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Reflections on Business Profits and the Arm's-Length Principle

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Over a decade ago I wrote an article questioning the current-day efficacy of the OECD model convention[1] and tax treaties based on it.[2] The central theme was that virtually all problem areas in tax treaties could be traced to corporate groups and the separate taxation of the companies in the group that was the norm underlying tax treaties. Since then the trend toward recognition of corporate groups within domestic tax law has continued apace. A measure can be regarded as recognizing corporate groups when, based on the fact that a company is a member of the group, it effectively ignores transactions between group members and looks at outcomes for the group overall (such as consolidation) or allows corporate groups to enter into transactions for tax purposes that other companies cannot (such as loss transfers).[3]

By and large, the recognition of corporate groups has been confined to within-jurisdiction measures. That is, consolidation and similar measures do not generally extend to non-resident companies. Two reasons may be suggested for this limitation. First, allowing non-resident companies to utilize the rules opens up the potential for manipulating tax jurisdiction rules. For example, a rule that companies can transfer assets to group companies without tax may lead to an asset effectively being withdrawn from the tax jurisdiction by a transfer from a resident company to a non-resident company.

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1 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model convention").

2 Richard J. Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)" (1991) vol. 45, no. 3 *Bulletin for International Fiscal Documentation* 99-111 and ". . . (Part II)" (1991) vol. 45, no. 4 *Bulletin for International Fiscal Documentation* 151-63.

3 Australia introduced the grouping of losses in 1984 and then progressively extended it to other areas such as foreign tax credits and transfers of assets. From July 1, 2002, Australia has introduced full-scale consolidation for tax purposes. I will often use illustrations of issues and trends from Australian law, but I am confident that they can be repeated for other countries. The taxation of corporate groups is one of the main subjects of the Vienna Congress of the International Fiscal Association in 2004.

Second, the group approach contradicts the separate-entity approach that underlies tax treaties, and countries wish to avoid clashes between the two ways of dealing with corporations in tax law. It is becoming increasingly difficult to avoid the clash, as we have seen in the recent cases dealing with the relationship between controlled foreign corporation (CFC) regimes and tax treaties.[4] The CFC regime is a consolidation-type measure: it involves a calculation of the income of the CFC and the attribution of that income to the parent in the group. Within the European Union the problem is even more acute. Much of the developing European Court of Justice non-discrimination jurisprudence in relation to companies concerns corporate groups. Attempts to limit group benefits to resident companies has been found to offend the freedom-of-establishment principle.[5]

For me, the contest between the separate-entity/arm's-length principles as currently construed and combined formulary apportionment is of the same kind—whether consolidation or separate-entity concepts should govern. It follows that one way of mounting the argument in favour of combined formulary apportionment is that the consolidation concept is increasingly being adopted into tax laws, which leaves the separate-entity principle of tax treaties the odd one out. Reasoning of this kind partly underlies debates in the European Union, where consolidation concepts are clearly predominant (in the merger and parent and subsidiary directives as well as in the ECJ cases). The home state taxation concept and the Commission's recent work on corporate taxation are other examples.[6]

Another way of approaching the issue is from within the current paradigm—that is, to look critically at the taxation of business profits under the arm's-length principle. This is the approach I will take in this chapter. Specifically, I will argue as follows:

- A fundamental shift in the development of the principle has occurred from branches to separate enterprises. This is not just a matter of legal form but affects basic assumptions and modes of analysis of transfer pricing.
- A transactional requirement for transfer pricing contradicts the current economic underpinnings of the arm's-length principle and is at the base of most current problems.

4 *Re A Oyi Abp*, [2002] 4 *International Tax Law Reports* 1009 (Supreme Administrative Court, Helsinki), and *Re Sté Schneider Electric*, [2002] 4 *International Tax Law Reports* 1077 (Conseil d'État (Assemblée), Paris).

5 See *Marks and Spencer plc v. Halsey*, [2003] *International Tax Law Reports* 536 (UK Special Commissioners), which covers much of the case law but goes against the trend. This case is now on its way to the European Court of Justice.

6 See Uwe Ilhi, Kerstin Malmer, Peter Schonewille, and Ivar Tuominen, "Dividend Taxation in the European Union," in International Fiscal Association, *Trends in Company/Shareholder Taxation: Single or Double Taxation?* Cahiers de droit fiscal international, vol. 88a (The Hague: Kluwer Law International, 2003), 71-96.

- The taxation of permanent establishments (PEs) is nowadays best viewed as a residence-supporting concept rather than as a source taxing principle and needs to be vigorously pursued to prevent wholesale erosion of the international tax base.
- Current transfer-pricing thinking contains the basis for evolution from the transactional to a "whole of enterprise" approach.
- The source principle for business income is based on a benefit principle of taxation separate from the arm's-length principle, which divides income between residence countries; the source principle requires greater recognition in dividing revenue between developing and developed countries.

Much of what I say reflects ideas that have been around for many years, though my perspective is different. Some of the ideas are novel and in progress—hence the reference to "reflections" in the chapter title.

History: Is There a Single Arm's-Length Principle?

There is an important changeover in the history of the arm's-length principle that receives little notice. It is well known that the principle has its origin in studies undertaken on behalf of the League of Nations by Mitchell Carroll in the early 1930s.[7] The focus was on branches, not subsidiaries, and that remained the position for 30 years. The League of Nations and OECD commentaries devote a great deal of space to the business profits article (and the related PE article) and virtually nothing to the associated enterprises article.

The modern history of transfer pricing can be traced to two developments in the United States. First, the United States issued regulations in 1968 that introduced the well-known comparable uncontrolled price (CUP), cost-plus, and retail price methodologies, and the mysterious fourth methods that were the origin of the second stage.[8] These rules were for the setting of prices for tax purposes in respect of actual transactions between separate but associated companies. They

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7 Especially Mitchell B. Carroll, *Methods of Allocating Taxable Income*, vol. 4 of League of Nations, *Taxation of Foreign and National Enterprises*, Studies of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country, League of Nations document no. C.425(b).M.2176(b).1933.II.A. (Geneva: League of Nations, 1933). The discussion in this volume echoes many of the issues currently being wrestled with and in a number of respects is closer to the guidelines on the taxation of branches than the model articles and commentaries produced by the League of Nations and the OECD. I take the latter group of documents as reflecting the international consensus. The early history is traced in Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length" (1986) vol. 30, no. 7 *Tax Notes* 625-81. Vann, supra note 2, traces the history of international taxation more broadly, as does Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (New York: Quorum Books, 1992). The recent history of the arm's-length principle is my own interpretation of events since 1990.

8 TD 6952, 1968-1 CB 218 (herein referred to as "the 1968 regulations").

had nothing to do with branches, which the US taxes using allocation of income and deductions under separate and differently structured regulations.

The 1968 regulations became the basis for the 1979 OECD report on transfer pricing and multinational enterprises,[9] which was not included in the commentary to the 1977 OECD model convention but was issued separately. There is no public record of the background to the report, so it is not known whether anyone asked how the report represented the "original intent" of the League of Nations and the OECD, given that the arm's-length principle originated with branches and the commentaries (and US regulations and international practice) on branches followed quite a different direction.

For the second stage we have much more recorded history. In its tax reform of 1986, the United States enacted the commensurate-with-income rules[10] for intangibles into its transfer-pricing regime and mandated a study of the area. This produced the 1988 report on transfer pricing,[11] which attracted much comment around the world. Legislation in 1990 required a further study, which appeared in 1992,[12] closely preceded by proposed regulations to rewrite the 1968 regulations. Both the private sector and other countries objected that the new US rules were not consistent with the arm's-length principle because they went beyond pricing and attacked transactions (which ironically meant that the guidelines in the OECD's 1979 report seemed to be accepted as the principle). The OECD produced two reports that recount—politely, of course—the stoush[13] between the United States and the rest of the OECD.[14]

9 Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979) (herein referred to as "the 1979 report").

10 Tax Reform Act of 1986, Pub. L. no. 99-514, 100 Stat. 2085 (1986), section 1231(1)(e), amending section 482 of the Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

11 Notice 88-123, 1988-2 CB 458.

12 United States, Treasury Department, Internal Revenue Service, Office of the Assistant Commissioner (International), Office of the Assistant Commissioner (Research & Statistics of Income), and Office of the Associate Chief Counsel (International), *Report on the Application and Administration of Section 482*, publication no. 3218 (4-1999) (Washington, DC: Department of the Treasury, April 21, 1999) (available at http://www.irs.gov/pub/p3218.pdf).

13 This word, probably of Scottish origin according to the Australian *Macquarie Dictionary*, seems to have fallen out of use except in the Antipodes where it commonly occurs. It means "fight" or "thrashing."

14 Organisation for Economic Co-operation and Development, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations—A Report by the Committee on Fiscal Affairs on the Proposed Regulations Under Section 482* (Paris: OECD, 1993); Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations Under U.S. §482 Temporary and Proposed Regulations* (Paris: OECD, 1993) (reproduced in (1994) vol. 2, no. 19 *Tax Management Transfer Pricing Report* 571-80).

The final accommodation appeared in the OECD draft transfer-pricing guidelines[15] and the final revised US regulations,[16] both issued, not coincidentally, in June 1994. On the surface they represent a clear victory for the US position. Notwithstanding the further elaborations in the final guidelines issued in 1995 and the chapters released subsequently,[17] it is no secret that the OECD accommodation papered over substantial differences in principle and practice between the United States and other countries. Since the guidelines appeared, greater convergence in interpretation may be emerging, which of course was one of their objectives, and many countries have altered their transfer-pricing law or administrative guidance or both to conform more or less closely to the guidelines.

The current guidelines still apply only to separate companies, though they contemplate extension to branches. The tension arising from the quite different application of the arm's-length principle to subsidiaries in the 1968 regulations and the 1979 report as compared to branches did not go unnoticed; in fact it was one of the issues addressed in a 1984 OECD report on the taxation of bank branches.[18] This report, in effect, moved toward an accommodation favouring the separate-entity approach to the general branch approach, though not definitively. It was possible, however, to quarantine bank branches from other branches, because they had been recognized as a special case from the very beginning by the League of Nations. Indeed the League models had special provisions for bank branches. The OECD dropped the special provisions without too much explanation but always accepted in the business profits commentaries that greater separation of bank branches, as compared with other branches, from the rest of the enterprise was appropriate.[19]

The OECD returned to the more general issue of branches in a 1994 report.[20] Despite the date of release, the work for this report mainly predated the 1990s separate-entity transfer-pricing developments at the OECD. This report did not

15 Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: Part I: Principles and Methods* [discussion draft] (Paris: OECD, 1994).

