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Taxation of Business Profits: The New Article 7

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On 22 July the OECD Council approved the 2010 Update to the OECD Model Tax Convention on Income and on Capital and it Commentaries.[1] The introduction of a new Article 7 on Business Profits by this Update (accompanied by a revised version of the Report on the Attribution of Profits to Permanent Establishments)[2] represents the most significant change to the distributive rules in the Model in decades.[3]

The process leading to the new Article 7

The process which led to the new article began in the mid 1990s. To see why we have reached a very unsatisfactory position, it is necessary to understand something of the internal workings of the OECD. The OECD body responsible for tax is the Committee on Fiscal Affairs (CFA). That Committee has several subsidiary bodies, two of which are Working Party 1 (WP1) in charge of the Model and Working Party 6 (WP6) in charge of the Transfer Pricing Guidelines[4] work. The working parties, at least in the early stages of the work, tended to operate in silos serviced by a bureaucracy now called the Centre for Tax Policy and Administration.

The work which led to the new Article 7 began in part as the extension of the work on the Guidelines after their initial publication in 1995. It also was in part a follow-up on the work that the OECD had done in the early 1990s on modern financial instruments[5] leading to the creation of a body called Special Sessions on Innovative Financial Transactions which started to work on the taxation problems of global trading in financial instruments.[6] When the more general work on attribution of profits

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[1] OECD, "The 2010 Update to the Model Tax Convention" available at http://www.oecd.org/dataoecd/23/43/45689328.pdf. The consolidated version has been published as *Model Tax Convention on Income and on Capital* (Condensed Version, 2010).

[2] OECD, "2010 Report on the Attribution of Profits to Permanent Establishments" (Attribution Report) available at http://www.oecd.org/dataoecd/23/41/45689524.pdf. This is a formal revision of the 2008 version to recognise the addition of the new Article 7 to the Model along with its entirely new Commentary and the removal of the former versions; there are no substantive changes to the earlier version.

[3] The other very important changes are in the administrative area: the "new international standard on tax transparency" (information exchange) in 2002 and 2004, the addition of assistance in collection in 2005 and the introduction of an arbitration provision in 2008.

[4] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010). The Guidelines were also the subject of substantial revision in 2010.

[5] OECD, *Taxation of new financial instruments* (1994) which was concerned with domestic as well as international tax issues.

[6] Two draft reports were produced in 1997 and 1998 which emphasised the role of the traders, see OECD, *The Taxation of Global Trading of Financial Instruments* (1998).

commenced in the late 1990s, the global trading work (and the Special Sessions)[7] were subsumed into the project which was allocated to WP6.

Just as it had done for the 1995 Guidelines WP6 started on the issue as far as possible with a clean sheet though there was a history in each case. It became obvious early in the work that the existing Commentary on article 7 dealing with the taxation of business profits of permanent establishments (PEs) was not compatible with the approach in the Guidelines and accordingly WP6 came up with a working hypothesis (WH) to guide the development of its work as follows:[8]

> The basis for the development of the WH is to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise can be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention is to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

The treaty people of WP1 were not involved in this work and several further drafts were released in 2003 and 2004 before it dawned on WP1 that the WP6 approach was overturning several long established positions on attribution of profits to PEs in the Commentary on Article 7. By then the horse had bolted. In 2005 the CFA set up a joint group of WP1 and WP6 to see how the work could be implemented and any objection by the WP1 delegates that the work could not proceed without overhauling the text of Article 7 and that was not appropriate was effectively quashed – by 2006 the decision had been taken to make the WH the Authorised OECD Approach (for which another acronym was invented – the AOA) and the joint group was directed to redraft Article 7 to give effect to it as well as revising the existing Commentary as far as possible to conform to the Attribution Report.[9]

The need to redraft Article 7 was largely a fig-leaf to give cover for the changes in the Commentary which was what WP6 found unacceptable – it was considered that the whole exercise would lose credibility if the Commentary was changed dramatically without any change to the Article. In 2008 the Commentary was revised in accordance with the directions and a new draft of Article 7 was released for consultation. In 2010 the final step occurred with the release of the new Article 7 and the new Commentary to accompany it. Because many existing treaties use the text of the former Article 7, the former Article 7 and its Commentary are retained as an appendix to the Commentary on the new Article 7. While the new Commentary may be revised in future, it is intended that the 2008 Commentary will be frozen in time for the future.

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[7] The global trading work dealt with allocation issues involving both PEs and separate enterprises and now appears as Part III of the 2010 Report. Because of it origins it still goes beyond the allocation of profits to PEs whereas the other parts deal only with PEs.

