Draft: not for quotation without reference to author

Do we need 7(3)? History and purpose of the business profits deduction rule in tax treaties

Richard Vann[*]

The rules in tax treaties for business profits of permanent establishments (PEs) have recently received their greatest alteration since they were created as a result of the *Report on Attribution of Profits to Permanent Establishments* representing over a decade of work by the Organisation for Economic Co-operation and Development (OECD).[1] One result is that the deduction rule has been deleted from the new business profits article in the OECD Model of 2010.[2]

This paper considers the history of the business profits deduction rule and, in that light, whether its purpose was to prevent certain kinds of discrimination against PEs or whether it was intended to operate as a qualification on the separate enterprise arm's length principle for PEs. It is argued that at least one purpose of the rule was non-discrimination in addition to and independent of that principle. As the principle has not changed in any way relevant to this issue, it is suggested that the OECD should restore a version of the deduction rule to the Commentary as an option for countries with the kind of rules at which it seems to have been directed. The history makes evident, however, that the rule was one manifestation of other deeper issues as to the appropriate way in which to allocate profits to PEs and those issues remain unresolved.

The Question

The former Article 7(3) (and Article 7(2) to which it is apparently linked) of the OECD *Model Tax Convention on Income and on Capital* (OECD Model) provided:[3]

> 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

[*] Challis Professor of Law, Sydney Law School.

[1] The Report exists in two "final" versions: OECD, *Report on the Attribution of Profits to Permanent Establishments* (2008) available at http://www.oecd.org/dataoecd/20/36/41031455.pdf, and OECD, *Report on the Attribution of Profits to Permanent Establishments* (2010) available at http://www.oecd.org/dataoecd/23/41/45689524.pdf, as well as a variety of earlier drafts. The former (called the 2008 Attribution Report) discusses the then current version of Article 7 on business profits and contained a recommendation that the article be redrafted to accommodate the conclusions reached on attribution. The latter was released contemporaneously with the final version of the new Article 7 (itself released in earlier drafts) and eliminates all discussion of the former Article 7 because it is intended as a companion to the new version of the article. As the interest here is on the history and purpose of the deduction rule, the former version will be referred to in this chapter.

[2] OECD, *Model Tax Convention on Income and on Capital* (Condensed version, 2010) 26-27.

[3] OECD, *Model Tax Convention on Income and on Capital* (Condensed version, 2008) 26-27. Because virtually all existing treaties are based on the 2008 version, its text and Commentary are reproduced as an Annex to the Commentary in 2010, note 2, 154-173, but for clarity references in this chapter are to the 2008 publication where that version is being discussed.

> same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
>
> 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Article 7(3) was often associated with the view that, as a qualification on the separate enterprise arm's length principle in Article 7(2), PEs cannot generally deduct certain internal (notional) charges, notably interest, royalties and management or service fees but only a proportion of actual expenses of these kinds incurred by the enterprise to third parties.[4] The competing views are expressed in the analysis of the deduction rule in the 2008 Attribution Report as follows:[5]

> The perspectives on Article 7(3) tend to focus on two competing interpretations. One interpretation is that the provision is aimed primarily at ensuring expenses of a PE's activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the PE's jurisdiction, or is not incurred exclusively for the PE. The other view is that Article 7(3) modifies the arm's length principle articulated in Article 7(2), in that[6] … another part of the enterprise cannot recover more than its costs with

[4] OECD 2008 Model, note 3, Article 7 Commentary paras 28-49 at 126-132. The Commentary was altered as far as was considered possible in 2008 as a result of the 2008 Attribution Report, note 1, to water down this view; it is stated more clearly in the previous 2005 version, OECD, *Model Tax Convention on Income and on Capital* (Condensed version, 2005) Article 7 Commentary paras 17-23 at 121-126. Again for clarity reference will be made to the 2005 version where that more clearly reflects the prevailing view before the 2008 Attribution Report.

[5] Note 1, Part I para 285; the OECD had available to it a much earlier unpublished version of this chapter when this material was drafted and closely followed the analysis of that version in paras 284-290; further looking into the history suggests that there were deeper factors at play and that the ambiguity noted as well as other ambiguities were present from the beginning.

[6] The other view came in two parts, the first of which has been deleted in the quotation. It was that "costs allocable to a PE should be deductible even if they exceed what an arm's length party would incur." Although it is possible that the deduction rule is thought in some quarters to deal with this matter, the problem was commonly raised in relation to Article 7(2). It concerned whether an excessive payment by the enterprise to an associated but separate enterprise which was not a resident of the PE country could be adjusted under Article 7 (Article 9 of the treaties between the country of residence of the enterprise or of the associated enterprise on one side and the PE country on the other side not being relevant as it requires an enterprise of the PE state to be involved). It arises out of the concluding words of Article 7(2) and in a further variant was thought also to create problems for adjustments between two PEs of the same enterprise in different states as opposed to adjustment between the (part of the) enterprise in the state of residence and the PE state. The 1977 Commentary expressed the view that adjustments were possible for both variants under Article 7(2) but also provided that countries concerned with the wording could alter it, OECD, *Model Double Taxation Convention on Income and Capital* (1977) Article 7 Commentary para 10 at 74. In 1994 a further (confusing) change to the Commentary was made suggesting that the problem only existed between PEs of the same enterprise but containing an alternative text that seemed to cover off both variants, OECD 2005 Model, note 3, Article 7 Commentary para 11 at 117. All reference to the matter was dropped from the Commentary in 2008. The new 2010 Article 7 deals with the matter expressly, note 2, Article 7 Commentary para 24 at 136 though with a reverse confusion – the new text can deal with both variants but the Commentary regards it as a problem only for associated enterprises. Treating this matter as an Article 7(3) problem

regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties.

The Report concluded that the first interpretation was correct historically but that the second interpretation which regards Article 7(3) as a qualification of Article 7(2) was adopted by a number of countries, even though they agreed that modification of the arm's length principle in this way was not desirable. Deletion of Article 7(3) was a simple way to resolve the issue though it was not suggested in the 2008 Attribution Report which regarded it as "needed" if understood in the sense of the first interpretation above; deletion came later as the redrafting of Article 7 occurred.[7]

The same part of the former Commentary dealing with deductions for interest, royalties and management or service fees also canvassed the issue of whether any profit should be attributed to good management of the enterprise and concluded in the negative. This discussion has a long history and is part of deeper divisions about the appropriate way to allocate profits to PEs, including the treatment of deductions. It helps to explain why ambiguity surrounded Article 7(3) and why its deletion does not represent a resolution of the deeper divisions.

League of Nations

Allocation of profits to permanent establishments was one of the matters left over for further work after the three original income tax treaty drafts were developed in the period 1925-1928 which taxed PEs on the portion of the income produced in the PE state and were very vague as to how this amount was to be determined.[8] The follow up work was started by the newly established Fiscal Committee in 1929 when it was decided to obtain detailed information on current practice and for this purpose to dispatch a questionnaire.[9] At the 1930 meeting, Adams, the main US delegate of the time, summarised the results of the questionnaire on the methods used in various

may have been regarded as strengthening the case for its omission. The matter is not further discussed in this chapter.

[7] Three other provisions in the former Article 7 suffered the same fate: the formulary apportionment fallback rule in paragraph 4, the purchase rule in paragraph 5 and the continuity of method rule in paragraph 6. The removal of the first two is clearly signalled in the 2008 Attribution Report, note 1, Part I paras 291-299, and of the third was the natural corollary as it was designed to prevent taxpayers or tax administrations making strategic switches between the main method and the fallback method; by contrast the deduction rule is described as needed at para 56.

[8] Much of the League of Nations published material is collected in Joint Committee of Internal Revenue Taxation, *Legislative History of United States Tax Conventions* (US Government Printing Office, 1962) Vol 4, "Model Tax Conventions" (hereafter LHUSTC4) available online at http://setis.library.usyd.edu.au/oztexts/parsons.html, item 3. Prior to 1930, the discussion of taxing business profits was brief and general, without any mention of deductions. In 1923 the economists' report had a two page addendum not reproduced in LHUSTC4 saying that theory did not provide a clear answer and referring to various ways briefly that profits could be determined, Bruins, Eunadi, Seligman and Stamp, *Report on Double Taxation* (League of Nations, 1923, document EFS73 F9) 52-53. In 1925 there was discussion of empirical/formulary methods in Europe, LHUSTC4 at 4076, which seem to be approved but the final resolutions, LHUSTC4 at 4091, talk in terms of profits being based on accounts. The 1927 draft model favours accounts as the primary method, LHUSTC4 at 4125, while the three 1928 models and commentary drop references to accounts and seem to go back to empirical/formulary methods, LHUSTC4 at 4162 (draft 1a), 4170 (draft 1b), 4173 (draft 1c), 4166 (commentary).

[9] LHUSTC4, note 8, 4199.

states and for apparently the first time the treatment of deductions receives brief mention:[10]

> *When a company has a debenture debt, is the charge on this debt ascribed solely to the real centre of management or is it distributed between the different permanent establishments? In the latter case, what is the system of distribution?*
> Practically all countries recognise the rule of apportioning the interest charge on a debenture debt of the company to the various branches or sources as a part of the overhead or debt in the proportion that they are concerned, or in proportion to capital employed (Italy, Sweden), to assets (Japan), to profits (Spain), or to income, receipts or some other factors (Germany), or to gross income (United States of America). Belgium regards such charges as attaching exclusively to the foreign central office responsible for the issue, unless a part of the loan has been especially allocated for the requirements of the Belgian establishments. Where the head office is abroad, Portugal takes no account of debts. As Great Britain does not allow interest to be deducted in determining assessable profits, no question of apportionment arises.

It is telling that the first deduction issue raised relates to interest as consensus on a single method to deal with interest still eludes the OECD 80 years later even after the recent years of work on attribution.[11] All approaches referred to by Adams seem to involve allocation of actual interest expense. The reference to overhead may also suggest that the principle extended beyond interest.