16 Code reg. sections 1.482-0 to 1.482-6.

17 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf) (herein referred to as "the OECD transfer-pricing guidelines").

18 "The Taxation of Multinational Banking Enterprises," in Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (Paris: OECD, 1984), 45-70 (herein referred to as "the 1984 report").

19 I.J.J. Burgers, *Taxation and Supervision of Branches of International Banks: A Comparative Study of Banks and Other Enterprises* (Amsterdam: International Bureau of Fiscal Documentation, 1991), part IV.

20 Organisation for Economic Co-operation and Development, *Model Tax Convention: Attribution of Income to Permanent Establishments*, Issues in International Taxation no. 5 (Paris: OECD, 1994).

go down the path of applying the guidelines in the 1979 report to branches but rather sought to bolster the case for different rules for branches (a recognition, perhaps, that the initial overall supremacy of the branch rules had been given up in 1979). Again we are left to read between the lines, but the report could be construed as a rejection of the application of the 1979 report to branches generally while conceding the special position of banks.

This was the last hurrah for the branch rules. Since 1997, the OECD has been moving inexorably to apply the guidelines to branches and has used for this purpose the "Trojan horse" of financial institutions. The first signs were the draft reports on global trading of 1997 and 1998,[21] which sought to align the taxation of global trading operations for branches and subsidiaries, though the main concern was to work out how the guidelines could be applied to global trading generally. The more directed exercise has come in the discussion draft released in 2001 on the attribution of profits to PEs,[22] and its companion piece from the E-Commerce Business Profits Technical Advisory Group.[23] The 2001 discussion draft was updated with respect to banks in 2003,[24] and the 1998 global trading draft was moved fully into the new framework at the same time.[25]

These recent drafts attack the established branch position head-on through the "working hypothesis," which is jargon for the direct application to branches of the separate-entity arm's-length principle as developed in the guidelines. It would be possible to limit this work as already accepted exceptions to the normal operation of the branch rules, but that is not the intention—the exceptions are being used to remake the rule. Even before these drafts have become final, they are effectively being accepted into domestic law and practice and into treaties.[26]

21 Organisation for Economic Co-operation and Development, *The Taxation of Global Trading of Financial Instruments* (Paris: OECD, 1998); Organisation for Economic Co-operation and Development, *The Taxation of Global Trading of Financial Instruments: A Discussion Draft* (Paris: OECD, February 14, 1997) (available at http://www.oecd.org/dataoecd/9/62/2090200.pdf).

22 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishment* (Paris: OECD, 2001) (available at http://www.oecd.org/dataoecd/46/14/1923028.pdf) (herein referred to as "the 2001 discussion draft").

23 Organisation for Economic Co-operation and Development, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions: A Discussion Paper from the Technical Advisory Group on Monitoring Applications of Existing Treaty Norms for the Taxation of Business Profits* (Paris: OECD, February 2001) (available at http://www.oecd.org/dataoecd/46/25/1923312.pdf).

24 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks)* (Paris: OECD, 2003) (available at http://oecd.org/dataoecd/13/48/2497776.pdf).

25 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs: Part III (Enterprises Carrying on Global Trading of Financial Instruments))* (Paris: OECD, 2003) (available at http://www.oecd.org/dataoecd/13/56/2497694.pdf).

26 The United Kingdom has changed domestic law so that the separate-entity approach is used for branches. The new UK-US treaty (Convention Between the Government of the United

The victory of the upstart guidelines over the traditional branch (and general transfer-pricing) position is all but complete.

Surprisingly, the one concession in the recent documents to the established branch approach concerns the treatment of interest—only real interest paid in real transactions with third parties will be deductible outside the financial institution area. This case goes to the heart of the difference between the guidelines and the branch position—the treatment of transactions. I will return to this theme in many of the following parts of the chapter.

The purpose of this part has been to suggest that far from representing the consensus reached in the 1930s on the arm's-length principle, the current interpretation in the guidelines represents a different approach that has grown out of an area that was not of great concern to the League of Nations—the taxation of separate but related companies. Of course we need rules for this area, but the question is why they needed to be different from the original branch approach.

Policy: Is There a Convincing Underlying Theory?

The guidelines justify the arm's-length principle on the basis of equality between related and unrelated firms. The use of market prices for transactions between separate but related companies produces the same tax outcomes as for transactions between unrelated companies. This is a reference to the standard tax criterion of neutrality. The principle is also justified on fairness grounds, both as between firms and as between jurisdictions. In these regards, formulary apportionment is compared unfavourably with the arm's-length principle.

The problem with this approach is that it fails to come to grips with why multinational enterprises (MNEs) are created in the first place. Although a variety

States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed at London on July 24, 2001, as amended by the protocol signed on July 19, 2002) takes the same approach; the exchange of notes in relation to the treaty provides that the OECD guidelines will be applied by analogy in calculating the income of a PE. Australia is moving more cautiously in the same direction: see Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (Canberra: Review of Business Taxation, July 1999), 668-70 (available at http://www.rbt.treasury.gov.au/; click on "Review of Business Taxation—A Tax System Redesigned," and then click on chapter 22, "Allocating Income Between Countries"); Board of Taxation, *International Taxation: A Report to the Treasurer*, vol. 1 (Canberra: Board of Taxation, 2003), 131-34 (available at http://www.taxboard.gov.au/content/rita_report/index.asp; click on vol. 1, "Chapter 4: Promoting Australia as a Global Financial Services Centre"); Australian Taxation Office, *Taxation Ruling* TR 2001/11, October 31, 2001 (available at http://law.ato.gov.au/pdf/tr01-011.pdf) (herein referred to as "TR 2001/11"); this ruling was produced under the auspices of the International Tax Rulings Panel of the Australian Taxation Office. I am a private sector member of this panel, and I drafted (or redrafted) substantial parts of the ruling. It is referred to in several footnotes below for more detailed reasoning on some issues discussed briefly in this paper. In mainland Europe, the treatment of branches and subsidiaries has generally been much closer for reasons explored hereinafter.

of theories are found in the formulary apportionment literature[27] and more recently in organizational literature,[28] there is a common theme. Firms generally, and MNEs in particular, are created because they generate returns internally above what can be obtained in market transactions. The returns are explained in a variety of ways, including economies of scale and scope and specialized knowledge and systems the value of which is reduced or destroyed if divulged to third parties. This value arises not from transactions but from attributes of the firm and so cannot be captured in a system entirely based on market transactions. Several features of modern business are consistent with this analysis of MNEs—the trend to outsourcing of routine functions where economies of scale are not available or significant, the emphasis on sticking to the firm's specialty (or knitting, in a common metaphor), and above all the importance of intangibles to firm value.

Centrality of Transactions in the Arm's-Length Principle

The justification of the arm's-length principle in the guidelines recognizes the centrality of transactions to its current interpretation. Because that interpretation developed in the context of separate but related companies, it is not surprising that the principle was interpreted in the sense of requiring the pricing of the actual transactions that were entered into by separate companies. The CUP, cost-plus, and retail price methods are natural ways to try to replicate market prices. It is but a short step to then *require* that the arm's-length principle be limited to the actual transactions undertaken by the parties. It is not, however, necessary that the principle be based on transactions, because there is nothing in article 7 or article 9 of the OECD model convention to require it,[29] but it is a deep-seated intuition for separate entities. I will return to these matters later.

From this perspective, what was different about the principle as elaborated in the 1968 US regulations and the 1979 report was the adoption of an approach, which accepted transactions entered into by related parties and simply sought to adjust the pricing. This had not been the approach to the application of the

27 For example, see Charles E. McLure Jr., ed., *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Stanford, CA: Hoover Institution Press, 1984), and Charles E. McLure Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* (Arlington, VA: Tax Analysts, 1986) for typical treatments from the 1980s, when the issue was a very live one in the United States.

28 Stanley I. Langbein, "Transaction Cost, Production Cost, and Tax Transfer Pricing" (1989) vol. 44, no. 12 *Tax Notes* 1391-1413 explores the various streams of (mainly) economic literature dealing specifically with MNEs. There has been a burgeoning literature on the issue since then.

29 There is no mention of transactions in either article; rather, a reference to "profits" in both articles and additionally to "conditions" in article 9.

principle to branches for the obvious reason that branches did not enter into actual transactions with the head office or other parts of the same company. So natural was this way of dealing with the matter for related enterprises felt to be that it did not seem to excite comment as a departure from previous practice.

Both the OECD transfer-pricing guidelines and the theories of MNEs converge in considering that the greatest value in most cases resides in intangibles. Because the current guidelines naturally evolved from the 1979 report, it was necessary to finesse the fundamental value issues raised by firm-specific intangibles in various ways. Indeed, most of the major developments can be related to this issue:

- principles for grouping transactions;
- the so-called profit methods;
- more material on intangibles, services, and cost contribution arrangements; and
- defining limited circumstances where transactions can be disregarded.

If transactions at market prices do not account for all the value added by a firm, there are at least two strategies to deal with the matter within a regime based on adjusting prices and not transactions. The additional value can be left as a residual that effectively belongs to the chosen company that holds the rights and its jurisdiction, or the value can be spread over the firm on some express or implied transactional basis. The first three changes above can be regarded as examples of these strategies. To go further requires the disregard of actual transactions. In this case, the current guidelines have simply acted to preserve the status quo by recognizing already existing cases in which countries were ignoring the transactional basis of the rules as the only permitted exceptions—namely, thin capitalization and notably the commensurate-with-income approach to intangibles in the United States. Nonetheless, both exceptions are expressed in more general terms:

> [W]here the economic substance of a transaction differs from its form . . . [and] where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.[30]

This formulation of the exceptions has the flavour of tax-avoidance rules, which is confirmed at the beginning of the justification for the exceptions and the indications throughout that they are exceptional cases. The justification goes

30 OECD transfer-pricing guidelines, at paragraph 1.37.

on to point out that related enterprises do not really care what the structures of transactions between them are and may enter into transactions of a kind not found between unrelated parties. Though these comments hint at the value issue, the reasons given for the particular exceptions are unconvincing. The failure to understand (or, perhaps more accurately, to acknowledge) the underlying concern giving rise to the exceptions has important consequences.

