionally separate enterprise.

The new commentary would then explain the process of hypothesising the FSE, but in outline only. All the detail of the process of hypothesising the FSE, together with the DDII to DDIV details on functional analysis, would then be published, possibly in the guidelines.

The prospect of amending a large number of DTCs to accommodate the AOA is daunting. However, if one is seeking certainty, there may not be a short-cut alternative.

3.4.2.3. Amendments to the remaining parts of article 7

DDI (2004) has indicated that article 7(4), (5) and (6) may not be necessary.

So far as article 7(4) is concerned, the branch reports have noted a wide usage of presumptive methods of taxation for PEs. So long as these exist in many jurisdictions, it seems that there is a need for article 7(4). There would still be the problem of enterprises with inadequate books or records for which some form of presumptive taxation might be appropriate.

DDI (2004) suggests that article 7(5) is no longer appropriate. It has to be emphasised, however, that article 7(5) deals with an unusual situation. If an enterprise established an office in another jurisdiction merely for the purchase of goods, that would not give rise to a PE (article 5(4)(d) MTC). The situation

addressed by article 7(5) is one where there is a PE in state H, but part of that PE is engaged in purchasing goods. Article 7(5) makes it clear that no profits are to be attributed by the mere purchase of goods, and it seems better to remain.

Finally, article 7(6) ensures that the profits to be attributed to the PE are to be determined by the same method year by year. Again, so long as a range of jurisdictions adopt presumptive methods of taxation and there are several options for capital attribution, this paragraph provides a useful protection to the taxpayer.

3.4.2.4. How to publish the DDs?

DDs I to IV now comprise in excess of 139,000 words. By contrast, the MTC commentary is just over 140,000 words. Clearly, the DDs could not simply be included as the commentary to article 7. Assuming the OECD decides to endorse the AOA, it seems more likely that an amendment would be made to the commentary to article 7 to remove all provisions that might be seen as conflicting with the AOA. The remaining part of the DDs, would be published as either free-standing reports or possibly as chapters to the guidelines. It would be preferable to do this with an appreciably briefer summary of the relevant principles in each part.

3.5. Recommendations

This section contains recommendations for discussion at the September 2006 IFA Congress. These are entirely personal to the general reporters. In part, these recommendations are based upon the general reporters' own experience of this area over the past few years. In part, they are based upon the data drawn from the branch reports.

There is no rush to complete the work on the attribution of profits to PEs. It is better to get it right, and, if possible, to test drive any proposals before applying them more broadly.

At present, we would recommend a more limited approach to the application of AOA. Specifically, if the AOA is to be proceeded with, its application should be restricted to banks, global trading and insurance only. Even in its application in these sectors, revisions to the existing DDs are clearly necessary. Critically, it would be essential to deal with the outstanding issues resulting from the various methods for the attribution of capital. There will also need to be adequate flexibility in the discussion of KERTs as they apply to joint assets and risk management; and either it should be completely clear that article 5(5) MTC has not been changed by the KERT approach or, if changes are intended to align the approach of article 5(5) with the KERT approach, then these need to be considered further before conclusions can be drawn. There should be no application of the AOA outside these sectors for a number of years until application in these sectors was fully embedded and any difficulties had been worked out.

Since the existing commentary indicates that special considerations may apply to banks and insurance companies, it would not be necessary to make substantial changes to the commentary. However, the existing commentary needs clarification in some places, even without the adoption of the AOA. A working party should be established to rewrite the existing commentary to provide such

clarification, without fundamentally altering the basic principles on which it is founded.

Meanwhile, an alternative form of wording for article 7 might be developed which clearly supports the AOA, and a suitable commentary should be developed. Once that has been developed – and it may take a matter of some years – and if there is a consensus both as to the wording of the new version of article 7 and the new commentary and the wider adoption of the AOA, this should be brought in as a new version of article 7. It will then be entirely clear which DTCs are based on the old wording and the existing commentary and which are based on the new approach.

Building on our concerns expressed above in relation to article 5(5) MTC, the OECD should withdraw from the DDs the discussion of DAPEs. There should be wider consultation on this issue, and further clarification, particularly of the different types of DAPE and those circumstances (which may be limited to employees of an enterprise acting as dependent agents) where it would be appropriate to attribute profits to the DAPE over and above the arm's length payment to the agent enterprise.

Further work should be carried out to determine how far constitutional principles or general principles of tax law, or European Community law, prohibit or restrict the application of the AOA.

Separate work should be carried out to determine how far the concept of symmetry can be extended more broadly to ensure that the method of eliminating double taxation operates so far as possible in a way that best achieves this key objective. If necessary, an amendment to the wording of the MTC should be made to provide clear support for this symmetry. In the final analysis, this may prove to be the most lasting result of the OECD's recent work.

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Table of cases

Abbreviation	Full title
<i>Betts Hartley Huett</i>	<i>Betts Hartley Huett & Co Ltd v. CIT</i> , Calcutta High Court 116 ITR 425
<i>Cudd Pressure</i>	<i>Cudd Pressure Control v. The Queen</i> , Tax Court of Canada, 29 May 1995; Federal Court of Appeal, 19 October 1998
<i>Max Factor</i>	<i>Max Factor & Co v. FCT</i> , 84 ATC 4060, Supreme Court of New South Wales
<i>NatWest I</i>	<i>National Westminster Bank v. United States</i> , US Court of Federal Claims, 7 July 1999 (1999) 1 ITLR 725
<i>NatWest II</i>	<i>National Westminster Bank plc v. United States of America</i> , US Court of Federal Claims, 14 November 2003 (2003) 6 ITLR 292
<i>NatWest III</i>	<i>National Westminster Bank plc v. United States of America</i> , US Court of Federal Claims December 2005
<i>NorthWest Life Assurance</i>	<i>The NorthWest Life Assurance Company of Canada v. Commissioner of Internal Revenue</i> , US Tax Court, 12 December 1996 (1996) 107 TC 363
<i>Twentieth Century Fox</i>	<i>Twentieth Century Fox Film Corporation v. The Queen</i> [1985] 2 CTC 328