Carroll Report

After receipt of a grant from the Rockefeller Foundation it was possible to carry out this work on a significant scale and the task was entrusted to Adam's assistant, Carroll.[12] He supervised a five volume study of profit allocation consisting of three volumes describing the treatment in many countries, one volume setting out the accounting treatment of branch profits and one volume containing Carroll's conclusions from the study. He poses the problem of dealing with overhead as the main question to be answered in allocating profits to a local PE of a foreign enterprise:[13]

> The general concept of taxable net income being the difference between gross income and allowable expenses incurred in earning such income, one of the principal problems of allocation is presented when the income arises in one country, whereas some of the incidental expenses are incurred in another country. Should income be allocated to the place of expense in order to cover it, or should expense be allocated to the establishment where the income arises and is entered in its books? Some items of income and expense are definitely

[10] LHUSTC4, note 8, 4218. His summary also canvasses most of the other issues related to deductions that were examined at greater length in the next stage of the project.
[11] The 2008 Attribution Report has a number of alternative "authorised OECD approaches" in relation to interest at a number of levels, note 1, Part I paras 136-206.
[12] LHUSTC4, note 8, 4209-4210, 4229-4230.
[13] Carroll, *Taxation of Foreign and National Enterprises Volume IV Methods of Allocating Taxable Income* (League of Nations, Geneva, 1933) at paras 333, 336, available at http://setis.library.usyd.edu.au/oztexts/parsons.html, item 5.

> allocable to a certain establishment, but there is generally a large residuum of items of income and expense which are not definitely allocable, and it is these items of income and expense that present the most difficult problems in allocation…
>
> The principal category of not definitely allocable expenditure is that incurred at the real centre of management of the enterprise which benefits the enterprise as a whole, such as interest paid on borrowed capital which is used throughout the enterprise, including establishments in other countries, and items of general overhead, such as salaries of directors and officers charged with the general administration of the business, the expense of a central staff of accountants or other technical experts, and sometimes the expense of a general advertising campaign conducted at the real centre of management. Should any profit be ascribed to the activities of general management as such, or the other indicated activities which take place at the real centre of management?

The first paragraph quoted suggests that the process is the mechanical one of moving expense to income or income to expense to achieve the necessary matching but the second indicates that more is at stake – where do the profits end up as a result of this process. Carroll's answer to this question is long and convoluted but can be summarised as follows.[14] He identified the case of manufacture of goods by a PE in one country and sale by a PE in another country as the principal issue that needed to be dealt with and, perhaps surprisingly in light of later developments, regarded banking and insurance PEs as not raising such difficult allocation problems.

The large majority of countries used the accounts of the enterprise as the means to allocate profits which he approved in preference to what he called empirical methods (such as a percentage of sales revenue being allocated to the PE of sale) and fractional apportionment (now commonly called formulary apportionment) . Most countries also used the sale between independents method for dealing with the case of manufacture in one country and sale in another (that is, treated the manufacturing PE as selling the goods to the sale PE) and in determining the profits taxable in each country allocated part of the interest and overhead expense incurred by the head office to PEs on some ratio basis, though often being quite strict in policing the allocation with the common result that such expenses were not recovered in the sale PE. The US in particular had specific legislation allowing a proportion of head office overhead for PEs of foreign enterprises but in practice found that this treatment was not reciprocated for US enterprises with PEs abroad.[15]

---

[14] Note 13, principally chs V, XII.

[15] League of Nations, *Taxation of Foreign and National Enterprises* (League of Nations, Geneva, 1932) 245-246 in chapter on the US by Weare and McMorris. This publication is effectively Volume I of the Carroll study though not labelled as such; the same point is made at various other points in the summary of US law and by Carroll in his general discussion. By this time there was jurisprudence in the US indicating that expenses incurred outside the US in relation to a US business or as general overhead or interest could be deducted even in relation to income years before enactment of the detailed source and deduction allocation rules in 1921, *Louis Roessel & Co Ltd* (1925) 2 BTA 1141, *Standard Marine Insurance Co Ltd* (1926) 4 BTA 853; cases involving the detailed rules began to appear in the 1940s (concerning income years in the 1930s), *Third Scottish American Trust Co Ltd* (1941) 41-1 USTC 167, *Balfour Williamson & Co Ltd* (1943) 1 TCM 852. The litigation suggests that the US had similar difficulties with overhead and interest expenses as did foreign countries. The language of apportionment used in the US was "there shall be deducted the expenses, losses, and other

Carroll fundamentally disagreed with the sale between independents approach and preferred what he called the remuneration for services approach, that is, in the manufacture and sale case the PE of manufacture was treated as retaining title to goods and the PE of sale was treated as a sales agent to be remunerated for selling services on a commission basis.[16] Indeed Carroll argued for extension of the remuneration of services approach to as many PE cases as possible where there was shared income and expense. He gave several reasons for this very strong preference.

First, he regarded the real centre of management of an enterprise as the main generator of its income and hence it should receive the main share of profits. In this regard he often mentions the Swiss system of the *praecipuum*,[17] a percentage of net profit awarded in priority to the real centre of management in recognition of the value of management before profits are allocated to PEs for other activities. Although that concept was used as part of a system of fractional apportionment of net profit which Carroll rejected except as a last resort, he clearly regards the underlying idea as correct and effectively produced by the remuneration for services approach.[18] Secondly, Carroll regards the remuneration for services approach as preferable administratively because it can be based purely on activities and accounts in the country of the sale PE whereas the sale between independents approach requires verification of the factory price outside the country of sale. Thirdly, it deals with timing issues and overall losses better than the sale between independents approach.[19] Fourthly, it required less fictions; while Carroll proposed the separate enterprise arm's

---

deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income."

[16] Note 13, para 677, "The control and management, financial and technical, are centred there [the principal establishment/real centre of management]. At the meetings of the directors the decisions are taken which make or break the enterprise. There the risks are centred. The profit or loss results from all the activities of the enterprise taken together, but how can the part attributable to the establishment in each country be most readily measured? If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services." In other words Carroll supports the approach that the recent spate of business restructuring in a separate enterprise context has been designed to achieve, see Vann, "The Secret Agent's Secrets" [2006] *British Tax Review* 345.

[17] Variants of this term are used in different languages, Carroll himself referring to "*préciput*." The Latin version used in the text literally means that which comes first. The system still continues in Switzerland, Oberson and Hull, *Switzerland in International Tax Planning* (Amsterdam, IBFD, 3rd edition, 2006) 106-110; the amount varies case by case and is usually stated to be in the range of 10% and upwards to over 30% of total profits, depending on what is done at the real centre of management.

[18] There is also a strong undercurrent in the discussion of greedy overreaching by countries of sale in the amount of profits they allocate to sale PEs; the remuneration for services approach reduces that problem significantly in Carroll's view.

[19] If the sale between independents approach is used a notional profit arises to the PE of manufacture when goods are sent to the PE of sale, but this involves recognition of income before the enterprise as a whole realises any income and may lead to adjustment of the notional profit if the goods are sold at a loss. Under the remuneration for services approach on a commission basis, neither the PE of manufacture nor the PE of sale recognise income until sale and losses are thrown onto the real centre of management if the sale is at an overall loss as the PE of sale still earns its commission. Carroll admitted one exception for the export of raw materials like agricultural produce and minerals from the country of production to which he would apply the world market price at the time of sale to determine the profit of the PE in the country of production.

length principle for PEs he considered that the theory should not be pushed too far and should be moderated by practical considerations.

Fifthly, and most germane to the issue under consideration, Carroll regards the remuneration of services approach as superior as it effectively eliminates the need to allocate interest and overhead; all that is necessary is to use the appropriate commission to reflect the activities undertaken by the sale PE and then deduct the local expenses of that PE. If a substantial part of the profits are being allocated to the real centre of management, then the overheads incurred there will be deducted against those profits, including interest expense as an enterprise selling on commission requires little or no capital. In this regard the sale between independents approach is doubly disadvantaged: it requires allocation of interest and overhead which he regards as an impossible task,[20] and also requires checking to ensure against double counting of overhead as some or all overhead expense is likely to be included in the notional sale price by the PE of manufacture to the PE of sale.

The overall outcome was that Carroll favoured the use of accounts and the separate enterprise arm's length principle which was in use by a majority of countries but rejected the most commonly used sale between independents approach in favour of the remuneration for services approach. In the result he did not have to develop elaborate principles for allocating interest and overhead though he recognised that the sale between independents approach required such principles. Two short paragraphs deal with deduction of interest and overhead under his preferred approach.[21] Interest would only be allowed on actual loans raised by the PE to the extent that the loans did not exceed what was appropriate for the PE; deduction of overhead would be avoided, with the ratio of gross profits of PEs used for allocation to the extent that it was considered appropriate to allow overhead.

Except in the case of banks, Carroll did not consider it appropriate to allow deductions for notional interest to PEs. He justified this approach in part on the legal impossibility of a loan from head office to PE but the same is true of the notional service or sale contracts required under the remuneration for services and sale between independents approaches. What he really seems to mean is that no notional contract should be constructed that does not rely on real inflows or outflows from the enterprise as a whole and this is in effect another argument for the remuneration for services approach because commission is tied to an external transaction. As borrowings by banks relate to their loans to customers, this condition is satisfied although the allowance of interest in intra-enterprise loans is effectively an application of the sale between independents approach.[22]

---

[20] In relation to interest, Carroll adds further issues against allocation in addition to those mentioned in the text: the policy problem of distinguishing between debt and equity to prevent deduction of returns to equity; a technical reason having to do with the legal nature of a PE (not separate from and therefore unable to contract with the rest of the enterprise as to which see further below note 22 and text); and a practical reason based on the difficulty of determining the source of funds of a PE.

[21] Note 13, paras 681-682.