The guidelines accept in many ways the modern approach to value creation in MNEs, especially through the functional analysis as the initial step in the comparability analysis. This requires that value drivers be identified on the basis of functions performed in the light of assets used and risks assumed, not by reference to transactions. But the value drivers have then to be tied to a transactional analysis which they effectively contradict. The practical result is a tax planning free-for-all, which has allowed MNEs to subvert the arm's-length principle by using transactions to allocate functions, assets, and risks rather than looking at them in terms of underlying economic substance. Tax administrations have to deal with transfer pricing based on an economic analysis with one hand tied behind their back because of the transactional *requirement*. In my view, rather than try to project the transactional *requirement* onto branches, which is what is now occurring, we should be relaxing it for subsidiaries.[31] It was not part of the original construct and contradicts the theory of the multinational.

Source or Residence Taxation

The introduction to the OECD guidelines talks about the application of the arm's-length principle in terms of both separate companies and PEs and in both residence and source situations without articulating clearly what is meant. In policy terms, we usually consider that the residence country is the place with which the *taxpayer* has the closest connection, while the source country is the place with which the *income* has the closest connection. When the arm's-length principle is looked at in this light, in the case of separate companies the function of the principle is to connect income with a taxpayer, while in the case of a PE it is to connect income with a jurisdiction.

Intuitively we accept a number of propositions from this application of the principle to PEs and separate enterprises in a world of source and residence taxation. First, and more obviously, we view the PE rule as a source rule for business profits. Source taxation is usually justified on the basis of a benefit theory of taxation,[32] and a PE gives a sufficient connection for taxation on this

31 To be clear, my concern is not that in many cases transfer-pricing adjustments proceed by reference to transactions, but rather that transactions are the only way to proceed, with the two limited exceptions referred to in the text.

32 Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni, "'What's Source Got To Do with It?' Source Rules and U.S. International Taxation," The David R. Tillinghast Lecture (2002) vol. 56, no. 1 *Tax Law Review* 81-155.

basis. The OECD commentary talks in terms of where income *originates* in discussing the PE business profits rule. The PE rule requires us to connect income with a jurisdiction, and this does not require a transaction to be linked to a taxpayer. Hence there is a reason in the very way in which the PE rule operates to conclude that transactions are not of the essence for PEs.

Second, when related parties resident in different jurisdictions are in question, the first issue is the attaching of income to the taxpayer. This very naturally is conceived in terms of finding a transaction in which the taxpayer has engaged and then determining a price for that transaction. Because tax treaties are fundamentally premised on the residence of particular taxpayers (and hence the separate-entity principle, because each company is a separate taxpayer), again there is a reason in the construct for viewing the application of the arm's-length principle to separate companies in a transactional and residence mindset. That is, we conclude that once income is attached to a separate company by a transaction on market value terms, the income is sourced at the residence of the entity in the absence of a PE. This version also can lead to the residual income after allowing for market value transactions being taxed exclusively in the residence country—which allows for considerable manipulation, given the lack of robustness of corporate rules for residence and the potentially large amount of the residual.

This is why I said earlier that there are some deep-seated intuitions that lead us to conceive of the arm's-length principle differently for PEs and separate companies. Once alerted to the issue, our logical selves conclude that one or other approach must give way. The current OECD direction is to move to the transactional separate-entity approach for branches, presumably on the basis found in the preface to the current guidelines that treaties inherently accept the separate-taxpayer principle.

My preference would be at the least to accept that branches and subsidiaries are different and that we can live with different approaches. Or, if pushed to be logical, I would prefer the branch approach for several reasons. It can be made to fit better with the economics than a transaction-driven approach. Further, we have discovered in recent times that separate legal entity does not necessarily equate with separate taxpayers—the issue of hybrid entities where different countries see different taxpayers. The OECD Partnerships Report[33] has begun the hard thinking required for this issue, but it does not address our question: How is the arm's-length principle applied to a hybrid?

Much of the hybrid tax planning currently emanating from the United States depends on one jurisdiction seeing related taxpayers and consequently a transaction (typically an interest deduction), while the other jurisdiction sees a branch and no transaction (especially as the "ban" on intra-entity interest is to remain apart from financiers). At first sight, this looks like an argument for applying the separate-entity principle in both cases and a (constructed) transaction that goes

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33 Organisation for Economic Co-operation and Development, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: OECD, 1999).

with it. However, I suspect that the international system would be better served by applying a branch approach to hybrids in both countries (which would mean that the interest deduction disappears).[34]

If we push the transactional logic of the OECD position a bit further, we realize a possible fallacy in our thinking about branches—maybe we are not dealing with source tax principles at all, but with residence tax principles. This possibility has two aspects. On the one hand, the PE concept has a quasi-residence status in tax treaties to the extent that one author has suggested that a treaty provision should be inserted to that effect.[35] We see this view of the PE in several areas of tax treaties:

- Source rules based on residence of the payer with a PE exception (interest in the OECD model convention, commonly royalties, but not dividends).
- Triangular cases involving PEs, which recognize that a PE can derive income sourced in a third country that is taxable in the PE country (generally the examples are in the context of interest).[36]
- Non-discrimination rules applicable to PEs.
- The exemption system in the residence country for business profits of a PE, which can be read as such a recognition.[37]

34 See H.D. Rosenbloom, "Banes of an Income Tax: Elections, Legal Fictions, 'Hypothetical' Determinations, Related Party Debt," 2003 Ross Parsons Lecture, Sydney Law School. His approach would go further in disregarding related-party debt as debt entirely.

35 John F. Avery Jones, "Are Tax Treaties Necessary?" The David R. Tillinghast Lecture (1999) vol. 53, no. 1 *Tax Law Review* 1-38.

36 "Triangular Cases," in Organisation for Economic Co-operation and Development, *Model Tax Convention: Four Related Studies*, Issues in International Taxation no. 4 (Paris: OECD, 1992), 27-41, reproduced in vol. 2 of the OECD model convention, supra note 1.

37 That is, the residence country of the company does not tax because it regards the PE as, in effect, a resident of the other country that has the residence rights of taxation. Such a view of the exemption for foreign business profits is not the usual one. To the extent that the exemption system extends to independent services income under article 14 of tax treaties, the same rationale can be applied—indeed, the similarity between business income and independent services income is what led the OECD to delete article 14 in 2000 from the OECD model convention. On the other hand, the same cannot be said for employment and real property income. Further, we can see similarity of thought in residence rules for companies based on the place of management. Australia, for instance, requires in relation to its management residence rule that the company carry on business in Australia as well as being managed there—an addition which at least one case found meaningless; see *Malayan Shipping Co. Ltd. v. Federal Commissioner of Taxation* (1946), 71 CLR 156 (HC). In tax treaties, the place of effective management is the tiebreaker for dual-resident companies, while a place of management is one example given of a PE in article 5(2) of the OECD model convention. The commentary on article 4 provides at paragraph 24 that "[a]n entity may have more than one place of management, but it can have only one place of effective management at any one time." The discussion paper by the Organisation for Economic Co-operation and Development, *Impact of the Communications Revolution on the Application of "Place of Effective Management" as*

On the other hand, it may imply that source rules for business profits are not based on the presence of a PE, which is a superadded concept on top of source. This in turn raises two questions—what is the fundamental policy underlying the source principle, and how does it apply to business profits? Traditionally, a distinction is drawn between active and passive income. Active income arises where the activity occurs giving rise to the income, and passive income arises where the activity of the payer occurs giving rise to the payment of the income. In the transfer-pricing context, this version is heavily relied on to support the view that it is where value-adding activity occurs that income should be sourced, treating the PE test as source-based, contrary to my current hypothesis.

If we think of source taxation in terms of benefit theory, then the place where the relevant activity of the payer is based has some claim if the income recipient is relying on institutions in that place. Although such a claim receives treaty recognition in a number of situations,[38] the immediate point to note is that it gives a claim to the place of sale in the business context in the sense of the location of the buyer. In the formulary apportionment literature there is considerable controversy surrounding the sales factor. What is currently lacking is a detailed justification or refutation of the sales factor as a sourcing principle under the income tax as a matter of general principle, given that it is accepted already in a variety of contexts.

Such a justification will not rely on functions performed in the country in the light of assets used and risks assumed. Rather, it will be based on some measure of benefit from the institutions in the jurisdiction. In many cases of sale of goods, the institutions of the country of the payer will have little importance. For instance, a cross-border seller of goods on FOB terms with payment secured by a letter of credit places little or no reliance on the destination country's institutions. On the other hand, in the case of many intangibles, little or no value can be obtained from transactions with a country if it does not enforce the monopoly rights of the seller. Is it not strange to maintain that no income from an intangible is sourced in a country when the owner of the intangible is prepared to spend large amounts of money in the country to establish or defend its monopoly rights there?

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a Tie Breaker Rule: A Discussion Paper for the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (Paris: OECD, February 2001) (available at http://www.oecd.org/dataoecd/46/27/1923328.pdf), noted the potential overlap of residence and source concepts in these kinds of tests, in effect treating the PE test as a source rule. The OECD's most recent paper on the issue, *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention* [discussion paper] (Paris: OECD, May 27, 2003) (available at http://www.oecd.org/dataoecd/24/17/2956428.pdf) simply has options for refinement or change to the test without tackling the issue of the "overlap." There are many links between residence and source rules in relation to companies, meaning that the two are not as distinct as we generally assume.

38 R.J. Vann, "The Taxation of High Value Services: Current Directions in Treaties," *Australian Tax Forum* (forthcoming).

Or, to put it another way and possibly more narrowly, the economic construct that underlies the transfer-pricing regime is based on the marginal cost view of pricing, and that view is not relevant to economic rents. So whenever a person derives an economic rent from a jurisdiction, that jurisdiction has a claim to tax, and intangibles give rise to rents. It is not necessary here to establish definitively what the right analysis is, just that there is a source taxing claim for business income that does not depend on a place of activity in the country asserting the tax claim. However, it should be noted that the analysis is closely related to the economic underpinnings of the MNE with its emphasis on firm-specific intangibles, which is where the current questioning of the arm's-length principle often starts.

Division of the International Tax Base

The previous discussion also has relevance to the division of the international tax base. It is often stated that the OECD model convention has a residence bias. Perhaps it could more accurately be said that the question of residence or source taxation is a matter of indifference to countries where income flows are in relative balance. Residence taxation is generally easier to enforce than source taxation and can avoid the distortions produced by gross-basis source taxation and the failure to fully account for losses (if there is profit in one jurisdiction but a loss in another jurisdiction). If the model convention were to be redrafted on the basis of the current and emerging practice of major OECD countries, the distributive rules could be reduced to a statement that residence-only taxation applied except for

- income and gains from land,
- profits from entertainment and sports activities,[39]
- profits from PEs other than international transport, and
- portfolio dividends.[40]

The balance argument cannot be applied readily to land because of the unequal distribution of mineral and hydrocarbon resources. Perhaps the same result flows from the freedom of movement (and hence of residence) of megadollar entertainers and sports stars, though most of their income (endorsements etc.) now derives from categories subject to residence-only taxation anyway.