[8] OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (2001) 4 (Preface para 3).

[9] OECD, *Report on the Attribution of Profits to Permanent Establishments* Parts I-III (2006) 2-3 (paras 1-10).

Not all countries agree with the new approach of the OECD. In particular New Zealand has expressed its disagreement with the Attribution Report and has indicated that disagreement in the Commentary. New Zealand prefers the previous Commentary the latest version of which was in 2005.[10] In 2009 the United Nations indicated that it was not going to adopt the new article 7.[11] As a result we now have effectively three positions being adopted by different groups of countries. Most OECD countries so far as can be judged will adopt the new Article and Commentary though it appears that countries are being given some time to develop their policy and so it is not clear at this stage how many of the OECD countries will in fact use the new Article 7. Australia's position at this stage is not positively known though it is likely to follow the general OECD changes. The second group are countries which will continue to use the former Article 7 but will accept the 2008 Commentary as its correct interpretation. The third group will continue to use the former Article 7 and not accept the Commentary changes made in 2008 as correct. Where countries which do not accept the new Article 7 will fall as between the second and third groups is also unclear. The fact that the 2008 Commentary is frozen will make the problem worse when future changes are made to the new Commentary which countries using the former Article 7 consider applies to that version as well.

This outcome is entirely unsatisfactory, particularly as the objective of the exercise was to achieve international consensus on the attribution of business profits to PEs. No doubt the OECD hopes that with the passage of time the former Article 7 and its Commentary will fade from view and the new Commentary will be applied to all treaties even if they do not adopt the new language. It will be many decades before this position is likely to be reached. Hence for the foreseeable future it will be necessary to take account of at least the three positions outlined in the previous paragraph and to accept that different treaties will be subject to different principles for the attribution of profits to PEs.

The main changes in the new Article 7

The former and new versions of Article 7 are contained in Appendix 1. The changes so far as the attribution of profits is concerned are apparently minor language differences in paragraphs 1 and 2 as set out below.

Pre 2010 Article 7	New Article 7
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 PE situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed	1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein. If the enterprise carries on business as aforesaid, *the profits that are attributable to the PE*

[10] OECD 2010 Model Commentary on Article 7 para 95, OECD 2008 Model Commentary on Article 7 para 74).
[11] UN, Recent work of the Organization for Economic Cooperation and Development on the attribution of profits to PEs: implications for the United Nations Model Double Taxation Convention between Developed and Developing Countries (2009), UN, Committee of Experts on International Cooperation in Tax Matters Report on the fifth session (19-23 October 2009). Both UN documents may be found through http://www.un.org/esa/ffd/tax/fifthsession/index.htm.

in the other State but only so much of them as is attributable to that PE.	*in accordance with the provisions of paragraph 2* may be taxed in that other State.
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 PE situated therein, there shall in each Contracting State be attributed to that PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.	2. *For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the PE referred to in paragraph 1* are the profits it might be expected to make, *in particular in its dealings with other parts of the enterprise*, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, *taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise*.

On the face of it there are four main changes in the text of this part of the article. First, there is a closer connection between paragraphs 1 and 2 indicating that the profits determined under paragraph 2 are the same profits referred to in paragraph 1. Secondly, the article applies also for the purpose of relief of double taxation (through the reference to Article 23). Thirdly, it is made clear that the principle in paragraph 2 applies not only as between the PE and the rest of the enterprise but as between the PE and the rest of the world. Fourthly, the transfer pricing terminology of functions, assets and risks is adopted which is intended as a pointer to the Transfer Pricing Guidelines being relevant for the application of the article. The first, second and fourth of these points require considerable elaboration and are dealt with under subsequent headings.

The third point can be dealt with more briefly. Under the former version it was not clear whether the hypothesis required by paragraph 2 applied only as between the PE and the rest of the enterprise, though a literal reading of the concluding words would suggest that this was the case. Some countries, including Australia, added words to the end of the former paragraph 2 in the following terms "or with other enterprises with which it deals."[12] These words made clear that the paragraph was to be applied on the basis that it operated between the PE and other enterprises as well as other parts of the same enterprise. The new Article 7 uses other words ("in particular" etc) but equally makes the point clear.[13]

[12] See Art 7(2) of Australia's recent treaties with Finland (2006), Japan (2008), Chile (2010), Turkey (2010). Australia New Zealand 2009 lacks the addition.