[22] See note 13, para 679 for the legal impossibility idea. Although he does not express it in terms of what the OECD has now labelled the relevant business activity and functionally separate entity approaches to attribution, the clear impression from Carroll's work is that his mindset is in terms of the former rather than the latter which is now the authorised OECD approach, 2008 Attribution Report, note 1, Part I paras 59-79. As Carroll comes from the US his approach in this regard is not surprising since US domestic law allocation rules are built on the relevant business activity approach.

Although Carroll at several points notes problems with royalties and management or service fees being used along with interest deductions to divert profits, they receive virtually no discussion in his proposed allocation regime for PEs. The main reason again flows from his preference for the remuneration for services approach. To the extent that research, services and management occur at the real centre of management, no expenses need to be allocated out and no contract of services from the real centre of management to the PE needs to be constructed as the profits from these activities accrue automatically to the real centre of management. To the extent that PEs carry out research giving rise to intellectual property or services like advertising without themselves utilising the research or services to earn income from third parties or being directly involved in the income earning activities of the enterprise, Carroll regarded the PEs in relation to these activities as only indirectly contributing to income and not generally to be rewarded for the research or services even on the remuneration for services approach. Rather the expenses of such PEs are to be allocated to the PEs of the enterprise or the real centre of management which carry out the activities directly earning the income of the enterprise. Carroll apparently does not feel any tension in rewarding these activities substantially when done at the real centre of management and not at all when done elsewhere, nor in relation to the allocation of overhead problems they reintroduce which he has otherwise assiduously avoided.

Draft Convention

At the meeting of the Fiscal Committee in 1933 after completion of Carroll's endeavours, a draft convention generally following his recommendations was produced containing the original versions of what became in the OECD Model Article 7 on Business Profits and Article 9 on Associated Enterprises, the latter covering adjustment of transfer prices between separate enterprises. There is no express mention of the fundamental divergence between Carroll's preferred remuneration for services approach and the majority practice of the sale between independents approach, the Committee merely noting:

> In view of the diversity of national laws and the extreme complexity and variety of the individual cases that arise, the Committee thought it advisable to prescribe only general principles. Mr. Carroll's very detailed report can be usefully consulted as a guide for the application of those principles to the complex cases that are encountered in practice.

Specifically in relation to interest deductions, the Committee stated in the brief Commentary:[23]

> [The equivalent of Article 7(2) of the OECD Model] does not expressly regulate the allocation of interest on debts, but it follows from the principles laid down … that such interest will not be attributable to an establishment unless it refers to debts contracted by the permanent establishment itself commensurately with its own needs as an independent enterprise. In the case of debts contracted by the international enterprise, a portion of the interest may be deducted from the income of the dependent permanent establishment, provided that the money borrowed has been used for the particular

[23] LHUSTC4, note 8, 4246.

> requirements of that establishment, that the amount reasonably corresponds to what would have been required by an independent enterprise and that the interest charges have not been included in the prices and remunerations entered in the accounts.

This view differs from the treatment of interest by Carroll under the remuneration for services approach and fits more closely with the sale between independents approach. The underlying assumption seems to be that there generally should be no deduction for notional interest. The 1933 draft contained, as Carroll suggested, a special article for banks which applies the general rules but also authorises deductions for internal interest charges at the interbank offered rate other than in respect of the permanent capital allocated to the PE, which is consistent with the view that notional interest was not generally allowed in the sense that a special rule was required for such deductions.[24]

The more interesting point is that this discussion occurs in a context where there is no equivalent to Article 7(3) – that provision does not make its appearance until later. The only provision that comes close to the issue in the 1933 draft states that business income does not include certain categories of income, and adds:[25]

> There shall be excluded with the above-mentioned items of income the related expenses (including general overhead) and charges.

So overhead expenses get an express mention only in this negative way, but the suggestion conversely is that for business income they are deductible. It is not clear, however, that the reference to overhead extends beyond the overhead expenses of the PE concerned to other overhead of the enterprise as a whole.[26] Deductions in the form of royalties and specific service fees do not receive any mention.

The Reports of the 1935 and 1936 meetings of the Fiscal Committee do not advance matters with regard to deductions although there is some redrafting, renumbering and expansion of the allocation rules for business profits. At this point the *Draft Convention on the Allocation of Business Profits* (1935 draft) in part read:[27]

[24] LHUSTC4, note 8, 4242, 4247. While the minutes of the meeting refer to the article on banks being necessary because it "derogates in certain essential points" from the general provisions on calculation of PE profits, it does not specifically identify this case (or any other case) as one of them. Further the Commentary on the banking provision states, "Moreover, it precludes the possibility of deducting interest on sums advanced to a permanent establishment in lieu of capital. As a matter of fact, this latter rule could normally apply also to enterprises other than banks." Which may suggest that internal interest charges are deductible. Perhaps this part of the banking provision is simply intended to set the interest rate to be used and to deny the deduction on PE capital (though its drafting, LHUSTC4, 4244-4245, suggests in relation to deductions that two functions are being performed, providing for a deduction which would not otherwise be available and setting its rate).

[25] LHUSTC4, note 8, 4247.

[26] This approach is consistent with Carroll's recommendations for drawing the line between business and other income and deductions associated with non-business income, note 13, paras 616-617. Carroll apparently did not feel the same difficulty of apportionment in this context as he did in relation to business income though the reason why is not clear.

[27] LHUSTC4, note 8, 4253-4254, Article III. This draft generally follows Carroll's recommendations but without any indication of a preference for the remuneration for services approach.

> 1. If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated.
>
> 2. The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.
>
> 3. If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.
>
> 4. If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting.

Paragraph 1 corresponds to Article 7(2) in the OECD Model except that the latter does not contain the reference to the use of accounts. Paragraphs 2 and 3 have no equivalent in Article 7 while the first sentence of paragraph 4 corresponds to the former Article 7(4) on formulary apportionment.

Mexico and London Drafts 1940-1946

For the next few years the Fiscal Committee was preoccupied with other matters but in 1939 a revision of the 1928 drafts was suggested.[28] Notwithstanding the

[28] Although not expressly mentioned in the Report of the 1939 meeting, the suggestion appeared in a pamphlet published by the League of Nations, Carroll, *Prevention of Double Taxation and Fiscal Evasion: Two Decades of Progress under the League of Nations* (Document II Economic and Financial 1939 IIA 8) 43 which is referred to in the Report, LHUSTC4, note 8, 4292; the suggestion is attributed to the 1939 meeting in the Report of the 1946 meeting, LHUSTC4, 4304. The need to make studies of

intervention of World War II considerable progress was made on this project, including the appearance in the drafts for the first time of the business deduction rule and publication of the Mexico 1943 and London 1946 drafts.[29] The dominant figure during this period was once again Carroll.[30] He prepared a lengthy document on treaty practice and revision of the League drafts, part of which was incorporated in an official League of Nations document.[31]

The former includes a section discussing the taxation of business profits and not surprisingly emphasises the influence of Carroll's earlier study and the League draft on treaty practice in relation to taxation of PEs. As evidence Carroll primarily relies on the slightly increased appearance of a power of rectification of PE accounts in which he includes versions of paragraph 2 above in the Draft Convention and the adoption of variations of the 1935 draft's equivalent to OECD Model Article 9. The latter of course does not refer to PEs but to separate enterprises.[32] He notes that there is variation in provisions he regards as influenced by paragraph 2 but does not mention that none of them contain the criterion of independent parties dealing at arm's length in that paragraph or paragraph 1 which is the central provision for the separate enterprise arm's length principle in the PE context.

The evidence for adoption of the work in actual treaties in relation to PEs is sparse. The nearest referred to by Carroll is the France Switzerland treaty 1937 which in the equivalent of the 1935 draft paragraph 2 refers to:[33]

---

the treaties concluded after the 1928 models to identify trends and the influence of the models was referred to at the 1936 and 1937 meetings of the Fiscal Committee, LHUSTC4, 4261, 4270.

[29] Naturally few documents were published in this period and it is necessary to rely on the League of Nations archives to understand developments. The fullest account of the period is found in Simontacchi, *Taxation of Capital Gains under the OECD Model Convention* (Kluwer, 2007) 62-119. The author wishes to thank Stefan Simontacchi for making available the main documents from this period relating to the deduction provision.

[30] He had attended all League of Nations Fiscal Committee meetings in the period 1927-1946 except for 1931 and 1933, was Chair at the 1938 and 1939 meetings, although no longer in government employment, and was the driving force during the war years.

[31] Carroll, *Revision of the 1928 Draft Conventions on Double Taxation in the Light of Treaty Provisions* (1939-1940), League of Nations Fiscal Committee, *Study by Mr Mitchell B Carroll on the Draft Conventions Prepared by the General Meeting of Government Experts on Double Taxation and Tax Evasion of 1928* (Document F/Fiscal/123, 1940), both provided by Stefano Simontacchi.

[32] The 1935 draft, judging by treaty provisions up to 1940, was clearly much more influential for separate enterprises than it was for PEs. The earliest version appears in the France US treaty of 1932, negotiations for which were initiated by France in February 1930, Joint Committee of Internal Revenue Taxation, *Legislative History of United States Tax Conventions* (US Government Printing Office, 1962) Vol 1, 8 and finalised by mid 1930, Carroll, note 28, 49. This was around the time Carroll commenced his work on allocation of profits. Carroll was originally in the US Department of Commerce which had different objectives to a fiscal authority (increasing the prosperity of US business); he spent a short time with US Treasury and then was in private practice. He was associated with various business and legal groups throughout including the International Chamber of Commerce, US Trade Council, American Bar Association and Inter-America Bar Association.

[33] Carroll, note 31, Part III, 24-25. France used this kind of language in several other treaties around this time in relation to its tax on income from movable capital, eg, France Sweden 1936, France Romania 1942. The English versions of the treaties referred to in this article are generally sourced from the Tax Analysts Worldwide Tax Treaties Database available by subscription from www.taxanalysts.org or www.lexis.com; in turn for the period to 1945 these seem to be based on League of Nations translations of the treaties which were not in English as an original language.