Can the balance argument be applied to PEs? It seems plausible that MNEs are relatively equally distributed among major OECD countries having regard to

39 Because of residence rules based on 183 days or government service and other factors such as frontier worker agreements and the shift out of employment to independent contracting for highly skilled services, services income is mainly taxed on a residence basis despite article 15 of the OECD model convention, unless attached to a PE.

40 Portfolio dividends are not covered in what follows. See Richard J. Vann, "General Report," in *Trends in Company/Shareholder Taxation*, supra note 6, 2-70, at 49-53 for arguments against source taxation of portfolio dividends.

the size of their economies. Removal of taxing rights in relation to PEs probably would not have an immediate impact on distribution of tax revenues among major OECD countries. However, given the lack of robustness of the rules for corporate residence, going forward the removal of taxation of PEs would have several obvious results:

- removal of subsidiaries and divisionalizing of MNEs (to remove taxing rights from countries where there currently are subsidiaries);
- inversion transactions (to remove the residence of the MNE to more favourable tax climates);
- tax competition among the major OECD countries (to attract the large MNE tax base); and
- most MNEs resident in one or a few countries with good treaty networks and low corporate tax rates.

Hence the PE concept is central to the operation of the OECD model convention, even between countries where income flows are in balance. It overcomes problems of defining corporate residence by ensuring that taxing rights follow substantial activities.[41] In other words, in the developed world the PE concept is mainly a residence-based or at least a supporting concept for entities. It is also a concept that was intended to generate significant taxing rights—the possibility of having a PE but being able to strip it of income, as suggested by the recent OECD attribution documents, contradicts this explanation of the PE. The very drafting of the PE and business profits articles suggests the conclusion advanced here (see below).

And by extension, the same result was intended for separate entities. If a company is resident in a country and has substantial activities there, substantial taxing rights are intended to accrue. Income stripping through a combination of functional analysis and transactional focus, as is possible under the current guidelines, was never intended to be part of the arm's-length principle for separate entities.

Nor is it in the interest of major OECD countries to interpret the PE definition narrowly or to be unconcerned whether the definition is effectively narrowed by developments in the way business is done. The shift of shipping companies to tax havens is an indication of what will happen to business profits in the absence of a robust PE concept.[42] A robust concept does not mean necessarily an expanded PE concept. It certainly does mean one that cannot be subverted by the tax-planning devices mentioned below. The recent OECD report on the definition of

41 Effectively, a resident entity is created for taxation purposes in a country when there are substantial business activities there, and we are not concerned whether it is a separate company in a legal and tax sense or whether it is a part of a larger entity.

42 The same problem does not arise for airlines because of regulatory regimes, substantial government ownership, and international agreements on landing rights.

PEs has begun to address these problems,[43] but protection of the PE tax base should be an ongoing priority.

There has been considerable debate over the last decade about the implications of e-commerce for division of the international tax base. With the tech bubble burst, the OECD studies largely finished, and more experience gained, we can probably conclude for the time being that the impact on international taxation is not as great as originally suggested. In the longer term, the impact of e-commerce may mean that the current PE concept is not enough to protect the residence tax base, at which point we will need to consider expansion or alternatives. For now we can defer this very difficult task, at least among the major OECD countries.

What about cases where income flows are not in balance? It is well recognized that the residence-only preference of the OECD model convention does produce a bias in this situation in favour of developed countries. Developing countries clearly feel that the PE concept is not an adequate recognition of source taxing rights. The argument above on source of business profits suggests that they are correct. Hence if we accept that inter-nation equity is important with respect to the distribution of taxing rights by tax treaties,[44] developing countries are quite entitled to seek to expand the income captured by payer-based source rules or, failing that, the PE definition and the income that falls under the business profits article. Following from the discussion on source of business profits above, in my view it is better to approach the problem through true source-based concepts rather than the residence-related PE concept. Developed countries are also right to be concerned with the distortion arising from gross-basis source taxes, but the positions need not necessarily be in conflict. What is needed is a tradeoff of broader source taxing rights for net basis taxation, rather than debates about PEs.[45]

My purpose in this part of the chapter has been to argue that a transactional approach to transfer pricing contradicts the current economic underpinnings of the arm's-length principle. The long-established approach to taxation of PEs is not as hamstrung by transactions and is preferable for that reason. More importantly, the taxation of PEs is nowadays best viewed as a residence-supporting concept rather than a source taxing principle and needs to be vigorously pursued to prevent wholesale erosion of the international tax base. PE taxation is not, however, the way to approach division of revenues between developed and developing countries.

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43 "Issues Arising Under Article 5 (Permanent Establishment) of the Model Tax Convention," in Organisation for Economic Co-operation and Development, *2002 Reports Related to the OECD Model Tax Convention* (Paris: OECD, 2003).

44 Richard A. Musgrave and Peggy B. Musgrave, "Inter-Nation Equity," in Richard M. Bird and John G. Head, eds., *Modern Fiscal Essays: Essays in Honor of Carl S. Shoup* (Toronto: University of Toronto Press, 1972), 63-85.

45 See Vann, supra note 38.

Law: What Do Tax Treaties Require?

The uninitiated reader might be surprised that so much meaning has been conjured from so little in tax treaties, especially as regards separate enterprises. Article 9(1) of the OECD model convention provides as follows:

> Where
>
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Read literally, the text suggests the following:

- a right to make adjustments in the way provided;
- no obligation to make the adjustment;
- no obligation that any adjustment made must be in the way provided;
- application to separate but associated enterprises, one resident in one state and the other resident in the other state;
- no coverage of other associated enterprises (for example, two enterprises in the same country whose dealings affect the tax base of another country);
- no coverage of unassociated companies;
- separate application to each associated enterprise (though see below in relation to article 9(2));
- application to profits;
- no limitation to transactions;
- no limitation to prices; and
- no coverage of losses.

When combined with a view that permissive provisions in tax treaties require independent support in domestic law to be operative, the conclusion might be that the provision in fact achieves nothing. On this reading, the only real bite is in article 9(2), and article 9(1) is a prelude to that provision. The commentary makes clear that the obligation under paragraph (2) is a relatively modest one—to make the corresponding adjustment if in agreement with the primary adjustment made by the other country. Even so, this would give some content to article 9.

Reading the current guidelines without reading the article, by contrast, suggests

- a right to make adjustments in the way provided;
- perhaps an expectation that the adjustment would be made;
- any adjustment made must be in the way provided;
- application to separate but associated enterprises, one resident in one state and the other resident in the other state;
- application to associated enterprises in the international context generally;
- perhaps an inference that market prices cannot be imposed between unassociated enterprises;[46]
- application to the enterprise resident in the state concerned;
- application to the enterprise resident in the other state;
- no direct application to profits except in a few special cases;
- limitation to actual transactions except in a few special cases;
- general limitation to prices for transactions;
- application to losses; and
- many procedural requirements not mentioned in the article.

In other words, the guidelines clearly go far beyond what the article literally requires. If we accept that article 9(1) is intended to be more than a preface to article 9(2), then it can reasonably be construed to contain an obligation to make any adjustment to profits in accordance with the principle of the article—if the issue is one of division of the international tax base relating to transfer pricing and the company is a resident enterprise that satisfies the associated-enterprise test.[47] In that sense, domestic rules would be overridden to the extent that they made adjustments in such cases on some other basis than the arm's-length principle. The prohibition, however, would not extend to preventing the application of market value principles under domestic law in other international contexts (so that the tax administration is not stuck with what the parties have done) or to other adjustment methods outside the specific associated enterprises covered. Coverage of losses could also be reasonably implied.

Clearly the current "guidelines" regarding transactions, prices,[48] and profit methods have no basis in the text of the article even though expressed in mandatory

46 Australia's transfer-pricing rules apply between unrelated companies on the basis that there could be other related transactions between the parties also on non-arm's-length terms with the intention of overall achieving a better tax outcome. Australia also taxes gifts under the capital gains tax as having been made on arm's-length terms (market prices) and applies market value rules to transactions in many other contexts.

47 The League of Nations draft was expressed in mandatory ("shall") terms, but the OECD used permissive terms ("may"), presumably because it did not intend to require adjustments when a country did not wish to make them or did not have the authority to do so under its domestic law.

48 The very term "transfer pricing" suggests a limitation to prices. It would be an interesting exercise to trace the earliest usage of the term, which does not seem to appear in the early international tax materials. The associated metaphorical expression "arm's length," which creates some difficulty in translation ("pleine concurrence" in the French version of the OECD transfer-pricing guidelines) has some history in treaties. Australia's earliest treaties, starting

terms. It would require a variant of the arguments used to justify reference to the OECD commentary in interpreting treaties to bring in the guidelines on these fundamental issues of the construction of the arm's-length principle.[49] As to the rest, the guidelines could generally be regarded as stating a preferred outcome rather than being mandatory.

Often it will not be important what the precise content of article 9 is. As already noted, in a spate of activity since 1995 many countries have now enacted more specific rules in domestic law that follow the guidelines to a greater or lesser degree of particularity or released rulings indicating an intention to follow the guidelines. Taxpayers are not likely to challenge the binding nature of the guidelines but rather to argue within them, considering the scope they give to tax planning.

Some of the same comments can be made in respect of article 7, though with much less force. Article 7 and its commentary have evolved together over a 70-year span, so there is a much closer relationship between the two than in the case of article 9, where the text and guidelines have a relatively independent history. Because of this and the relatively more extensive text, interpretation is a more productive exercise. Article 7, which is analyzed in detail under the next heading, "Interpretation and Practice: Where Is the Arm's-Length Principle Going?" provides as follows:

> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
>
> 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

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with the United Kingdom (signed October 29, 1946), the United States (signed May 14, 1953), and Canada (signed October 1, 1957), and ending with New Zealand (signed May 12, 1960) used the phrase "dealing at arm's length" in the equivalent to article 9(1). In the French version of the treaty with Canada, this is expressed as "relations conduites au mieux de ses intérêts." It was common for early treaties of Anglo-Saxon countries to include the phrase in the business profits article (for example, Canada-United States (signed March 4, 1942), UK-US (signed April 16, 1945), Canada-UK (signed June 5, 1946), Canada-New Zealand (signed March 12, 1948), and New Zealand-US (signed March 16, 1948); similarly, France-UK (signed December 14, 1950) (expressed as "traitant d'une manière normale" in the French text) but not France-US (1932)). The New Zealand-UK treaty of May 27, 1947 also has the phrase in the associated-enterprises article.