[13] 2010 Model Commentary on Article 7 para 24. The pre-2008 Commentary suggested that some countries has similar issues even as between the PE and other parts of the enterprise besides the head office. It suggested that the same conclusion could be reached as between the PE and the rest of the enterprise beyond the head office on interpretation of the pre 2010 OECD version of Article 7 but invited countries if they wished to clarify the matter in their treaties by deleting the concluding words "and dealing" etc, OECD, *Model Tax Convention on Income and on Capital* (2005 Condensed Version) Commentary on Article 7 para 11.

Functionally Separate Entity versus Relevant Business Activity

The close linkage between paragraphs 1 and 2 in the new version of Article 7 is designed to choose between two methods of applying the provisions. The preferred position of the OECD is referred to as the functionally separate entity approach. Under this approach the PE is treated as a functionally separate entity to the fullest extent in applying the arm's-length principle in paragraph 2. The alternative approach is the relevant business activity approach under which the amount of profit that is available for allocation under paragraph 2 is limited.

The OECD does not apparently realise that there are in fact two issues underlying this difference. The first concerns whether paragraph 1 has a separate limitation on the profits which are subject to paragraph 2. Different forms of limitation can be potentially extracted from the previous version of paragraph 1. First, the profit available for allocation might be limited to the overall profit of the enterprise so that, for example, if the enterprise made an overall loss no profits could be allocated to the PE. Secondly, the limitation may be the channel profits, that is, the amount of profits which the enterprise makes with respect to the transactions which occur through the PE. Under this variant if the enterprise made a loss on the particular transactions that were ultimately effected through the PE in conjunction with the rest of the enterprise, then again no profits could be allocated to the PE. Thirdly, the amount that could be allocated to the PE may be subject to a limit where the transfer price as between the rest of the enterprise and the PE exceeds the sales revenue derived by the PE (or the transfer price from the PE to the rest of the enterprise conversely exceeds the sales revenue if the final sale is not effected by the PE).

In the case of the limitation based on the overall profit or the channel profits of the enterprise it is easy to see how the former version of paragraph 1 could be read to contain such a limit. This problem is clearly fixed by the 2010 version of Article 7 as the link with the profits which may be taxed where there is a PE under paragraph 1 to the amount calculated under paragraph 2 is made explicit. This clarification, however, does not directly address the difference between the functionally separate entity and the relevant business activity approaches which in a textual sense seems to turn entirely on the meaning of paragraph 2. What is involved in this difference really concerns two ways of calculating the profits of a PE. The difference can be best demonstrated by way of an example.

Assume that the head office of an enterprise manufactures goods with a cost of 60 and ships them to its PE in another state and the value of the goods at the time of shipment is 100, that is, the correct transfer price at this time is 100. The PE in the other state sells the goods and incurs its own separate costs of sale of 20. For simplicity it is assumed that there are no shared costs between the head office and the PE. The sale price in the example is alternatively 150 or 50. This difference could arise if the goods were damaged while stored at the PE or were obsolete at the time they were sold by the PE. The table below represents the outcome under the two approaches.

Table 1: Relevant business activity v Functionally separate entity

	Relevant business activity		Functionally separate entity	
PE	Case 1	Case 2	Case 1	Case 2
Revenue	50	0	150	50
Expense	20	20	20	20
Cost of goods sold			100	100
PE Profit	30	(20)	30	(70)
[Head Office Profit	40	(10)	40	40]
Total Profit	70	(30)	70	(30)

Under the relevant business activity approach, revenue and expense is calculated on the basis of allocation by source to the head office and PE, in other words, there is no recognition of a deemed transaction of sale between the head office and the PE. In Case 1 where the goods are sold for 150 the revenue is allocated as to 50 to the PE and as to 100 to the head office. This allocation of revenue reflects the transfer price of 100 when the goods are shipped to the PE and so the transfer price enters only in an indirect way to allocate revenue. As the PE has its own expenses of 20 the profit of the PE on this approach in Case 1 is 30. In the case of the functionally separate entity approach the same result is reached in Case 1 for the PE's profit but the method of calculation is different. In this case the head office is treated as having sold the goods to the PE for 100. In turn the PE has expenses of 120 being its own expense of 20 and the deemed purchase price of the goods from the head office for 100.