> the profits or benefits (if any) derived indirectly from the fixed establishment, or conveyed or assigned to third parties, whether in the form of increases in the price of purchase or reductions in the price of sale or in any other form.

The closest adoption of the 1935 draft in relation to PEs seems to be its incorporation by reference as a guide in the Hungary Netherlands treaty 1938 Article 4(3):[34]

> If an undertaking has permanent establishments in both Contracting States, each State shall tax that part of the income which is earned in its territory. For the purpose of giving effect to this article, the supreme tax authorities of the two Contracting States shall by common accord lay down rules of apportionment and shall be guided in this connexion by the "Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation" prepared by the Fiscal Committee of the League of Nations.

In the discussion of empirical (percentage of turnover) methods Carroll refers to early Austrian arrangements that used a customary commission basis in the state of sale where no other specific method applies, harking back to his preference for the remuneration for services approach in the country of sale. He also has a section on the *praecipuum*, though not by that name, which indicates that a special allocation to the real centre of management was often expressly excluded in treaties, though found in a few treaties.

In the League document reproducing parts of Carroll's study, there is a discussion of the 1928 draft 1c which Carroll regarded as dominant in treaty practice of the three 1928 drafts and a suggested new draft. In the discussion of draft 1c, Carroll asks whether the following amendments relevant to the discussion here should be made:

> a) that where the activities of a branch are in the nature of those of a commissions agent or broker, the assessment may be based on the customary commission for such services …
> b) that no allocation of income shall be made to the head office of the enterprise unless profit-making operations are affected there; or that a minimum percentage of net income should be allocated to head office …

His draft includes an addition to the percentage of turnover provision in paragraph 3 of the 1935 draft of the customary commission basis but nothing on a special allocation to the real centre of management. Deductions do not receive any mention in either document outside the special provision for banks.

A sub-committee of the Fiscal Committee met in the Hague in April 1940. The draft it produced did not include Carroll's suggestion for the use of customary commission but did adopt the *praecipuum*:[35]

[34] Carroll was apparently unaware of this treaty at the time as it is not mentioned in the list of comprehensive treaties in his 1939 pamphlet for the League of Nations, note 28. The pamphlet was less forceful in asserting acceptance of the Draft Convention and Carroll's work, though it does state that the accounts "would be verified by reference to local factors, thereby obviating the need of recourse to head office accounts" which it will be recalled was one justification for the remuneration of services approach, and he regards his recommendations as having been adopted by the Fiscal Committee, note 28, 28, 31.

> If by application of the above-mentioned rules the total profit of the enterprise which is attributable to the real centre of management of the enterprise is less than … % of that profit, that part of the profit shall, however, be attributed to the real centre of management as a compounded assessment (*de facon forfaitaire*) for purposes of taxation and shall not be taxable in the State where the other establishments of the enterprise are situated.

When this draft was considered by the first regional tax conference in Mexico in June 1940, Carroll's customary commission suggestion was added to the percentage of turnover provision corresponding to paragraph 3 of the 1935 draft. The *praecipuum* was replaced with the first appearance of the deduction rule:[36]

> In determining the net income on the basis of the separate accounting of the permanent establishment, there should be deducted a properly apportioned part of the general expenses of the head office of the enterprise.

There are a number of questions raised by this sudden appearance of a specific provision on deductions. If the *praecipuum* approach was regarded as unacceptable why not just delete it, rather than replace it by the deduction rule. The answer to this question is suggested by one of the few existing treaties which referred to deductions, The closest provision to this deduction rule in an earlier treaty is in France Switzerland 1937:[37]

---

[35] Legal of Nations Fiscal Committee, *Second Report of the Meeting of Members and Corresponding Members of the Fiscal Committee, Mexico City, June 3-15, 1940 Prevention of International Double Taxation, Income & Property Taxes* (Document F/Fiscal/127, 1940) 11, footnote 1. This document provided by Stefan Simontacchi contains the 1940 Mexico draft and in the footnotes records its variations from the Hague draft.

[36] Note 35, 10 (commission provision) 11 (deduction rule). The author has not been able to trace a direct source for this form of drafting. The obvious candidates are the US provision, note 15, and the French provision next quoted in the text. Though each expresses the same idea, neither seems to be the direct source. The 1935 draft in relation to PEs similarly does not seem to have any history in actual treaties and this provision seems to continue the trend. The other main change to the paragraphs of the 1935 draft quoted above was the addition of a corresponding adjustment rule to paragraph 2. In the draft overall the definition of business profits in the earlier versions has disappeared and with it the related rule on deductions; the text of the drafts regarding financial institutions remains essentially the same but according to the Commentary the provisions "state explicitly certain corollaries of the method of separate accounting" rather than derogating from the general principle, LHUSTC4, note 8, 4341. By contrast Carroll still thought it was "necessary to overcome the general rule of law that one part of a legal entity cannot charge interest to another" (Carroll, "Allocation of Income for Tax Purposes" Paper for 1945 Meeting of Tax Committee of the Inter-America Bar Association, Santiago, 6, again provided from the League archives by Stefan Simontacchi).

[37] Protocol Ad Article 4 para 7. This was also the treaty Carroll referred to as the closest adoption of the League 1935 draft for allocation of profits to PEs, note 33 and text. The Hungary Switzerland 1942 treaty is an instructive comparison; it contains the same rule for allocating profits to PEs which Switzerland borrowed from its French treaty but retains the *praecipuum* and so omits the deduction rule. Switzerland has a number of other treaties still in operation which permit the *praecipuum* generally or in specific cases, Denmark 1973, Ireland 1966, Netherlands 1951, Sweden 1965; for later usage of this provision by France, see note 41 and text. Very occasionally other treaties prior to 1946 had provisions on expenses in a formulary apportionment approach such as Czechoslovakia Poland 1925 Article 2(3), "The common receipts of such establishments shall, as a general rule, be allocated in proportion to the funds and capital allotted to those establishments, and the common expenditure shall be allocated in proportion to the receipts. In certain cases the Finance Ministers of the two States may agree upon a different system of allocation. … Receipts obtained in one country from the sale of goods

It is understood that a proportion of the general expenses of the head office of enterprise, shall be debited to account of the several permanent establishments.

Carroll in his study of treaty practice and suggested revision of the League drafts noted that this treaty seemed designed to preclude the *praecipuum* through its exclusion of the head office from being a PE if no profit earning activities were carried out there.[38] As noted previously the Swiss *praecipuum* approach allocated a certain amount of net profit to headquarters activities which meant in effect that head office expenses were deducted against that income. If no such headquarters allocation was accepted by the other country, the alternative was to ensure that the head office overhead expenses were appropriately allocated to PEs.[39]

While this link between the exclusion of the *praecipuum* and the inclusion of the deduction rule provides an explanation for the change made to the Hague draft, it would mean that the deduction rule was only required in a very limited number of cases – for countries which used the *praecipuum* concept and agreed in a treaty to give it up. Moreover, viewed from this perspective it seems to be only a precautionary rule as it is assumed in other contexts in the Hague and 1940 drafts that revenue is necessarily brings with it related expenses without special rules.[40] France nonetheless continued the practice established by the 1937 treaty with Switzerland of including its own particular forms of the rectification of accounts and deduction provisions in many of its subsequent treaties until the end of the 1950s.[41] Something more would seem to be involved suggesting a broader purpose for the rule.

Although the minutes of the meeting where the change occurred do not provide much insight,[42] the change continued through the two subsequent Mexico (1943) and

---

purchased in the other country, and the expenditure corresponding to such receipts, shall as a general rule be divided equally among the establishments concerned in the transaction."

[38] Carroll, note 31, Part III, 28.

[39] Avery Jones and others, "Origins of Concepts and Expressions Used in the OECD Model and Their Adoption by States" (2006) 60 *Bulletin for International Taxation* 220, 242 note 258 in relation to Switzerland UK 1954 and the Swiss view of the deduction provision there. Although there was no actual deduction of head office expenses under the Swiss system which operates as a formulary method of allocating *net* profit of the whole enterprise, the separate enterprise arm's length principle operating through separate accounts require that revenue and expense of a PE be identified and so required adaptation to expressly include or exclude the *praecipuum* idea. *Praecipuum* could be included as an overriding amount of net profit as in the Hague draft or by allocating some proportion of revenue to the head office and with it part of the expense. If it were excluded then the expense of head office management activities that related to PEs needed to be moved to the PE, compare note 13.

[40] As seen above, note 25 and text, the definition of business profits in the 1930s drafts worked by expressly excluding certain items of income and their related expenses. Although this provision is dropped from all the 1940s drafts, the issue of excluding certain revenue and expense remained. Both the Hague and 1940 Mexico drafts (though not the 1943 Mexico and 1946 London drafts) contained an exclusion from attribution of profits to PEs for purchasing activities. When this was picked up by the OECD, the Commentary consistently provided that related expenses could not be deducted even though there was no reference to that effect in the text of the Model, note 3, Commentary Article 7 para 57 at 134.

[41] Canada 1951, Denmark 1957, Finland 1957, Italy 1958, Luxembourg 1958, Netherlands 1949, Norway 1953, Saar 1948, Switzerland 1953 (the last again with the exclusion of the *praecipuum*). In its treaties with major powers, France does not insist on this practice, Germany 1959, UK 1950, US 1939. The French practice was also adopted by some other countries, eg, Norway Switzerland 1956.