49 An Australian case refers to the "international tax literature" in the early 1960s for the different methods of adjusting profits internationally without specifying any details: *Case 53* (1963), 11 CTBR (NS) 261, *Case N69* (1963), 13 TBRD 270. The case held that the method specified in the treaty article overrode the domestic provision to the extent that it permitted other methods.

> be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
>
> 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.
>
> 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
>
> 5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
>
> 6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
>
> 7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

The basic features, compared with article 9, can be noted for now. First, article 7 is more clearly mandatory for both countries. Second, it seems to give more detail on what is required in applying the arm's-length principle. Third, it clearly permits the continuation of formulary apportionment where customary, though subject to the constraint of general consistency with the arm's-length principle (a very telling clue to the original intent as to the meaning of the principle). Fourth, it requires consistency of method from year to year, which suggests that there is a considerable degree of latitude allowed to countries in applying the article, provided that they are consistent in their approach. Finally, it has a special rule preventing attribution of profits for purchasing activities, suggesting also that the arm's-length principle is not the beginning and end of taxing PEs.[50]

Interpretation and Practice: Where Is the Arm's-Length Principle Going?

Until relatively recently, there has been a distinct development of the separate-entity and branch applications of the arm's-length principle. This part of the

50 Not surprisingly, the discussion draft suggests that we do away with the parts of the article that contradict the separate-entity view it promotes for branches.

chapter will demonstrate the differences and their consequences. First, a summary of the counterproductive results of the guidelines for separate enterprises will be provided. Second, the interpretation of article 7 will be analyzed in some detail to show how it is currently different from the guidelines based on existing jurisprudence. Finally, the application of the guidelines in the PE context will be considered.

Stripping Profits Under the Guidelines

Under the comparability analysis required by the guidelines in relation to separate but associated enterprises, one aspect is to determine the functions of the enterprise in the light of the assets used and the risks assumed. This approach, which mainly springs from developments in the United States in the 1980s, leaves considerable room for manipulation of the nature of an enterprise so that its return is minimal. One feature of this development is the change in the nature of business in recent decades so that there is a much broader spectrum of the ways in which business is done and financed. Hence there is a wider field of comparables or paradigms that can be used as models in setting relations between associated enterprises. Not surprisingly, these models are utilized to reduce profits allocated to high-tax countries and to increase profits in low-tax countries.

With respect to manufacturing, the paradigm that is relied on is contract manufacturing. The main difference between an ordinary manufacturer and a contract manufacturer is that the latter takes no inventory risk. It manufactures to the order of another enterprise, which carries the risk of being able to sell the manufactured items. Such arrangements are now commonplace between independent parties. The transfer of inventory risk between associated enterprises is a simple matter of entering into a contract in terms similar to those used between unrelated enterprises for contract manufacturing. To the MNE, of course, the arrangement is meaningless because the inventory risk remains within the group, but the risk by this means can be conveniently located wherever desired. The result is that a minimal cost plus profit is left in the country where the manufacturing operations occur.

For sales, there are several techniques to shift profits. At least in mainland Europe the popular method is the commissionaire arrangement. This does not rely on transfer pricing as such but rather on manipulation of the PE definition to have sales effected by a foreign enterprise in a way that does not amount to a PE. Many US multinationals rely on this technique within Europe to prevent any sales profit being taxable in the country of sale, as the rash of literature on this issue indicates. Attention is now being turned to replication of the commissionaire in common law countries, including sales into the United States.[51] The splitting of functions among different enterprises or locations in the one country is a well-

51 See, for example, J. Momsen, "Double Tax Agreements: Commissionaire Arrangements" (1997) vol. 5, no. 4 *Taxation in Australia, Red Edition* 185-92.

established alternative for avoiding a PE,[52] though as noted above the OECD is trying to counter this method by changes to the commentary on article 5 in the 2002 update.

Where the commissionaire or splitting route cannot be used to avoid a PE, the paradigm will be the "salary salesperson," with the tasks given to the local enterprise being routine and as insignificant as possible. The local enterprise will carry little or no risk and can be rewarded on a simple cost plus time spent basis. Sale on commission involves risk to the local enterprise and can be avoided if it is desirable to squeeze the local profit to a minimum.

Post-sale, there are issues of product warranties and product liability. Providing warranty services involves PE issues but is unlikely to involve more than a very small cost plus amount of profit if done by an associated enterprise. Product liability and related issues have produced a whole industry of captive insurance, which pulls out major risks (generally to tax havens). Tobacco companies in Australia have diverted 10 percent of sales revenue through this route,[53] and given the current litigation and insurance situation, this figure can probably be upped considerably.

Intangibles fall into two basic categories—production and marketing. A well-advised MNE will ensure that no intangibles are attributed to a sales jurisdiction if this is the desired result. For production intangibles, this result is relatively easy to produce because the intangible can be held in a convenient entity, wherever the R & D is done; reliance can be placed on a contract researcher or cost contribution arrangement paradigm, depending on how income is to be distributed. Marketing intangibles require more managing, but so long as planning is done in advance from a foreign location the same result follows as for

52 See *Case 110* (1955), 5 CTBR (NS) 656 for an Australian example going back to the 1940s. Australia has sought to avoid this problem by adding to the PE definition to cover such cases: see, for example, article 4(8) of the Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Canberra on December 7, 1967, as amended by the protocol signed on January 29, 1980. Another concern of Australia is the cost toll operation of the kind illustrated in *Kaiser Aluminium & Chemical Corp. v. Commr.*, 76 TC 325 (1981) (for a description of the structure of the Gladstone alumina refinery, not for the analysis of section 367 of the Internal Revenue Code of 1954, as amended), which has also led to another special PE provision in Australia's treaties: see article 5(4)(d) of the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Sydney on August 6, 1982, as amended by the protocol signed on September 27, 2001. The drafters of these provisions assumed that creating a PE meant that the PE country was able to tax profits.

53 *W.D. & H.O. Wills (Aust.) Pty Ltd. v. FCT* (1996), 32 ATR 168 (FCGD), which held that the Australian general anti-avoidance rule (which overrides tax treaties) did not apply in this situation; presumably the revenue authority did not argue transfer pricing on the basis that the price was within the bounds of comparables.

production intangibles.[54] Again, the key is to move risk out of the country where the intangible is to be exploited. This result is not likely to be a problem if the marketing intangible is an internationally well known brand name.

Outbound transfers of intangibles are also possible where the creation occurred in the jurisdiction. This is still a very active area in the United States, notwithstanding the many US rules designed to deal with the issue. Most other countries do not have US-type rules so that the result is easier to achieve.

The OECD model convention provides for zero source taxation of royalties but requires that deductions be given for royalty payments to associated enterprises so long as the amount of the royalty is arm's length.[55] This construct greatly assists in attributing profits to intangibles and stripping them from the source country. Even where tax treaties give rights to tax royalty payments at source, the changes to the OECD commentary in recent times, including 2002, have ensured that the taxing rights are increasingly ineffective. While there are reasonable arguments for this result at a technical level,[56] it is hard not to conclude that the underlying agenda is not technical. The OECD needs to evaluate whether its technical analysis in recent years is producing a suitable policy outcome in relation to source taxation. In particular, a reading of the guidelines and the e-commerce TAG reports[57] suggest a degree of capture of the OECD by MNEs in relation to stripping profits from source jurisdictions.

Financing demonstrates the same trend. In 1987, the OECD produced a report that advanced the proposition that financing was subject to the arm's-length test.[58] As a result, many countries either in their tax law or their practice have introduced an arm's-length test into their thin capitalization rules. The timing of the report was significant. Twenty years ago, junk bond financing was relatively unknown. In the 1980s bull market, the management and leveraged buyout phenomenon produced a new paradigm that presented the possibility of stripping profits through highly leveraged structures within MNEs.

This possibility can play out in different ways in different countries. At the extreme, a lowly leveraged MNE can argue that internal high leverage is arm's-length on the junk bond analogy. An alternative is to allocate third-party debt to jurisdictions whose thin capitalization rules are limited to related-party debt,

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54 For example, a worldwide marketing campaign devised and implemented offshore that is delivered in a country on television, radio, etc. so that no PE is created.

55 Articles 12 and 24(4) of the OECD model convention.

56 See Vann, supra note 38.

57 Organisation for Economic Co-operation and Development, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (Paris: OECD, 2001).

58 Organisation for Economic Co-operation and Development, *Thin Capitalisation: Taxation of Entertainers, Artistes and Sportsmen*, Issues in International Taxation no. 2 (Paris: OECD, 1987) (herein referred to as "the 1987 report"). The 1979 report was to similar effect but was briefer and less specific on the topic. The 1987 report galvanized several countries into action on the topic.

which is common. If the country is relatively insignificant on the world trading stage, it is possible for even a lowly leveraged MNE to finance its whole investment in a country by third-party debt. Australia (with a small proportion of world trade) has recently reacted to this possibility by extending its thin capitalization rules to third-party debt. It was felt necessary in taking this step to introduce an arm's-length qualification, but the rule was artfully constructed to try to limit problems.[59] Australia has also tried to resist erosion of its tax base (with less justification) in the case where a foreign parent was subject to a junk bond buyout and tried to push the debt down to its subsidiaries.

It is understood that at least one OECD country has recently queried the view that financing is subject to the arm's-length test. There is certainly an argument that how an investment is financed is different from how the investment is carried out, though it may be noteworthy that article 9(1) refers to "financial" as well as "commercial" relations and article 24(4) assumes that interest deductions are subject to article 9(1). However, the wide variety of paradigms for financing nowadays is similar to the trend in other areas and produces the same results. It is true that the guidelines permit the disregard of transactions in the thin capitalization area, but this possibility has not stopped the massive loading of debt by US MNEs into other high-tax OECD countries (with the corresponding interest income ending up in low-tax—often OECD—countries).[60]

As noted above, there is a basic issue across the whole transfer-pricing area in relation to the disregard of transactions. If this issue is not tackled, then it is possible, using the techniques just listed, to take a substantial operation in a source country and effectively dismantle and reconstruct it in such a way that virtually no profits are left there. US MNEs have been actively pursuing this strategy in ways detrimental to US and foreign taxing jurisdiction in recent times. No doubt other MNEs will follow in due course.