Parenthetically it may be noticed that the head office profit in Case 1 is 40, that is, revenue of 100 less expenses of 60. Article 7 in both its new and former versions does not say anything as to how the head office is taxed, only as to the PE. That is why the head office profit is in brackets in the table.[14]

It is in Case 2 where the goods are sold at an overall loss that the difference in the two approaches arises. For the relevant business activity approach there is now only 50 of revenue to allocate which is less than the transfer price of 100. As this approach does not recognise deemed revenue or deemed expense but simply allocates actual revenue and actual expense there is only 50 of revenue to allocate. It might be debated as to how this amount would be allocated but for simplicity it is assumed in the example that all of the revenue is allocated to the head office. In this case the PE has no revenue and expenses of 20 with the result that it makes a loss of 20. In the functionally separate entity approach the PE is treated as having expenses of 120 as above and revenue of 50. The result in this case is that the PE incurs a much greater loss of 70. It will be noted in Case 2 for the head office that there is also a difference in the amount of profit or loss between the two approaches.

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[14] There are different views on how the head office profit is calculated. If the transfer to the PE is treated in the residence country as a sale by the head office then the result is likely to be as in the table for an exemption country (a foreign tax credit country would bring in the actual revenue of 150 as it would include the total revenue of the enterprise for the transaction). Alternatively the dealing may only regarded as relevant for determination of the PE profit in which event the head office is taxed on actual revenue and expense with an exemption for the PE profit under an exemption system using the PE profit calculated using the notional dealing. The different ways of dealing with the head office show up most noticeably when the goods are shipped to the PE in income year 1 and sold by the PE in income year 2.

In each case the bottom line total profit and loss of head office and PE is the same for the two approaches as that outcome depends on actual revenue and expense. The difference is in the way the overall outcome relates to the results of the PE. In particular in relation to the functionally separate entity approach it is possible to have profit in a PE when the enterprise makes a loss overall on a transaction and a loss in a PE when the enterprise has a profit overall on the transaction in more cases than in the relevant business activity approach and the amounts of the profits and losses may be different. The version of the relevant business activity approach set out above is not the only possible version but it conveniently demonstrates the difference between the approaches. The problem arises under this version when the total sales revenue of the PE is less than the transfer price. This is the third situation identified above in relation to differences between the two approaches.

The authorised OECD approach is to adopt the functionally separate entity approach and to reject the relevant business activity approach. This has potentially significant consequences for countries like Australia which in their domestic law clearly adopt a process of allocation of revenue and expense in determining the profits of a PE under the transfer pricing rules.[15] The OECD only clearly separated the two approaches in 1994, but only required use of the functionally separate entity approach where the activity concerned is part of the main business activity of the enterprise, in the example above the manufacture and sale of goods. In other areas, particularly in relation to interest, royalties and management fees which are discussed below, the OECD has always until the 2010 changes required an allocation approach. The significance of the change in 2010 is that the functionally separate entity approach is now generalised to all activities of a PE.

In the actual example above it would be unlikely in the real world that the difference between the relevant business activity and functionally separate entity approaches would show up. This is because it is accepted that transactions can be aggregated under transfer pricing principles in calculating the appropriate amount of profits to be allocated to an enterprise or to a part of an enterprise. Hence if only some of the goods sold were damaged or obsolete, the losses involved would be absorbed into the other sales of the same product by the PE and if the total revenue for all sales of similar items exceeded the transfer price, the difference would disappear. The Australian Taxation Office ("ATO") adopts the relevant business activity approach in its interpretation of transfer pricing rules in domestic law (clearly correctly), and also notes that for the reasons just given the differences will not generally be relevant.[16]

In a broader sense, however, the adoption of the same approach across all dealings of a PE has significant consequences. This can be demonstrated by considering the Australian case which effectively supports the ATO view, *Max Factor*.[17] In that case the Australian PE of an American resident enterprise asked the head office to purchase certain materials for it. The materials were forwarded to the PE and in due course the PE remitted funds to the head office with respect to the materials. At the time the materials were "sold" by the head office to the PE, the exchange rate between the US dollar and the Australian dollar was different from the exchange rate when the PE "paid" the head office for the materials. The PE claimed a deduction for the

[15] *Income Tax Assessment Act 1936* s 136AE(4), (7).
[16] TR 2001/11.
[17] (1984) 15 ATR 231, 84 ATC 4060.

exchange loss on the basis that similar facts involving separate entities would have given rise to a deduction. The court rejected the claim in effect saying that the enterprise was taking money from one pocket and putting it into another pocket and it is not possible to make an exchange loss out of such internal dealings. Canada has case law to similar effect and the drafting of the US regulations dealing with interest expense were premised on a similar view, though a recent court case has held that the regulations were effectively nullified by the arm's-length separate enterprise principles in the business profits article.[18] Under the new Article 7 it will be necessary to recognise exchange losses in the kind of case.