[42] The English version of extracts from the minutes provided by Simon Simontacchi are sketchy. Mexican delegates supported the Hague draft but after the member of the League Secretariat raised

London (1946) drafts with only a slight change in wording ("should be deducted" changed to "may be deducted").[43] The commentary to the 1943 and 1946 drafts states:[44]

> Though the method of fractional apportionment is mentioned by the Model Convention only in the third place, after the methods of separate accounting and percentage of turnover, this does not mean that the partial use of fractional apportionment is excluded when, as is generally desirable, branch establishments are taxed according to the method of separate accounting. There are, indeed, in most enterprises with two or more establishments certain items of expenses that must necessarily be apportioned in order to achieve the object of separate accounting, *which is to place branches of foreign enterprises on the same footing as domestic enterprises*. An application of this idea is found [in the deduction provision]" [emphasis added]

The emphasised words in the quotation indicate the purpose – a form of non-discrimination rule. As is evident from the quotation, however, this is regarded as only one application of the non-discrimination nature of the business profits rules; the commentary also regards the separate enterprise arm's length principle applied to PEs as a form of non-discrimination.

Focusing for now on the issue in relation to the deduction rule, it has already been noted that foreign PEs of US enterprises often had their overhead expenses disallowed, even though the US allowed such expenses for US PEs of foreign enterprises. Although the problem may have been largely a practical one of proving such expenses to the satisfaction of the local tax administration, a number of countries had/have rules in their tax law that effectively denied deductions for actual head office expenses either because they did not relate *exclusively* to the activities of the PE (that is, apportionment was/is forbidden) or because they were incurred outside the PE country.

To some extent these further rules were directed at potential avoidance (even where actual expenses were provable which was difficult for expenses paid outside the country, their relevance to the PE was difficult to establish and partly depended on the say-so of the taxpayer). And to some extent they were simply the outcome of the systemic nature of the deduction system in question, for instance, if the general deduction rule covered only expenses exclusively related to the earning of taxable income as in the UK and many countries whose tax law in this respect derives from the UK.[45] In both cases such rules effectively discriminated against PEs and their

---

questions about how the amount would be fixed and Carroll pointed out that the US did not have any concept of the real centre of management, the *praecipuum* provision was dropped. There does not seem to be a record of discussion of the substitution of the deduction rule.

[43] LHUSTC4, note 8, 4400-4401. The report of the 1940 Mexico meeting, note 35, indicates that while the principles were agreed, the language was not, so some drafting change was to be expected. It does not seem that the change from should to may was intended to be significant.

[44] LHUSTC, note 8, 4341. The commentary is not official in the same way as the OECD Commentary; it was prepared by the League Secretariat subsequent to the meetings and was not approved as such by the delegates who adopted the drafts. For the justification for the equivalent of Article 7(2) in terms of non-discrimination, see LHUSTC4, note 8, 4338.

[45] Although these provisions existed at the time, Carroll's five volume project did not seem to detect reliance on them to disallow deductions. The problem that these rules create is that the head office

foreign owners but in cases where they also applied to domestic enterprises (as was common), they are not touched by the modern explicit non-discrimination rules in Article 24 as explained hereafter. In any event there was no express PE non-discrimination rule in the League drafts (although Carroll's 1940 draft contained one).[46] There is, however, no explicit statement that the purpose of the deduction rule was to deal with such cases.

Although the League work during this period was concerned with the draft models and not revisiting the detailed work on allocation of the 1930s, not surprisingly the debate about the remuneration for services and sale between independents approaches lurks below the surface. The adoption of Carroll's suggested commission rule for the percentage of sales fall back rule favours the former while the deduction rule favours the latter. The commentary, however, in a number of respects very clearly supports Carroll's preference. To the extent that profits are to be allocated to purchasing offices (which the commentary generally rejects), the remuneration for services by commission basis is considered the only justifiable approach. More significantly in relation to the fall back rule on commission, the commentary states,[47]

> It may be noted that this "commission basis" may, when appropriate, be used by establishments keeping regular accounts and entitled to be assessed according to the method of separate accounting.

As with Carroll's earlier work there is no express mention of deductions for royalties and specific service fees. The League drafts of the 1940s, however, refer in the PE definition to "other fixed places of business having a productive character" which are designed to exclude places of business which do no directly contribute to sales such as research establishments etc.[48] Presumably their costs were intended to be distributed to the productive establishments as Carroll had proposed but there is no statement to this effect.

In summary the League of Nations work provided the equivalents of Article 7(2) and 7(3) of the OECD Model. The purpose of the latter is stated to be non-discrimination but there are a number of deeper issues which touch deductions. While the *praecipuum* as such is rejected, the idea underlying it and the debate around the remuneration of services and sale between independents approaches which significantly affect what overheads can be deducted in the PE state are unresolved.

OEEC

For a decade after the conclusion of the League of Nations work in 1946, there was little activity on tax treaties in international organisations as the United Nations was caught up in a variety of political issues which rendered its Fiscal Committee so

---

overheads relate to both income taxable to the PE and income of the rest of the enterprise which is not taxable in the PE country, thus failing the "exclusively" test. Rules denying deductions for payments outside a country also will disallow head office overheads.

[46] League of Nations, note 31, 19 in Article XX.

[47] LHUSTC4, note 8, 4340. Further, the commentary, 4348, emphasises that one purpose of the accounts rule is that it is only necessary to check events and documents in the PE country which is one of Carroll's arguments for his preferred approach. The commentary shares Carroll's earlier concern about overreaching by the country of sale (which it calls extra-territorial taxation).

[48] LHUSTC, note 8, 4334-4335.

ineffective that it was disbanded in 1954. Nonetheless countries were very active in negotiating treaties, especially the UK and the US who had considerable catching up to do compared to mainland European countries who generally had reasonably extensive pre-War treaty networks (other than with the UK or US). The UK and the US adopted the separate enterprise arm's length provision for PEs from the League drafts in their 1945 treaty though in a much stripped down form and then continued in the same vein for the next decade.[49]

The deduction rule did not appear in the UK US 1945 treaty but began to appear in many US treaties from 1948 in two variants. It will be noted that in terms of the rules concerning apportionment of expenses and payments outside the country, the 1946 League draft seems, expressly at least, only to deal with the former – it lacks the words referring to the place where expenses are incurred in the modern version of Article 7(3). The first US variant which also lacks this element made its earliest appearance in the New Zealand US treaty of 1948[50] and the second variant which covered it in the Canada US protocol of 1950:[51]

> In the determination of the net industrial and commercial profits of the permanent establishment there shall be allowed as deductions all expenses, wherever incurred, reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable.

Moreover although the League draft covers only head office expenses and arguably thus does not extend to expenses of PEs in other countries that benefit a particular PE, all the US treaties that included the deduction rule applied it to all overhead expense not just head office expense as does Article 7(3). The US practice spread, though not broadly, to some other countries by the mid 1950s.[52]

The US legislative history says very little and does not give any clear guidance on the purpose of the provisions. The New Zealand provision is said to "spell out rules of

[49] The first treaty to adopt the League style of language directly was Canada US 1942 which was negotiated during the period when the work of the League Fiscal Committee was effectively confined to the Americas and represented an attempt by the US to develop a treaty network within the Americas generally which did not eventuate, see Simontacchi, note 29, 88-89. At the 1940 Mexico meeting the US delegates are recorded in the minutes, note 42, as expressing the view very strongly that they considered the League draft on allocation of profits to PEs much too detailed and that they preferred a simple statement of a "little" rule. The Canadian treaty reflected a turnaround in this view as it adopted paras 1 and 2 and a combined version of paras 3 and 4 of the 1935 League draft quoted above, note 27 and text. A few other treaties of the 1940s used similar versions, South Africa US 1946, Belgium US 1948 but the US used only the first sentence of the first paragraph out of the quoted part of that draft in most other treaties of the period.

[50] Article III(5), "In the determination of the industrial or commercial profits of the permanent establishment there shall be allowed as deductions all expenses … which are reasonably applicable to the permanent establishment, including executive and general administrative expenses so applicable." The deleted words which created problems of their own are discussed in note 94 and text below. To similar effect are Australia US 1953, Austria US 1956, Germany US 1954 and Switzerland US 1951.

[51] Article I(a). To similar effect are Belgium US protocol 1952, Finland US 1952, Honduras US 1952, Italy US 1952, Japan US 1954; nine US treaties signed in the period 1945-1960 that entered into force lacked the deduction rule. Note that from this time on the deduction rule uses "shall" rather than the "may" of the League 1943 and 1946 drafts.

[52] First variant, eg, Austria Germany 1954, Canada Germany 1956, Canada Netherlands 1957; second variant, eg, Switzerland UK 1954. For the similar approach but with different wording adopted by France in this period, see note 41 and text.

administration inherent in the Article in any event" and to be "included to conform to the desires of the New Zealand delegation" suggesting that nothing was achieved from the US viewpoint.[53] In relation to Canada the provision is said to give "formal recognition" to and be "declaratory" of existing practice under the Canada US 1942 treaty, without indicating what the practice was apart from allowing a proportion of head office expenses.[54] Only in relation to one treaty does it seem to be suggested that something was gained by the provision.[55]

While Canada had a rule which would have created a problem for apportionment, it was repealed in 1948[56] and there was no rule preventing deduction of expenses paid offshore. Belgium is a country with both forms of rule and the same provision appeared in a 1952 protocol to the Belgium US 1948 treaty so this would appear to be the first case where the provision was effective to deal with both of the rules referred to above. Belgium accepts that the deduction provision overrides its domestic law in both these respects.[57] That treaty and protocol, however, were approved in the US along with the Australia US 1953 treaty which does not contain the "wherever incurred" wording. Australia had neither form of rule then (or now). The legislative history suggests that both variants of the rule were to the same effect but otherwise does not identify the specific problems to which it is directed.[58] If rules of these two kinds are the basis of the business profits deduction rule (indicating a non-discrimination purpose), the same comment as for the French treaty practice following the France Switzerland treaty 1937 can be made – there is no clear correlation between cases where the problems arise and the rule is being used.[59]

The next stage of development of the business profits deduction rule was in the Organisation for European Economic Co-operation (OEEC), the predecessor of the OECD which became the international organisation responsible for tax treaties in the mid 1950s following the failure of UN work in the area. Working Party 7 (WP7) consisting of delegates from the UK and Netherlands was set up in 1957 to deal with what became Articles 7 and 9 of the OECD Model. In its first report the deduction rule appeared in its modern form with a few minor language differences, though