Tax administrators involved in drafting the guidelines may respond that this is neither the intention nor the result of their efforts. It is true that the guidelines emphasize that the transactions have to reflect some commercial reality and that country administrations can challenge the outcome of the tax planning described. They may be successful in their challenges in some cases. What cannot be doubted is that in recent times MNEs have been actively pursuing the strategies described. When auditing is reduced to minimal levels, as has occurred in major OECD countries (even allowing for increases in transfer pricing audits), it is not surprising that many MNEs are willing to gamble on the audit lottery given the bottom line consequences. What effect

59 See the Australian Taxation Office, *Taxation Ruling* TR 2003/1, March 5, 2003 (available at http://law.ato.gov.au/pdf/tr03-001.pdf), for an explanation and interpretation of the rule.

60 Added to which the European Court of Justice is in the process of dismantling the domestic thin capitalization rules in the European Union as in breach of non-discrimination norms.

the removal of various integrity mechanisms that made it difficult for MNEs to fully exploit the potential of the guidelines will have is yet to be determined.[61]

Interpretation and Application of Article 7

Article 7 on business profits, as noted above, was the origin of the separate enterprise arm's-length principle in international taxation. Nonetheless, its interpretation remains a matter of debate. The OECD produced reports in 1984 and 1994 and a discussion document in 2001, partially revised and expanded in 2003, on the issue. The most recent, in particular, will replicate the kinds of results just discussed in the PE context. Why this should be seen as a desirable change is unclear. What is clear is that it runs counter to 70 years of interpretation of the business profits article.

Like the agency PE principle,[62] the interpretation of article 7 involves a confusion of civil and common law approaches to business profits of a branch. The current commentary reflects this confusion, from its beginning up to the changes made as a result of the 1994 report. The confusion is not to be solved, however, by the adoption of the guidelines but by a return to the original purpose of the PE principle and the recognition that there are different ways of getting to the same or at least similar results.

At the base, there is contradiction, or perhaps misunderstanding, between two conjunctions: of civil law—exemption—accounts based systems; and of common law—foreign tax credit—tax law based systems (the conjunctions are by no means accidental). One system leads to an accounts approach to the PE issue, while the other leads to an allocation approach. The results of the two approaches need not be different in principle, which in my view was intended to be recognized in the business profits article. The OECD commentary in a confused way suggests this result. The discussion draft, on the other hand, takes the view that the former approach is the only acceptable approach.

The problem can be best illustrated by an example. Assume that a branch sells goods manufactured by head office. The cost of manufacture at head office is 100 and the goods are worth 130 when transferred to the branch. The branch has costs of 10 and sells the goods to a third party for 150. It is assumed that there are no shared costs for the purposes of simplicity.

Under the accounts-exemption approach, the calculations would be as follows:

61 What I have in mind are rules that constrained tax planning at the corporate level, such as imputation systems that depend on domestic tax paid and conformity rules for financial and tax accounts. Neither of these is relevant in the United States.

62 John F. Avery Jones et al., "Agents as Permanent Establishments Under the OECD Model Tax Convention" [1993] *British Tax Review* 341-83; Sidney I. Roberts, "The Agency Element of Permanent Establishment: The OECD Commentaries from a Civil Law View (Part One)" [1993] no. 9 *Intertax* 396-420; and ". . . Part Two" [1993] no. 10 *Intertax* 488-508.

	Head office	*Branch*
Revenue	130	150
Expenses	100	140 (goods 130 and other costs 10)
Profit	30	10

From the point of view of the home office country, 30 will be taxable and 10 exempt. From the point of view of the PE country, 10 will be taxable. The accounts will be symmetrical, and there will be no overlap or aggregation between the accounts (putting aside an exemption with progression system).

For a foreign tax credit-tax law country, allocation of revenue and expenses will occur as follows:

	Resident enterprise worldwide income	*Branch*
Revenue	150	20
Expenses	110	10
Profit	40	10

From the point of view of the residence country, any foreign tax on the branch will be creditable subject to the foreign tax credit limit. If this limit is determined on a country-by-country, item-by-item basis, then the residence country will have a similar calculation of the branch profit for foreign tax credit limitation purposes, assuming that it allocates revenues and expenses on the same basis as the PE country (which is also assumed in the example to be a country that works on an allocation system for determining source taxing rights). If the limit is calculated on some other basis, such as a worldwide basket system, then there will be no symmetry at all between the residence and PE country calculations because the residence country will not need to calculate the branch profit separately for limitation purposes. Further, there will be clear overlap of the accounts in that the residence country will include the full revenue from the transaction with the third party, whatever the treatment in the PE country. From the point of view of the PE country, assuming that it is an allocation country, it will include the share of the revenue allocated to the PE in that country and deduct expenses allocated to that country.

It will be noted that so long as a PE country that is a foreign tax credit-allocation country uses the arm's-length price to determine the allocation of income and deductions (apart from the ignoring of the transfer from head office to branch as either revenue of head office or expense of the branch), the result will generally be the same from the point of view of the PE's country taxing rights as where the PE country uses the exemption-accounts based system. The critical difference between the two approaches is that one treats the head office branch transfer as a transaction that directly enters the calculation of profit of each arm of the enterprise. The other only has regard to actual transactions with third parties and allocates the revenue and expenses for the purpose of determining the taxable profit in the case of the PE country and the foreign tax credit limit in the residence country. The head office branch transfer enters the process, if at all in the case of the residence country, only indirectly in providing a means for the allocation of revenues.[63]

The link of one approach to civil law and the other to common law comes from the fact that civil law countries generally calculate taxable income from the financial accounts of an enterprise. This leads naturally to a PE (enterprise segment) basis for taxing in countries other than the country of residence. It is also related to the exemption system, because the foreign part of the enterprise is treated similarly to a separate entity (see the discussion of the PE principle as residence-supporting above) and the exemption based on the approach that the business profits of a foreign enterprise cannot be taxed in the head office state even when remitted there. It is but a short step to extend this reasoning to dividends and capital gains on shares in subsidiaries to produce a participation exemption.

Common law countries do not generally rely directly on financial accounts for taxation purposes but rather spell out the tax base rules in detail in the tax law. The result is that any accounting concept of an enterprise (business) as distinct from a taxpayer is not present in the tax system, leading to a focus on the taxpayer rather than an enterprise (business).[64] This in turn leads to worldwide taxation of taxpayer income rather than the separate calculation of income by reference to segments of enterprises (parts of taxpayers). Relief by credit is a corollary of this approach, as is allocation of income and deductions to do the calculation. It is also natural under such an approach to be inclined not to permit deferral in subsidiaries.[65]

Because an allocation approach is used for residents more or less automatically in the mechanics of the foreign tax credit, allocation is naturally extended in foreign tax credit countries to non-residents in determining how much income can be taxed at source. It is noticeable that common law countries often do not

63 I have generally referred to the PE country rather than to the source country in the text in view of the earlier discussion on the purpose of the PE concept. A number of treaties entered into by Anglo-Saxon countries modify article 23 of the OECD model convention to insert, among other things, a reference to source of income to tie relief into the domestic foreign tax credit system. That fact does not affect the discussion here. It is quite possible for a "residence" country to give credit for another "residence" country tax (most notably the special credit provision in US treaties dealing with non-resident US citizens, but see also paragraph 3 of the commentary on article 8 of the OECD model convention). Similarly, a "source" (PE) state may be required by the non-discrimination provision to give a foreign tax credit to the PE for tax in another "source" country, and some countries, notably again the United States, include provisions like this in domestic law.

64 See, for example, Hugh J. Ault et al., *Comparative Income Taxation: A Structural Analysis* (The Hague: Kluwer Law International, 1997), 177-78, 191-92, and 250-53 for the separation of the enterprise (business) from the taxpayer in civil law systems.

65 The debate about the interaction of tax treaties and CFC regimes is also tied up with this difference in thinking—is the focus of tax treaties on income or taxpayers?

use a PE-type concept in domestic law to define source taxing rights over business income, at least in the early versions of their law.

The contrast presented here is to some degree pushed further than is actually the case nowadays. There has been cross-fertilization of the systems. Exemption countries may defer the taxation of head office profit until the branch generates income by a sale to a third party, rather than taxing at the time of the transfer to the PE. Credit countries now often use PE-type concepts in domestic law for some aspects of international taxation and a number of common law countries substantially use the exemption system. They also may give a greater role in practice to transfers between parts of a taxpayer, especially outbound transfers from a PE.[66]

Whether the explanation just presented for the differences is correct or not, the critical question is whether the OECD model convention and commentary permit both methods of calculating branch profits or only the accounts-based method. Both the model convention and the commentary contain unconscious mixtures of both methods. Article 7(1) suggests an allocation system and article 7(2) the accounts-based system. In my view, the model convention was not intended to prefer one method over another. So long as the outcome generally was in accord with the arm's-length principle, how a country got there was not important. This view is reinforced by the acceptance in the commentary of proxy methods for determining branch profits and in the model convention by the authorization of global formulary methods so long as the outcome is generally consistent with the arm's-length approach.[67]

In the original League of Nations models, this view was supported by a provision suggesting that the business profits article worked through the calculation provided in domestic law, not by completely overriding it. The original models also contained special rules for financiers. The dropping of both these provisions could be argued to support the accounts-only approach to the article, but such a view gets little comfort from the explanations, such as they are, given in relation to the changes. Moreover, parts of the article 7 commentary are written on the assumption that the same outcomes still apply even though the provisions are no longer in the model convention.

One source of confusion in the debate, the meaning of paragraph 3 of article 7, can conveniently be clarified at this point. The original of this provision was separated from paragraph 2 by several intervening paragraphs and was clearly directed at overcoming domestic law rules that created problems in calculating income in an international situation—rules that gave deductions only for payments made in a country and rules that did not permit apportionment when an expense has a mixed purpose, part related to income

66 See, for example, the discussion of practical issues in TR 2001/11.

67 The technical explanation to the US model convention confuses the two different uses of formulary methods in its justification for the deletion of paragraph 4 of the OECD model convention: United States, Treasury Department, United States Model Income Tax Convention of September 20, 1996, Technical Explanation, paragraph 94.

taxable in a country and part related to income not taxable in a country. Such rules still exist in the domestic law of some countries, including OECD members. The simple purpose of paragraph 3 was to override these rules in determining the income of a branch (and in doing so to reinforce the view that otherwise domestic tax rules apply to PEs).