The OECD recognises that this shift in its position may mean that the domestic law of some countries (such as the US and Australia) which had tracked what was thought to be the approach adopted in treaties will no longer be aligned with the treaty treatment. To deal with this issue, the OECD makes clear that Article 7 operates only as a limit on the amount of profits that can be taxed.[19] If the domestic rules produce a lower amount of profit subject to tax, then the treaty does not affect that amount. If, however, the domestic law produces a higher amount that is subject to tax compared to the limit imposed by Article 7 as interpreted by the OECD, then the limit is binding and the country can only tax the amount up to the limit. For Australia which does not conform to the OECD approach in its domestic law, the obvious question is whether the law will be amended. It seems likely that such an approach will be forthcoming. Indeed it was recommended as a gradual evolution of Australian rules by the Ralph Report in 1999 and the approach has since then been adopted in relation to the exemption for foreign PEs of Australian companies and dividends received by PEs.[20]

It will be noted that the example above involves a PE that makes losses as well as profits, whereas the language of both versions of article 7 only refers to PE profits. The OECD simply states that the reference to profits includes losses without any discussion or elaboration:[21]

> As explained in the Report, the attribution of profits to a PE under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities.

The ATO has accepted this position in its ruling on attribution of profits[22] but this view is not accepted in all quarters and it was not explicit in the OECD Commentary on business profits prior to 2010.

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[18] *Cudd Pressure* [1995] 2 CTC 2382, 95 DTC 559, *National Westminster Bank* (1999) 44 Fed Cl 120, (2003) 58 Fed Cl 491, (2005) 69 Fed Cl 128, (2008) F 3d 1347.

[19] In recognition of its different approach Australia entered an Observation on the 1994 Commentary when the functionally separate entity first appeared that it only recognised actual revenue and expense. The Observation was withdrawn in 2005 by which time the OECD had made clear that Article 7 only operated as a limit and did not require domestic law to adopt one particular approach to the calculation of PE profits.

[20] Review of Business Taxation, *A tax system redesigned* (1999) 668-669, *Income Tax Assessment Act 1936* ss 23AH(12)-(14), 44(1)(c), *Income Tax Assessment Act 1997* s 67-25(1DA).

[21] 2010 Model Commentary on Article 7 para 20. The Attribution Report at 11 (para 3) does not take the matter any further despite the cross reference, "It should be noted that under the authorised OECD approach, the same principles should be applied to attribute losses as to attribute profits. References to attributing 'profits' should therefore be taken as applying equally to attributing losses." Previously references to losses in the Commentary on Article 7 were clearly to specific losses, for example, a particular bad debt, and not to the overall profit or loss position of the PE.

[22] TR 2001/11.

Functions, assets, risks: Application of transfer pricing principles

The reference to the transfer pricing terminology of functions, assets, risks, in paragraph 2 is designed to introduce the modern transfer pricing analysis to the treatment of PEs. The functionally separate entity approach adopted by the OECD is a critical part of this change. The OECD recognises that PEs are different from separate enterprises particularly in the fact that it is not possible generally speaking to have legal transactions within the same enterprise only between separate enterprises. Moreover, it is necessary to determine in the case of a PE exactly what the boundaries between the PE and the rest of the enterprise are, which is largely automatic in the case of a separate enterprise.

To deal with these differences the OECD has introduced a two-step approach for the application of transfer pricing principles to PEs. In the first step is necessary to have reference to the definition of PE and having identified the activities which fall within that definition to conduct a functional analysis to determine the overall importance of those activities in relation to the enterprise as a whole. Having conducted the functional analysis, the first step involves the attribution of capital and assets to the PE in order to construct a balance sheet for the functionally separate entity. In this process the risks borne by the PE play a critical role. As these matters are essentially issues of transfer pricing approaches and methodologies they will not be pursued here.

The second step involves treating the dealings of the PE with the rest of the enterprise as if they were transactions between separate enterprises and applying the transfer pricing guidelines by analogy to those dealings. Again this is largely a matter of transfer pricing and so is not to elaborated here.

The main changes on the ground: old presumptions and new presumptions

The approach just described sounds very abstract. To make it concrete it is helpful to look at a number of the specific areas where the new approach produces changes from the former Article 7 and its Commentary. Under the former Commentary it was stated that a PE could not deduct notional or deemed interest, putting aside financial enterprises, or notional royalties, and that management services were to be dealt with on an allocation of cost basis only.[23] In effect for interest, royalties and management fees there could only be an allocation of actual expenses of the enterprise to the PE and no notional loan, license, or management service agreement between the PE and the rest of the enterprise. These were the “obstacles” that made the new Article 7 necessary.