---

[53] US Treasury, "Memorandum concerning Income Tax Treaty Negotiations between the United States and New Zealand" (12 April 1951) sourced from Tax Analysts database, note 33.
[54] See Joint Committee, note 32, Vol 1, 494 (Transmittal Message), 607 (Senate Foreign Relations Committee Report).
[55] US Treasury, "Technical Memorandum to Accompany the Text of the Proposed Income Tax Convention between the United States and Austria" (30 July 1957) sourced from Tax Analysts database, note 33, "The article confers two benefits to American business interests (a) it recognizes the allowability of head office expense and (b) some assurance that in any case in which conflicting rules of source arise a solution will be found."
[56] Avery Jones, note 39, 241.
[57] Avery Jones, note 39, 241-242.
[58] The Transmittal Message in relation to the Belgium US protocol 1952, Joint Committee, note 32, 257, states, "That new paragraph would contain provision corresponding, for example, to article III(5) of the existing income-tax convention with New Zealand and article I(a) of the existing income-tax convention with Canada, under which a reasonable part of head-office expense of an enterprise would be deductible by a foreign branch. Such provisions are designed to encourage, in practical operation, the application by Belgium of principles similar to those recognized by the United States."
[59] Note 41 and text.

numbered as paragraph 4 (paragraph 3 being the purchase rule).[60] It was clearly derived from US treaty practice. They explained that provision as follows:[61]

> This paragraph amplifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. In the Group's view it is valuable to include paragraph 4 if only for the sake of removing doubts. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the actual amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise it may be appropriate to take into account only a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, the amount of expenses of the permanent establishment should, in the Group's view, be the actual amount so incurred.

The non-discrimination justification has disappeared from view and there is no mention of the kinds of specific rules that created problems for overheads. Like the US, the rule seems to be regarded by the OEEC as precautionary. Its inclusion on that basis is perhaps surprising as WP7 generally favoured brevity in writing the business profits rules rather than spelling them out in great detail as had occurred in the League drafts. Apart from the first two sentences, language of this kind continued to be used by the OECD up until the omission of Article 7(3) from the Model.[62] To understand why the precautionary view changed over time it is necessary to return to broader issues about taxation of business profits.

WP7 in its first report also raised for discussion the issues of deductions for interest, royalties and management/services fees and the use of the *praecipuum* prefaced by the following comment:[63]

> In the Working Group's opinion the general directive of paragraph 2 that the allocation of profits to a permanent establishment should be made on the basis of the fiction that the permanent establishment is a separate enterprise need not necessarily be applied rigidly in all the consequences which could in theory be associated with it. In a number of actual cases such an application of the said fiction might well raise difficulties. The Working Group has deemed it desirable to bring up for discussion specific cases and has endeavoured to propose solutions which meet the requirements of practice.

These issues attracted considerable discussion in the Fiscal Committee,[64] though the initial position taken by WP7 survived more or less intact throughout the process and

---

[60] FC/WP7(57)1, 4. The OEEC archives are available online at www.taxtreatieshistory.org; documents are referred to by the OEEC system of numbering. The UK was the rapporteur for WP7 and thus primarily responsible for its contents. It was not a significant user of the deduction rule at this time.
[61] FC/WP7(57)1, 15.
[62] OECD 2008 Model, note 3, Article 7 Commentary para 27 at 125-126.
[63] FC/WP7(57)1, 11-12.

up until recently. As in earlier times the issues were seen as potentially qualifying the "theory" of the separate enterprise arm's length rule.

For interest and royalties WP7 rejected deduction of notional interest or royalties payments "to avoid difficulties in practice" but would permit deduction of a share of actual expenses of that kind, specifically referring to the deduction rule in that context. Banks are excepted from this approach in view of "the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises." That is, they draw the line on the basis of whether the notional transaction is like the transactions entered into by the enterprise with third parties as part of its main business activities. For services the issue is expressed more in terms of whether there should be a mark-up rather than whether the notional transaction should be recognised at all but practicalities are again the justification.[65] The discussion of the *praecipuum* is to the same effect, it again being noted that the head office expenses of management would be deducted against PE income but without a mark-up.[66]

The last issue as usual opens up broader questions. Although Carroll had made headway with the League of Nations, as a way of implicitly rewarding management, towards acceptance of the remuneration for services approach, it is decisively rejected by WP7 – indeed it is not clear that the delegates were even aware of the early history in this area. The sale between independent approach is accepted without question in the application of what became Article 7(2) in terms that remained in the Commentary until 2005.[67] In the discussion of ancillary services, the remuneration for services commission method is heavily criticised in rejecting any mark-up:[68]

> the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a commission figure in the profits of every permanent establishment that has incurred expenses otherwise than for its own purposes could be defended in theory as a consequential application of the fiction of separate enterprise (as said above), it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional commission. In the great majority of cases the accounts of the permanent establishment would doubtless take account only of the actual expenses incurred … it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then to re-write the accounts of the permanent establishment. Considerations

[64] The substantive discussions of the work of WP7 are in the following documents: FC/M(58)4, FC/M(58)5, FC/M(59)2, FC/M(59)3 (the main discussion of these particular issues), FC/M(59)4, FC/M(60)1. Other important issues debated were force of attraction, fallback empirical/formulary methods (the original draft did not contain such a provision but what became Article 7(4) was inserted during the discussions), profits from purchasing activities and the relationship with other articles (which was left unresolved as the dividends, interest and royalties articles were also in course of development).

[65] The limit to exclude notional transactions akin to the profit earning activities of the enterprise from this approach only appeared late in the process by confining the no mark-up view to "ancillary" services, FC/M(60)1, 6.

[66] FC/WP7(58)1, 12-14.

[67] FC/WP7(58)1, 11, OECD 2005 Model, note 4, Article 7 Commentary para 14 at 118-119.

[68] FC/WP7(58)1, 13.

> of practical administration seem to the Group to weigh heavily against such a course.

As noted previously the sale between independents approach considerably increases the need to deduct interest and overheads in calculating the profits of PEs which may explain why the matter attracted particular attention in the OEEC. It is clear that initially WP7 thought the issues around interest, royalties and ancillary services related to the way in which the general separate enterprise arm's length principle was to be applied rather than having anything directly to do with the deduction rule, though the conclusions reached by WP7 were regarded as activating the deduction rule. Perhaps for that reason, although no explanation is given, in the next report of WP7 the ordering of the text Article 7 which prevailed until it was rewritten in 2010 was settled on.[69]

The Fiscal Committee discussion of interest, royalties, services and the *praecipuum* involves the same mix of issues as noted in the League period: the significance of the separate enterprise fiction (in particular the argument that because the PE and the rest of the enterprise are part of the same legal entity in the usual case a PE cannot enter into legal transactions with the rest of the enterprise), concerns about disguised distributions of profits (debt-equity type issues), economic arguments about the operation of the separate enterprise arm's length principle, possible double counting of expenses and practical concerns. There is no mention of a non-discrimination basis for the provision. The UK delegate became convinced during the discussion that there was an economic reason for the proposed treatment of interest, royalties and ancillary services and that these issues properly belonged with the Commentary on the deduction rule. That change was made in the final report of WP7 and continued until recently. Further, in deference to Switzerland's objections, the residence country was permitted to utilise a *praecipuum* but if this were not accepted by the PE country, the residence country was expected to give way but otherwise the clear preference for the sale between independents approach over the remuneration for services approach remained.[70]

OECD

In 1977 the apparently logical consequence of the 1963 Commentary suggesting some conflict between Article 7(2) and (3) was moved to the text by explicitly linking them, making the former subject to the latter and the Commentary was changed to the same effect.[71] In 1994, the link made in 1977 was elaborated by an addition to the Commentary explicitly putting the internal charges issue in the divide between Articles 7(2) and (3) and significantly elaborating on when one or other applied, based on whether the dealing was directly related to the external business of the enterprise (such as transfer of goods from head office to PE for sale by the PE to third parties) or

---

[69] FC/WP7(59)2. This draft also introduced the equivalents of Article 7(4), (6). In the League of Nations drafts the deduction rule was also separated from the separate enterprise arm's length principle.
[70] FC/WP7(60)1, 11-13, OECD 2005 Model, note 4, Article 7 Commentary paras 17.4-23 at 123-126. The emphasis on the practical reasons for the position regarding interest and royalties was also removed as there was disagreement whether it was practice or something deeper in the debate.
[71] OECD 1977 Model, note 6, Article 7 and Commentary paras 11, 15 at 28-29, 75, 76. The Commentary says that Article 7(2) is subject to Article 7(3), that the latter clarifies rather than amplifies Article 7(2), and the reference to its purpose being to avoid doubt has gone.

was purely internal in which case only an allocation of expense was allowed.[72] In relation to royalties, the idea that notional transactions were not permitted because the enterprise was a single legal entity was explicitly adopted along with a cost contribution approach to intellectual property.[73] The material on the *praecipuum* remains more or less untouched at this point.

It was still asserted that the two provisions were consistent:[74]

> there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

This hints at yet another explanation of Article 7(3), that it was designed to ensure net taxation of business profits, which is taken up under the next headings.