By a series of changes to the position and wording of paragraphs in article 7 and the headings in the commentary, paragraph 3 has come to be seen by some as a rule for distinguishing cases where markup on transfers to and from the PE is appropriate (which is taken by some to mean accounts-based treatment) and when no markup is appropriate but a sharing of costs (which is clearly referring to an allocation approach). For me, this simply compounds the confusion between two very different ways of getting to the same result. The "rules" in the commentary currently under a heading that refers to paragraph 3 are about the substantive application of article 7, not a switchover from accounts to allocation.

The need to recognize both methods of reaching an arm's-length result, in my view, is demonstrated by the outcome if paragraph 2 is treated as requiring an accounts-based calculation. The effect for an allocation country is to wipe out its whole tax system for allocating business profits between countries and to leave a void to be filled by constructing accounts that an allocation country knows nothing about in its internal tax law. Or to put it another way, you simply get to make up the rules. While it is intended that tax treaties will override inconsistent domestic law, it would be surprising if the common law countries had agreed en masse to the wholesale destruction of their internal law dealing with international business income. Until recently, they gave no indications of such an understanding of the effects of tax treaties.

The drastic effects are demonstrated by two recent cases in the United States, *North West Life Assurance* and *National Westminster Bank*.[68] In each case it was held, in effect, that US allocation-type rules were inconsistent with the accounts-based approach that tax treaties required and were wiped out. We are not directly told the result, but it seems that in the former case the financial accounts were simply used to determine the taxable profit of the branch and in the latter case an attribution of capital to the branch. This is astonishing stuff—what depreciation rates were used in the taxpayer accounts in the former case, what timing rules, etc? It simply cannot be the case that article 7 requires all of the rules in internal law on these matters to be ignored, but it is hard to see how they can enter the position to the extent that they are tied to the allocation method in tax law of the country, which is wiped out by the treaty. Where did the attribution-of-capital rules come from in the latter case? The 1984 report makes clear that both allocation and accounts-based methods can be used to, in effect, construct branch

68 *North West Life Assurance Co. of Canada v. Commissioner*, 107 TC 363 (1996), and *Natl. Westminster Bank v. U.S.*, 99-2 USTC 50, 654 (Fed. Cl. Ct. 1999).

capital, and is that not what the US allocation regulations for foreign bank branches effectively do?[69]

A related issue is what the word "profits" means in article 7. The 2001 discussion draft distinguishes two meanings—the relevant activity approach (which operates on the real revenue and expenses of the whole relevant activity) and the functionally separate approach (which uses separate accounts for different parts of the relevant activity and constructed transactions between them). It concludes that the latter is the correct approach. This is not surprising, given that the working hypothesis is the accounts-based approach. What is not realized in the draft is that what is being talked about is not two different understandings of profit as such but two different methods of calculating the profits.

The relevant activity approach is used by countries that have allocation systems and the functionally separate approach by countries that have accounts-based systems. It is true that different results inevitably arise in some cases,[70] but different results are usually the outcome of different treatment of revenue and expense either in domestic law generally (for example, entertainment expenses) or in the amounts of revenue and expense that enter the calculation in two countries. The differences are usually not an artifact of the two approaches. These differences can occur even assuming that the countries agree on the market value of the transfers to or from the PE, for example, from different methods of accounting for inventory or different treatments of interest expense. We tolerate such differences—indeed, even much greater differences—in the application of other parts of the model convention,[71] so why are they such an issue in the PE context?

69 By contrast, *Cudd Pressure Control Inc. v. Canada*, [1995] 2 CTC 2382 (TCC); aff'd. [1999] 1 CTC 1 (FCA) in Canada generally accepts allocation as not overridden by treaty. The taxpayer's argument tried to force an accounts-based system on the revenue authority. In retrospect, perhaps the case could have been run on the allocation of revenues rather than on the expenses issue; the taxpayer could have got the result it wanted if some of the revenue had been allocated to head office, rather than all to the PE. Note that one reason why the court rejected the taxpayer's argument is that the accounts of head office and PE were not symmetrical because the notional rent claimed as a deduction in Canada did not appear in the income of the head office. As noted above, this is an inevitable outcome for a foreign tax credit residence country's using an allocation system like that of the United States in this case. Australia likewise has a number of cases that do not regard the treaty as overriding the allocation method: for example, *Max Factor & Co. v. FCT* (1984), 15 ATR 231 (NSWSC) (no exchange loss possible for tax purposes on transfer of funds from branch to head office).

70 If the branch transaction with a third party produces less revenue than the market value of the transfer from head office—say 120 in our example above—an allocation approach cannot get the same result as the accounts approach because the 130 figure can never enter the calculation. This result is very unlikely in practice because revenue of the same type from third parties will be aggregated under an allocation approach that will mask the case of a particular transaction where the third party amount is less than the transfer amount: see TR 2001/11. The discussion draft again recognizes that in practice the two approaches need not be greatly different but without understanding what lies at the heart of the issue.

71 See, for example, Organisation for Economic Co-operation and Development, *Cross-Border Income Tax Issues Arising from Employee Stock-Option Plans: Revised Public Discussion Draft*

Another related issue is whether article 7 deals with losses. As noted above, it is assumed that article 9 deals with losses even though only the word "profit" is used. There are good reasons based on context in the model convention why losses should be regarded as within article 7, even where domestic law seems to interpret the word "profits" differently[72]—for example, the awkward interaction of domestic loss rules and treaty profit rules that would result (with force of attraction prevented only for profits) and the operation of articles 10(4), 11(4), and 12(4), which return dividends, interest, and royalties to the business profits article without any requirement that there actually be profits for that article to operate on.[73]

It is possible under both the allocation and the accounts methods to produce, in effect, a profit in one part of an enterprise and a loss in another; consider the result for the branch if the expenses of the branch in the numerical example given above were 30 instead of 10.[74] What cannot happen under the allocation method is that one country can end up with a loss based on the market price of the transfer to or from the PE where this is less than the revenue produced from dealings with third parties. I do not regard this outcome as inappropriate from a policy perspective. It is hard to find anything in article 7 that prohibits it without reading a great deal into the article, and the fact that a different result would flow when a subsidiary is involved is not a convincing reason why the PE treatment should be changed.

This raises the question whether branches should be treated differently from subsidiaries, assuming that the current orthodoxy for the latter is correct in their case. There are several differences between branches and subsidiaries that can justify different outcomes for the application of the arm's-length principle. First, the PE is not treated as a separate enterprise for the purposes of all aspects of the model convention—for example, there can be no dividend, interest, or royalty

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(Paris: OECD, 2003), paragraph 60: "The question of allowing a deduction where shares are issued pursuant to a stock-option is, however, a matter of domestic tax policy. While it is true that the fact that countries' rules vary in that respect may create difficulties and possible compliance problems, this is just another example of mismatches resulting from differences between countries' rules for computing profits, a matter that is generally not dealt with in tax treaties." Though it could be that the business profits article is an exception, it would be an exception that ate up the rule. The commentary on the OECD model convention, including that on article 7, often makes clear that the terms of the model are very flexible and intended to accommodate a wide variety of domestic rules.

72 See, in Australia, *American Thread Company v. Federal Commissioner of Taxation* (1945), 73 CLR 643 (HC).

73 See TR 2001/11.

74 For both the separate accounts and the allocation methods, the result in the PE country would be the same: a loss of 10. The calculation under the allocation approach in the residence country may be different if for the purposes of the foreign tax credit calculation (as in Australia) the loss of the branch is not allowed to enter as a deduction in the calculation—that is, foreign losses are quarantined. Even in accounts-based countries, the treatment of foreign losses in the residence country can produce a variety of outcomes.

withholding tax under article 10, 11, or 12 (in cases where the last permits tax at source) on transfers from PE to head office of notional dividends, interest, or royalties.

Second, the PE and head office are part of the same enterprise, and it is not possible to shift risks between them legally in the same way one can with separate companies. A PE disaster will generally take down the head office, while a subsidiary disaster will not have the same effect on a parent. If it is wished legally to replicate the subsidiary outcome for a PE, it is necessary to enter into non-recourse transactions, which limit the liability of the enterprise to the assets of the PE, and this is simply not possible for all dealings by a PE—for example, in relation to product liability under consumer protection laws.

Third, and similarly, the nature of tenure of assets held by a subsidiary vis-à-vis a parent is different from the position between the head office and a PE. A subsidiary can actually lease or buy, whereas a PE shares ownership with the head office. To these differences it can be replied that they are simply legal consequences and that it is possible to construct accounts between different parts of a taxpayer that produce tax consequences on the basis of assumed transactions. It is possible but strange that the regime in the guidelines, which is so insistent on not disregarding the legal form of transactions, can in the case of a PE sweep the legal position aside as a mere matter of lawyer's mumbo-jumbo.

Fourth, there is a difference between entering into transactions that have legal effect (as between parent and subsidiary) and simply recording an assumed transaction in accounts. Real transactions have more than income tax effects, which the parties have to consider and which place some constraints on the possibilities, such as who can sue to protect intellectual property rights, and whether VAT, stamp duties, or other transactions taxes apply. The discussion draft seriously suggests that it will simply be what is written in the accounts or whatever other documents are required[75] that will determine the initial nature of the dealing for calculating the PE's profit. Certainly one lesson that should be learned from the US check-the-box regulations in the international context is the potentially destructive nature for the international tax system of purely elective tax treatment where the election has no other commercial consequences.

Hence it is not to be regarded as odd that the commentary on business profits of PEs produces differences from the position for separate companies. Two specific matters often referred to are the "bans" on deductions for internal interest and royalties. The discussion draft proposes that the ban on internal royalties go while the ban on interest remain. Yet related-party interest (thin capitalization) and royalties (commensurate with income) are the two cases under the guidelines where transactions can be disregarded. Is it really the case that taxpayers and tax

75 It will be interesting to see how in practice the extensive transfer-pricing documentation requirements for separate enterprises are to be applied to fictitious transactions of head office and branch.

administrations are now going to construct intra-entity royalties and then apply the commensurate-with-income rules to disregard them in some cases?

It is not, however, in these specific areas that the different position in the business profits article and commentary is most significant. It is the recognition that in many instances the accounts can be disregarded (read transactions reconstructed as well as prices changed) and that profit splits of one kind or another and proxy calculations of profits are permitted for PEs and are consistent with the terms of article 7. The approach of the model convention and commentary to business profits is much more pragmatic and much less doctrinaire than the guidelines (and, by extension, than the discussion draft). They accordingly are not so open to the kind of manipulation as the guidelines noted above and the discussion draft, despite their imperfections.