Initially these rules of thumb were stated as such without any real justification. In 1994 a justification and explanation was put forward for royalties as follows:[24]

> 17.4 Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will

[23] This is clearer in the 2005 version, 2005 Model Commentary on Article 7 paras 17.1-23 than the 2008 version where there are significant changes in relation to the Commentary on interest as a result of the Attribution Report which were not regarded as contradicting the previous Commentary.
[24] As it existed before 2008, see 2005 Model Commentary on Article 7.

> often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate to a compensatory charge.

The 2008 version of the Attribution Report notes that this is inconsistent with the functionally separate entity approach and generally criticises it as follows:[25]

> 108. The discussion in paragraph 17.4 is deficient in a number of respects. It focuses on whether an internal "royalty" could be paid and is silent on other important issues such as the impact of intangible property on the comparability analysis, the allocation of a return to intangible property from third parties, the rewarding of the parts of the enterprise that may have performed the functions leading to the creation of the intangible, and the use or maintenance of the intangibles. Further the paragraph flags up the issues of allocating costs of development of an intangible and the risks of adverse consequences related to an intangible but without providing much in the way of guidance as to how to perform such an allocation. The rest of this section aims to provide guidance to remedy the current deficiencies.
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> 109. It would be overly prescriptive to allow only one approach for dealing with the variety of ways in which intangible property can be exploited. Indeed, although the language of paragraph 17.4 of the Commentary (reproduced above) favours the cost allocation model, there is a clear implication that arm's length notional payments between different parts of the enterprise could be allowed if the costs of creation could actually be identified as having been, in practice, incurred by one part of the enterprise. Unfortunately, the paragraph does not explicitly distinguish between legal and economic ownership and this may have led to an overstatement of the difficulty in identifying which part of the enterprise has borne the costs and risks of creating and developing the intangible property in certain circumstances. Nor has it recognised that more than one part of the enterprise may have contributed to the development of the intangible property.

Surprisingly the same kind of justification is used elsewhere in the Attribution Report in establishing new presumptions or rules of thumb as described below. It is not surprising in the light of this passage that the previous rules of thumb do not survive in the new OECD world. Thus management fees are subject to the "normal" approach

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[25] The main change between the 2008 and 2010 versions is that references to (and so criticisms of the existing Commentary) are removed so that the Report in its final version simply states the outcome rather than the process. Unfortunately this means that understanding what the Attribution Report means (like the different versions of Article 7) requires recourse to multiple documents.

of the Guidelines (that is, treated as separate dealings subject to mark-up usually on a cost plus basis though some countries in effect allow a no mark-up basis by using the same kind of cost contribution analysis that was previously championed for royalties).

The same approach applies to royalties. It is now possible to have notional royalties payable by the PE to another part of the enterprise such as the head office. This change is not of too great significance because it was always possible under the former Article 7 to arrange to have royalties paid by a PE to a related enterprise to bypass the restriction on deductions that existed in the former Commentary. What is of much greater significance is the recognition that the ownership of assets within the enterprise may be allocated to another part besides the PE even where the asset is effectively used by the PE. Late in the process it was realised that this could lead to a position where a PE was able to deduct payments of rent to another part of the enterprise which was treated as owning the premises occupied by the PE. On the other side, however, it would not be possible to tax this notional rent at source precisely because it is notional rent and most countries do not have any provisions for taxing notional rent in their domestic law.

This odd result has been dealt with in two ways in the new Commentary. First, the possibility is provided for modifying the business profits provision so that the notional deduction, particularly of rent and interest which may be taxed at source under the OECD Model, is subject to tax in the state of the PE as if it were actual rent or interest. The new Commentary, however, does not support states adopting this approach. Secondly, a new rule of thumb is provided for tangible property (note that this rule does not apply to intangible property). Property will generally be considered to be owned where it is used so that in the case of real property used by a PE that property will generally be treated as owned by the PE, and the same applies to tangible property. As a result it will normally be the case that there is no notional deduction of rent for the PE. This replicates the result reached in the Canadian case of *Cudd Pressure* referred to above where the taxpayer argued that specialist equipment used by a PE was rented by the head office to the PE but the court found for similar reasons as in the *Max Factor* case that the equipment was owned by the PE and entitled to depreciation only.