At the same time, the 1994 changes began to move the Article 7 approach towards that which prevailed for transfer pricing between separate enterprises which is not surprising as the OECD was just starting on substantial revision of the transfer pricing guidelines at this time.[75] In particular the functional analysis makes its appearance (albeit briefly) and the Commentary is neutral between the sale between independents and remuneration for services approaches – which approach applies depends on the functions assumed by different parts of the enterprise.[76] In relation to services a mark-up is now permitted:[77]

> [w]here the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise [but not where] the provision of services is

---

[72] OECD 2005 Model (the last to retain the 1994 changes intact), note 4, Article 7 Commentary paras 17-17.2 at 121-122. This idea had been used in relation to banks from OEEC times, see note 65 and text. Until this time the Commentary was quite explicit that interest etc were being dealt with in relation to Article 7(3) as a matter of convenience, OECD 1977 Model, note 6, Article 7 Commentary para 16 at 76, "Apart from what may be regarded as ordinary expenses, there are some classes of payment between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point."
[73] OECD Model 2005, note 4, Article 7 Commentary para 17.4 at 123. To some extent the same approach is applied to interest, para 18 at 124.
[74] OECD 2005 Model, note 4, Article 7 Commentary para 17 at 121.
[75] Although both the Report on Attribution of Income to Permanent Establishments and the draft transfer pricing guidelines were released in 1994, the former had been largely produced prior to 1992 when work on the revision of the guidelines began.
[76] OECD 2005 Model, note 4, Article 7 Commentary para 12.1 at 117.
[77] OECD 2005 Model, note 4, Article 7 Commentary paras 17.6-17.7 at 123. The effect is to shift part of the enterprise's profit away from the PE either to the PE rendering the services (if the state of location of that PE asserts taxing jurisdiction) or to the state of residence of the enterprise.

merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it.

The treatment of interest likewise reflects some shift though "the ban on deductions for internal debts and receivables should continue to apply generally" but not to banks.[78]

The shift implicit in these changes is carried (almost) to its logical conclusion in the 2008 Attribution Report. Under the general approach in that Report the PE is hypothesised in the first step of the analysis and attributed assets, liabilities and capital based on a transfer pricing functional analysis. In the second step the transfer pricing guidelines are applied by analogy to the dealings of the PE with the rest of the enterprise as if the dealings were transactions between separate entities. As a result of this approach it is possible for notional interest, royalties and service fees to be deducted by the PE. The fulsome adoption of the functionally separate entity approach in that Report is not, however, applied in every respect and always to the fullest extent.[79]

What is more important about the Report is its emphasis on significant people functions and risk in driving the attribution of profits:[80]

> the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE.

In effect this adopts the idea underlying the *praecipuum* of rewarding (and privileging) management functions and represents a significant shift in transfer pricing analysis generally, but particularly for PEs. We have come full cycle and are now much closer to the Carroll approach to PEs than the sale between independents approach which has prevailed for much of the history of attribution to PEs.[81] One

---

[78] OECD 2005 Model, note 4, Article 7 Commentary paras 18-20 at 124-125.
[79] It would require a much longer chapter to deal with this in any detail. It can be noted, for example, that the credit rating of a PE is not performed separately from the enterprise as a whole based on the fact that the overall enterprise is a single entity and cannot have separate different credit ratings for different parts; notional interest will not be deductible outside the finance sector unless the enterprise has a full-blown treasury operation and tangible assets used by a PE are generally regarded as owned by the PE (in contrast to intangible property where use does not imply ownership), 2008 Attribution Report, note 1, Part I paras 33, 36, 100, 130-135 (credit rating), 186-188 (treasury dealings), 104, 229-234 (tangible property).
[80] 2008 Attribution Report, note 1, Part I para 18.
[81] In relation to financial enterprises the relevant people are referred to as the "key entrepreneurial risk taking" (or KERT) personnel. The emphasis on risk reached its high-water mark in the 2004 draft of the Report when ownership always followed management of risk in relation to an asset but was then diluted to the statement in the text which allows other people than the risk managers to determine ownership of assets other than financial assets. For the general implications of the Attribution Report in relation to risk and personnel and the significant shift in thinking involved for transfer pricing generally, see Vann, note 16, Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World" (2010) 2(3) *World Tax Journal* 291.

implication should be that fewer overhead and other deductions of the enterprise as a whole are allocated to the PE so that the deduction problem is solved in the way Carroll proposed, but the overall impression of the Report is that PE deductions will be an even more fraught issue as dealings are constructed between PE and the rest of the enterprise to generate deductions in relation to a much broader range of notional transactions.

Hence in the OEEC/OECD period the 1946 discrimination explanation of the business profits deduction rule disappeared, that is, the rule was not directly relevant to the separate enterprise arm's length issue, but to a more basic question of whether certain expenses enter into the PE attributable profits calculation at all. As the treatment of interest, royalties and services fees that became linked to the rule were hard to fit with the separate enterprise arm's length principle, it is not surprising in the new Article 7 that the deduction rule has been eliminated as the reasons for it (apart from discrimination) have been generally rejected in the 2008 Attribution Report. The OECD Model, however, has a special non-discrimination rule for PEs so it remains to consider whether that rule can perform (some of) the functions of former Article 7(3). Before turning to that question, the treatment of the provision in the other major model tax treaties of the US and UN are briefly considered to see what, if anything, they add about the history and purpose of the rule.

UN and US Models

After its earlier failure in relation to tax treaties, the UN returned to the topic in the late 1960s with the formation of the *Ad Hoc* Group of Experts on Tax Treaties between Developed and Developing Countries. One of the first issues addressed was the taxation of business profits where a number of variations on OECD positions were adopted. In particular there was a much fuller version of Article 7(3) which in effect took the OECD Commentary position on interest, royalties and service fees directly into the text of the article.[82] Many of the familiar arguments in the history above recur but of main interest here is the explicit mention of one of the rules which is thought to underlie the non-discrimination explanation of Article 7(3) but seems to receive no express mention in the League of Nations, OEEC or OECD history:[83]

---

[82] See UN, *Tax Treaties between Developed and Developing Countries* (Document E/4614 ST/ECA/110, 1969) 13-15, 29, 62-63, UN, *Tax Treaties between Developed and Developing Countries Second Report* (Document E/4936 ST/ECA/137, 1970) 14, 46, UN, *Guidelines for Tax Treaties between Developed and Developing Countries* (Document ST/ESA/14, 1974) 28-29. This position arrived at very early in the deliberations has remained the UN rule since, the Model adding to the OECD version the following, *Model Double Taxation Convention between Developed and Developing Countries* (Document ST/ESA/PAD/SER.E/21, 2001) 14-15, "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 to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments 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 moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments 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 moneys lent to the head office of the enterprise or any of its other offices."

[83] UN, *Tax Treaties between Developed and Developing Countries*, note 82, 14.

Deductions of expenses incurred outside territory

> … some members from developing countries felt that expenses incurred outside their territory should not be permitted to reduce the profits of the establishment. Other members from the same group, while not rejecting the deduction entirely, pointed to the difficulties of determining the expenses of the foreign head office that could be identified specifically for purposes of the establishment. One member from a developing country, who was of the opinion that the rule in paragraph 3 of article 7 was too broad, drew attention to the observation in the OECD Commentary, where it was stipulated that deductions for interest, royalties and fees for management services charged by the head office of the permanent establishment should generally not be allowed. As this principle was rational and sound and since the general rule of determining the profits under paragraph 2 gave the impression that such expenses could be charged to the permanent establishment, he suggested that a passage based on the Commentary … should be incorporated into the relevant paragraph 3. … Some members from developed countries expressed the view that the disallowance of such expenses as a deduction was not compatible with the principle of paragraph 3, but they were prepared to consider the last suggestion.

Here the rule about disallowance of expenses incurred outside the PE country is closely linked to Article 7(3) as elsewhere in UN documents as a reason for the rule – the non-discrimination explanation of the League of Nations in 1946. Such rules were commonly found in countries, especially Latin American countries, with strict territorial tax systems. The same kinds of differences of opinion about the relative scope of Articles 7(2) and 7(3) as discussed above is also evident which was further reason for spelling out the position clearly.

As a result of its more prescriptive nature, the UN Model provision does not lend itself to the kind of interpretive flexibility that was found over the years in the OECD version. It also raised much more squarely the issue of needing to change the article if the conclusions of the 2008 Attribution Report were to be accepted. The UN has flatly rejected that report and will retain its current version of Article 7(3).[84]

The US Model in its successive versions of 1976, 1977, 1981 and 1996 also added words to the deduction rule by specifically extending the list of deductions that it covered to:[85]

---

[84] UN, *Report on the fifth session of the Committee of Experts on International Cooperation in Tax Matters* (19-23 October 2009) 9, available at http://www.un.org/esa/ffd/tax/fifthsession/index.htm, "it should be noted that the Committee had not viewed the approach in the OECD 2008 report as relevant to the United Nations Model Convention. Th[e next] update should also include a short statement as to why the United Nations Model Convention varied from the new OECD approach."

[85] *United States Model Income Tax Convention*, 20 September 1996, sourced from Tax Analysts database, note 33, Article 7(3). The earlier versions of the US model also found there are the same. The 2006 version reverts to the OECD wording of Article 7(3) and includes in relation thereto model protocol language requiring that the OECD Attribution Report in effect be applied to its interpretation. This means that the US in 2006 read Article 7(3) as requiring non-discrimination (see note 5 and text) and that depending on the situation there could be a mark-up on services to a PE from head office, as is made clear in the 2006 Technical Explanation of the provision (which also, however, retains the net taxation explanation of 1996). The 2006 model and explanation appear on the Tax Analysts database.

> research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment)

The 1996 Technical Explanation stated the purpose in this way:

> This paragraph is in substance the same as paragraph 3 of Article 7 of the OECD Model, although it is in some respects more detailed. Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, *ensuring that business profits will be taxed on a net basis* … The paragraph specifies that the expenses that may be considered to be incurred for the purposes of the permanent establishment are expenses for research and development, interest and other similar expenses, as well as a reasonable amount of executive and general administrative expenses. [emphasis added]

In terms of the list of expenses little is added, but the US here provides another explanation of Article 7(3) as designed to ensure that a PE is taxed on a net basis. As mentioned above this idea is also hinted at in the OECD 1994 changes. This might be just a variation of the non-discrimination idea but it could also be designed to produce net taxation of a PE even if an equivalent local enterprise is not taxed on such a basis but is subject to some other form of taxation, for example, a local insurance company taxed on a percentage of premiums as a form of income tax. Generally earlier documents assume that business profits will be taxed on a net basis rather than requiring it though there are occasional hints that net basis taxation was an issue of concern.[86] The US is sensitive to this matter as shown by the requirement for net basis taxation in relation to income from real property which is expressed in a way which reinforces the net taxation view of Article 7(3):[87]

> A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. …

In the UN and US cases there is thus more justification for a non-discrimination reading of Article 7(3). This may have been necessary in 1940-1946 when the deduction rule was introduced as the then models did not have a PE rule in the non-discrimination article as the OECD now does in Article 24(3). In the modern context the issue arises of the relationship of Article 7(3) and Article 24(3) and the results for discrimination of the omission of the former from the Model in 2010.