The effect of applying the guidelines to PEs is clearly evident in the case of the recently much-discussed server PE and in the emerging debate over agency PEs. The main (but not the only) purpose of the PE definition is to give taxing rights to the PE state. Whether PE taxation is a source principle or a residence-supporting principle, the purpose will be undone if PEs are exposed by the discussion draft to the profit-stripping practices possible under the guidelines. To say the least, it is a quixotic result to have a prolonged debate as to whether a server can constitute a PE, and then, when it is concluded that it can in some cases, have another parallel prolonged debate that concludes that no profits will normally be attributable to the PE. A simpleminded reader of the PE and business profits articles, observing the de minimis carveouts in the PE article, would conclude that once the threshold had been crossed, more than trivial taxing rights were intended to arise.

In the case of agency PEs where the PE is constituted by a separate person (enterprise) to the enterprise that has the PE, a similar line of argument is being used to suggest that there will rarely be any profit of the PE (as opposed to the profit of the agent, which will be taxed to the agent). All the effort expended over the years in relation to agency PEs may turn out to have been a waste of time in view of the enlightenment of the guidelines.

If the agent that habitually enters into contracts on behalf of the enterprise is not an associated person of the enterprise within article 9, then the agent will generally be paid the market value of its services and taxed on them in the country where the agent's activities are conducted. If the agent is not of independent status within article 5(6) so that it constitutes a PE of the principal, there will be no additional profits to tax to the PE because the market value reward of the functions performed by the agent in the country is the amount paid to the agent so that the revenue (value of the agent's services) and expenses (amount paid to the agent) of the PE are equal. Further, the OECD commentary was recently amended to point out that the agent itself need not be a resident of the country where the activities occur or have a PE there. Thus, it should be possible to arrange things so that the agent's fee also does not get taxed in the country of the PE constituted by the agent's activities.

The argument does not entirely preclude a residual operation for agency PEs. The commentary has long noted that employees can be agents for this purpose. Hence where employees are travelling salesmen, the selling profit element on their sales activities would be caught. Further, if the enterprise using the agent has other related functions in the jurisdiction, it may be possible to find some profit in relation to them.

The latter line of argument seems to be emerging as the favoured response. If, say, the principal has, in the country where the agent is operating, goods stored in a warehouse owned by a third party unrelated to the principal or the agent, there are clearly assets and risks in the jurisdiction related to but above and beyond the functions performed by the agent. Although the PE article makes clear that warehousing of an enterprise's goods does not give rise to a PE, it is also clear that once there is a PE, any profits relating to what would on their own be auxiliary or preparatory activities become taxable as part of the PE if they are attributable to it. Even so, it is unlikely that there will be much profit attaching to the warehousing activity after the warehouse owner has been paid if the general reasoning in relation to agents just discussed is accepted. Further, if the warehousing is done by someone other than the agent it may not be attributable to the PE constituted by the agent.

The question is whether these relatively minor cases are all that were intended to be caught by the agency PE provision. There is little in the commentary on PEs to suggest such a narrow result. The overall context suggests that where agents conduct selling activities, the selling profit should be allocated to the PE jurisdiction and the selling activity will give rise to profit (that is, more than the agent's fee). To put it in terms of the guidelines, it is assumed that functions (along with assets and risks) follow activities and cannot be separated from them simply by suitable contractual arrangements. To put it more concretely and to return to an earlier example, while contract manufacturers do exist in the real world, in an enterprise or group of associated enterprises that carry on normal manufacturing operations with all the risks and assets that usually entails, there can be no contract manufacturer.

Another possible explanation is to note that an agency PE will usually be an associated enterprise (because of the exception for agents of independent status). In many cases this means that article 9 could be applied to adjust the agent's reward if it was not arm's-length, and the agency PE may simply be an alternative way of getting to this result (though with a different taxpayer). Again, however, this explanation effectively strips the agency provision of much substantive operation and gives it at best a residual operation.[76]

76 If the associated enterprise that is the agent is not a resident of the country where the agency is performed, then article 9 would not be applicable and article 7 may be the only route available. There are a number of cases like this in which articles 7 and 9 are potentially incomplete but it is possible to interpret away the problems, see TR 2001/11.

There are several other provisions found in tax treaties whereby PEs are created in relation to third-party activities for the enterprise that are vulnerable to the same line of argument. These include warehousing and processing PEs.[77] Again, it would seem very odd if no effective taxing rights were attracted by these provisions in a treaty, because they give rise to long and hard treaty negotiations in many cases. Similarly, a number of extensions to the PE concept where the enterprise itself is conducting the activities are based on the assumption that significant taxing rights arise. Examples are substantial-equipment PEs[78] and short-term offshore PEs,[79] both of which are particularly relevant to the oil and gas industry, where substantial rents are earned. The former case in particular could be made the subject of the kind of argument adopted for attribution of profits to server PEs, leaving little, if any, profit to tax.

As with associated enterprises, many of these interpretation issues for article 7 are becoming moot as countries move into line with the discussion draft even before it is complete. It will be no surprise if the aggressive tax planning based on the guidelines increases when they are extended to PEs.

In summary, the guidelines—often in conjunction with other developments in international taxation, such as commissionaire arrangements and the US check-the-box regulations—have spawned a new generation of tax planning which threatens to undermine the international tax base. It is contrary to the many years of development of PE taxation principles to extend the guidelines approach to PEs. Moreover, such an extension is not required either by the text of the OECD model convention or by the policy underpinnings of transfer pricing. Policy would be better served by going in the opposite direction and reasserting PE-type principles in relation to separate enterprises.

Conclusion: Does the Arm's-Length Principle Have a Future?

To this point, the focus has been on what is bad in the guidelines—particularly the clash of the economic analysis of MNEs underlying them and the transactional requirement that they so strongly insist on. It is this issue which needs to be resolved above all. Several lines of development are possible, and at the moment it is an open question where we will end up. One thing is clear from the evolution of transfer pricing—there is no option of standing still in the current dynamic environment.

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77 Article 5(5)(b) of United Nations, Income and Capital Model Convention, January 11, 2001, reproduced in International Bureau of Fiscal Documentation, *Tax Treaties* (Amsterdam: IBFD, 2003) (CD-ROM), release 1 is an example of the former, and Australia's treaties regularly include the latter.

78 Australia regularly includes such provisions in its treaties.

79 These are regularly included in treaties by countries with offshore oil and gas, for example, the United Kingdom, Ireland, Norway, and Denmark.

Within the framework of the guidelines there has already been a shift to profit methods, and these plus several other features that link with them—such as aggregation of transactions—can have the effect of relaxing the transactional requirement even if the rhetoric is maintained. And once we start to look at transfer-pricing issues from a group perspective, which effectively the profit methods do, much of the damage that can be done by a narrow transactional construct is counteracted, even if the first stage in the analysis is transactionally based. In the case of the transactional net margin method, the profit comparisons look at groups that conduct similar overall activities, and profit-split methods can allow the spreading of the return to the intangibles on the basis that it is an attribute of the group. It is possible that the profit methods could be subverted in the same way that pricing methods have been, but it is not inevitable.

By this backdoor route, we may return to where we began with more emphasis on a whole-of-enterprise approach (then head offices and branches, now groups of companies). In particular, something must happen on the interest deduction front, whether in the form of a ban on deductions within an enterprise or group and recognition of only third-party interest, which is spread across countries by allocation, or in the form of toughened thin capitalization measures. The former is the approach for branches that is still to apply under the discussion draft for non-financiers. The latter has been occurring steadily since the mid-1980s. A whole-of-enterprise or group approach may also provide some solutions for hybrid entity tax planning.

At the administrative level, the heavy compliance demands that the particularistic nature of transfer pricing creates may be ameliorated by the ongoing development of advance pricing arrangements (APAs) which are acknowledged and encouraged by the guidelines. The potential here is that eventually precedential principles will emerge from the many different APAs that are issued. Such a development requires that the general content of APAs become public, which is already occurring to some degree. Once it is clear how tax administrations will treat particular fields of activity, taxpayers are likely to be inclined to follow the guidance as a way of reducing compliance costs and having more certainty of outcome.

In effect, APAs could become a type of formulary apportionment, but without some of the drawbacks of general formulas which adopt a “one size fits all” approach. There would be a range of formulas for different industries and different ways of doing business in an industry. Such a development has already been mooted.[80] It is likely to be a relatively drawn-out process, perhaps too drawn-out to solve the problems for division of the international tax base caused by integration (globalization) of markets.

In that event, countries may move to impose formulas rather than allowing them to evolve. The obvious candidate for this approach is the European Union,

80 See, for example, Jinyan Li, “Global Profit Split: An Evolutionary Approach to International Income Allocation” (2002) vol. 50, no. 3 *Canadian Tax Journal* 823-83.

soon to be a group of 25 countries, which will include more than half the member countries of the OECD. Within the European Union processes also tend to be slow—debates on the consequences of market integration for corporate taxation have been going on since the beginning.

However, two forces are combining at the moment which may produce the necessary momentum for change. On the one hand, the Commission is in an activist phase in trying to push its corporate tax agenda forward; on the other, the European Court of Justice (in part prompted by the Commission) is currently dismantling many of the elements of the international tax system within the European Union on the basis of non-discrimination. If the pillars of the international system become sufficiently shaken in the process, the transfer-pricing regime may be brought down with them. Certainly the transfer-pricing rules are very much on the current Commission agenda.

Within the European Union and the OECD, developments along these lines will help to defend the robustness of the corporate tax base and its fair division among countries. In relation to developing countries, more is required. I have argued that the taxing of business profits to PEs is a residence-supporting tax principle, which is one of the necessary measures to overcome the lack of robustness of corporate residence rules. While the PE taxing principle may have started life as a source taxing concept for business profits, that is not the reason why the principle remains so important to the international tax system. We need to be vigilant that PE status cannot be avoided by simple tax planning and that the existence of a PE generally attracts a substantial tax base to the country of the PE.

If this view of the function of the PE concept today is accepted, several important consequences follow. First, transfer-pricing rules are about allocating the international tax base to protect the residence tax principle, not the source tax principle. Second, the PE concept is not the appropriate means to ensure that developing countries have access to a fair share of the business tax base. It is necessary to develop appropriate source rules for business income that do not depend on the existence of PEs. The mechanisms for doing so already exist in the current treaty framework. What is needed in this context is that OECD countries recognize this source taxing claim and that developing countries recognize the distorting effect of gross basis taxes and work with OECD countries to devise workable solutions.