In relation to the funding of the PE, the new Commentary is extremely complicated and only a brief outline will be provided here. The OECD takes the position that the credit worthiness of a PE is the same as the enterprise as a whole and therefore it will have the same credit rating. If a PE were indeed treated as a separate and independent enterprise then in many cases it would have a lower credit ratings than the overall enterprise. The justification that the OECD provides in the Attribution Report for its view is as follows:

> 99. It is an observable condition that PEs generally enjoy the same creditworthiness as the enterprise of which they are a part. Accordingly, under the authorised OECD approach, the "separate and independent enterprise" hypothesis requires that an appropriate portion of the enterprise's "free" capital be attributed to its PEs for tax purposes and that the PE be attributed the creditworthiness of the enterprise as a whole. It is worth re-emphasising that an attribution of "free" capital in excess of the amounts recorded in or allotted to the PE by the home country may have to be made for tax purposes,

> even though there may be no need to formally allot “free” capital to the PE for any other purpose.
> 100. Generally, under the authorised OECD approach, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole; an exception being where for regulatory reasons the capital attributed to the PE of one jurisdiction is not available to meet liabilities incurred elsewhere in the enterprise. In addition, it was also determined that there is no scope for the rest of the enterprise guaranteeing the PE’s creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.
> 101. It has been suggested that in hypothesising the same creditworthiness throughout the enterprise and not recognising intra-enterprise guarantee payments the authorised OECD approach fails to recognise the fact that the creditworthiness of an enterprise is greater than the sum of its parts; *i.e.* that the very act of hypothesising the PE as a separate entity has the effect of degrading the creditworthiness of all parts of the enterprise below that of the enterprise as a whole. Whilst not denying this effect it is not clear why one part of the enterprise, such as the head office, would have the higher creditworthiness necessary to enable it to guarantee the transactions undertaken by the PE. The authorised OECD approach is based on the factual situation of the enterprise, which is that the capital, risks, etc. are fungible, so it would be inconsistent to grant all the benefits of synergy to the head office.

As noted above this is just the kind of reasoning that the OECD has criticised in relation to the treatment of notional royalties.

The treatment of interest deductions proceeds in two stages. The first stage concerns the allocation of capital to the PE and here the OECD has more than one authorised approach. It is important to note a sleight-of-hand that occurs in this discussion, namely, that capital is equated with the lack of an interest deduction. There are many reasons why interest may not be deductible, for example, the capital protection rules in Australian domestic law and the outbound thin capitalisation rules which are a process of allocation of interest rather than denying deductions, which seems to be overlooked. More importantly it is simply incorrect to equate the distinction between debt and equity as turning on the deductibility of interest in a commercial sense. Tax deductibility has nothing whatever to do with the distinction between debt and equity in a commercial context which is what should drive the arm’s-length test.

The approaches authorised by the OECD are an allocation of actual capital approach and a thin capitalisation approach. The latter approach is not meant in the sense of an arbitrary debt to equity ratio but rather what an independent lender would provide by way of loans to a third party in a similar position to the tested PE. Arbitrary methods such as regulatory capital and debt to equity ratios are in effect semi-authorised methods. It is recognised that more than one authorised approach can produce differences in outcome in the PE country and in the residence country with possible double taxation or double non-taxation. The new Article 7(3) is designed to deal with this and similar problems.

The second stage in the interest deduction process is the method used to link capital to income earning activities. Here the OECD in effect has three authorised methods. If an enterprise has a fully fledged treasury operation then that operation is entitled to

earn a mark-up on its activities in providing funding for the enterprise as a whole and dealings between the treasury centre and a PE can be recognised as loans on that basis, even if they do not reflect external borrowings. In the absence of such an operation, the OECD recognises the tracing approach and the fungibility approach. Under the former as occurs in Australia domestically borrowed funds are traced to income earning activities on a flow of funds and/or tracing of purposes approach. Under the latter all borrowings are treated as generally supporting the activities of the enterprise and are spread evenly across the enterprise accordingly. Again having more than one authorised approach can lead to differences in allocation between countries. The OECD recognises that in the absence of a treasury operation, the outcome is in effect the same for non-financial enterprises after the 2010 update as before 2008, that is, deduction for the PE only of an appropriate part of the external funding costs of the enterprise.