[86] For intimations of this issue see the debate about Spanish terms for income/profits in the Mexico 1940 minutes, note 42.
[87] Tax Analysts database, note 33, for all versions of the US model.

Non-discrimination and business profits

The OEEC/OECD non-discrimination article (apart from the deduction rule now in Article 24(4) of the OECD Model which dates from 1977) was developed slightly earlier than the business profits rule but partly parallel with it so it is not surprising that WP7 of the OEEC did not consider how Article 7 fitted with Article 24. Indeed the parallel work may have contributed to the lack of consideration of the possible non-discrimination explanation of Article 7(3) as the OEEC working parties generally steered clear of issues that seemed to belong with another part of the OEEC work. It was noted above the League of Nations gave non-discrimination as part of the explanation for the equivalents of both Articles 7(2) and 7(3).

The history of the non-discrimination article would take us far beyond the reach of this chapter but in any event it is only recently that the OECD has begun to explore the relationship of that article with the rest of the Model as part of a review of its non-discrimination rules, the first part of which was to revise the Commentary on the current non-discrimination article.[88] In that process the OECD recognised that if another provision of the Model permitted a particular form of discrimination, to that extent the operation of Article 24 was excluded. Conversely, although not stated as such, if another provision of the Model prevents discrimination not covered by Article 24, the latter would not be seen to qualify the former. Further, Article 24 is not to be interpreted as covering covert discrimination but is limited to explicit discrimination.[89]

If we turn to the separate enterprise arm's length rule in Article 7(2) in any of its versions, it has the typical language of a non-discrimination rule ("engaged in the same or similar activities under the same or similar conditions") but critically does not provide a referent like nationality or residence which would give the rule bite as a non-discrimination rule unless it is read in. This is exactly what the League of Nations did in 1946:[90]

> [the separate enterprise arm's length principle] helps to enforce the principle of equality of treatment of *foreigners* by placing, in principle, branches of foreign enterprises on the same footing as similar establishments of *domestic* enterprises as regards the computation of receipts and expenses. [emphasis added]

The OEEC working party on non-discrimination did not adopt this view and hence felt that a separate provision was necessary, developing Article 24(3) for this purpose.[91] That is not to say that Article 7(2) cannot work as a rule dealing with covert discrimination. This approach is now adopted by the OECD in the 2010 Commentary for explaining why no separate treaty rule is needed to deal with domestic law tax rules that deny deductions for expenses that do not relate exclusively

[88] OECD, *Application and interpretation of article 24 (non-discrimination): Public discussion draft* (2007) available at http://www.oecd.org/dataoecd/59/30/38516170.pdf, incorporated with some modifications in the Article 24 Commentary in 2008.
[89] OECD 2010 Model, note 2, Article 24 Commentary paras 1-4 at 332-333.
[90] LHUSTC4, note 8, 4338.
[91] FC/WP4(1), 5-7. WP4 consisted of delegates from the Netherlands and France.

to taxable income (the problem arising from domestic apportionment rules noted above):[92]

> domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2 or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2 …

This is a plausible way to dispose of such apportionment rules as a problem for PEs and is consistent with the much greater play given to the separate entity aspect under the functionally separate entity approach now endorsed by the OECD.

It is hard to see, however, how such an approach would deal with a domestic rule such as noted by the UN which denies deductions for all enterprises, resident or non-resident with a PE, for expenses incurred offshore as there is no impact from treating the PE as a separate enterprise under Article 7(2) on the effect of such a rule. Moreover, Article 24(3) could not apply in such a case as there is no difference in treatment of residents and non-residents in relation to such payments though in the nature of a PE it is much more likely that such rules will impact on non-residents with PEs than residents, a case of covert discrimination.[93]

Some states introduce an explicit non-discrimination element into Article 7(3) in their treaties, for example, Australia's treaties typically add the words "and which would be deductible if the permanent establishment were an independent enterprise which paid those expenses."[94] The purpose is to deal with the kind of expenses that are denied or limited in deduction to all enterprises such as entertainment expenses so that a non-resident with a PE cannot argue that the deduction of such expenses is required by Article 7(3). The Commentary in 2008 was amended to make clear that Article 7(3) did not have this effect.[95] If such a limit is adopted, however, it seems to reintroduce

---

[92] OECD 2010 Model, note 2, Article 7 Commentary para 31 at 139. For this kind of rule, see note 44 and text.

[93] Attempts to bring in Article 24(4) in some combination with Articles 7(2) and/or 24(3) would likewise seem doomed to failure because the denial of deduction rule, if expressed in the simple form in the text, would equally apply to an offshore payment to a resident or non-resident by a resident or a non-resident. It is possible that a PE could get better treatment than a resident by arguing that if a notional transaction is involved, it can treat the notional payment to the rest of the enterprise as having been made onshore and not offshore. The OECD 1977 Model, note 6, Article 7 Commentary para 15 at 76 stated in relation to Article 7(3), "The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment." This would not help in the case in question as it was dealing with deducting a share of an actual payment that in the case in question is assumed to be made offshore. But the idea, if applied to the functionally separate entity approach, could mean that the deduction is available without any payment being made under a notional transaction. The OECD Model 2010, note 2, Article 7 Commentary para 34 at 140 deals with reconciliation of Article 24(3) with the separate enterprise arm's length principle and states that Article 24(3) requires that the result be the same if the transaction is notional or the PE is deducting a share of actual expense but in applying Article 24(3) it seems to tie the tax treatment back to the actual expense incurred by the enterprise to third parties and so would not assist the taxpayer in the example under consideration.

[94] Australia Japan 2008. The New Zealand US 1948 treaty also had this addition, see note 50 and text.

[95] OECD 2008 Model, note 3, Article 7 Commentary para 30 at 126. In one sense it is surprising that the OECD took so long to come to this conclusion; in another it is not as difficult line drawing is then

problems for a domestic law tax rule denying deductions generally for offshore payments (or similar rules applicable equally to residents and non-residents which involve covert discrimination) as a resident enterprise cannot deduct them either.

The broader justification of Article 7(3) that it is intended to provide for net taxation of PEs goes further than this covert non-discrimination approach though also encompassing it. It would require that a PE be taxed on a net basis even if in similar circumstances a resident enterprise is taxed differently and not just apply to rules more directly covered by the language of Article 7(3). Unless general deduction denial or limitation rules such as for entertainment are to be overridden, the difficulty is to draw a distinction between rules that do not have any international implications and rules that are apparently neutral but prevent net taxation in international situations in a way involving covert discrimination. Any number of possibilities can be imagined. A rule requiring some form of gross taxation of say agriculture in a developing country where most farmers are small and subsistence in nature would hardly work appropriately for a multinational agri-business and may amount to covert discrimination. On the other hand some form of such taxation for insurance may be appropriate for both local and multinational enterprises because they would be more substantively similar.

It seems unlikely that the fairly literal OECD approach to the non-discrimination article would find in Article 7(3) such an extensive prevention of covert discrimination that required this kind of line drawing. There is nothing in current or historic OECD materials that would support such an approach. The Commentary already provides an example of a possible non-discrimination provision outside Article 24 in relation to taxation of entertainers under Article 17 on a net basis:[96]

> Where a resident of a Contracting State derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions.

This provision neatly demonstrates the issue. The particular problem at which it is directed is not covered by Article 24 because, in relation to Article 24(3), the non-resident need not have a PE and, in relation to the deduction provision in Article 24(4), because gross basis taxation of entertainers is generally not limited by reference to whether expenses are incurred to non-residents. Accordingly it was considered necessary to provide an optional non-discrimination rule outside Article 24 but it will be noted that the suggested provision takes the tax treatment of the resident

involved as appears in the following text. The League of Nations had an express provision to bring it about. It is not a problem under the OECD 2010 Model with the deletion of Article 7(3).

[96] OECD 2010 Model, note 2, Article 17 Commentary para 10 at 224-225. Compare the similar US model provision, note 87 and text.

as the referent even though requiring net taxation. How would that affect a provision like a denial of entertainment expenses applicable to residents and non-residents alike – such rule contradicts the requirement of net taxation but not the similar treatment as residents.

In summary on non-discrimination, the current approach under the OECD Model would seem to require quite specific and well framed rules to deal with possible forms of covert non-discrimination in the area of taxation of business profits rather than relying on broad interpretation of existing rules. The author is in favour of the OECD approach, being unconvinced by the current broad approach of the European Court of Justice under EU rules as the appropriate kind of response. Nonetheless covert discrimination should be dealt with where possible and to that end a provision like Article 7(3) but clearer in its drafting and intent would seem to be necessary at least as an option in the Commentary to the extent that general rules denying deductions for offshore payments continue to exist. The OECD should also seek to identify and deal with other domestic tax rules that can impact unfairly on PEs. The new Commentary to the OECD 2010 Model represents a beginning not an end to addressing this issue.

More broadly the treatment of deductions demonstrates the deep kinds of divisions that exist in thinking about the taxation of PEs and multinational enterprises generally. The 2008 Attribution Report represents a return to an approach that allocates profits away from PEs especially in relation to the important intangible elements that go towards generating the income of the modern multinational. The current OECD exercise of reconsidering the treatment of intangibles in the context of separate but associated enterprises may begin to provide a rebalancing in thinking but that is by no means inevitable.