The final and very significant new presumption concerns the freedom of a PE to frame its dealings as it wishes. As between separate enterprises the OECD recognises that the Transfer Pricing Guidelines place little constraint on contractual freedom and this has been reaffirmed in the 2010 addition on business restructures. In contrast in the PE case the OECD requires that risk follows functions, that is, it is not possible to separate within a single enterprise the control of risks and which area bears the risk as it is in the case of separate enterprises, for example, through captive insurance arrangements. This limitation on contractual freedom is a very significant difference between PEs and separate enterprises. What the OECD fails to recognise, expressly at least, is that in the modern world PEs are in fact very often separate enterprises. This arises most commonly under the US check-the-box rules which allow the US to treat as a PE what in fact is a separate corporation. In such cases of course it is quite possible to have an actual legal transaction between the PE and other parts of the enterprise because of the legal personality of the PE.

Addition to the new Article 7: Corresponding adjustments

Paragraph 3 of the new Article 7 is completely new and modelled on Article 9(2) on corresponding adjustments. The ATO adopted the position, as did many other countries, that the obligation to make such adjustments was effectively implicit in paragraph 2 of the former Article 7 because of the use of the peremptory language "shall."[26] The OECD also seems to still take the position that paragraph 2 is sufficient in many cases and it is not perfectly clear which cases it considers are covered separately and in addition by paragraph 3. The first possibility is where there is a difference in interpretation of paragraph 2 because countries adopt different OECD authorised approaches if more than one approach is available which would occur most frequently with interest deductions. The second possibility concerns disagreement over the actual transfer price. At different points the new Commentary suggests that only the first of these is covered by the new paragraph (3) or that both are covered.

As with the corresponding adjustment provision in Article 9 the OECD makes clear that the process in paragraph 3 applies to each of the parties of the treaty reciprocally, that it only creates an obligation in a particular state to make an adjustment when it agrees with the analysis of the other state which has already made an adjustment, and that no particular method is prescribed for making the adjustment though in the PE

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[26] TR 2000/16 para 3.6.

state it will normally be by reductions in the attributable profits and in the resident state an adjustment to the relief of double taxation. It is also made clear, particularly by the references to articles 7 and 23 that the provision does not have effect for other purposes of the treaty and therefore does not require any secondary adjustments, for example, by a treating an amount overpaid as a distribution or contribution to capital. There is no time limit on the adjustment requirement and the Commentary therefore raises the issue of whether that matter should be dealt with in the provision. It is to be noted that in recent Australian treaties the formerly unlimited limitation period in domestic law has been subjected to a treaty time limit and it may be that they similar approach will be adopted for Article 7 in new treaties.

It is possible to read the new Commentary as in effect saying that the first state to adjust wins so long as the other state agrees that the adjustment is within the arm's-length possibilities. The OECD regards the process as in effect requiring neither state to adjust if they both agree that the price used by the taxpayer on a symmetrical basis is within the arm's-length possibilities. The former Commentary made clear that in the usual case source state adjustments took priority over resident state adjustments and in that sense there may be a shift and possibly perverse incentives created by the new Commentary.

Deletions from the new Article 7

Apart from paragraph 3 the most obvious change in the new Article 7 is that it is considerably shorter than the former Article 7 through the deletion of former paragraphs 3-6. The only thing that has stayed the same in the new Article 7 is the priority rule as between Article 7 and other articles containing distributive rules in the OECD Model, Article 7(7) which is now renumbered Article 7(4).

The deduction provision

Former paragraph 3 required that a PE be allowed deductions for expenses which were related only partly to the activities of the PE and expenses which were incurred outside the PE state. The paragraph, however, was often read as setting the limit between cases where a mark-up was required on a dealings between the PE and the rest of the enterprise and an allocation of expenses was appropriate, that is, without any mark-up or profit for the other part of the enterprise.

The deduction provision was deleted partly because of this ambiguity as the latter reading is inconsistent with the now authorised functionally separate entity approach. If the provision is regarded as limited to apportionment and payment outside the PE state situations, then it is not clear that the deletion is justified. The new Commentary deals with this issue by simply stating that paragraph 2 overcomes the difficulties. It certainly is consistent with the functionally separate entity interpretation that any difficulties with apportionment rules are overcome because the PE now has to be treated as a separate entity and accordingly only incurs its part of an enterprise expense and no need for an apportionment arises. Rules which still exist in the laws of some countries such as Belgium and in Latin America that an enterprise can not deduct a payment made outside the state are not, however, obviously dealt with by the functionally separate entity approach because a separate enterprise resident in the PE state which made a payment overseas would equally be denied a deduction under such rules.

The new Commentary also deals with the operation of the non-discrimination provision dealing with PEs in paragraph 3 of Article 24. It seeks to adapt the use of dealings rather than actual revenue and expense in determining the profits of the PE to the requirement in the non-discrimination rules that the PE be treated in the same manner as a domestic enterprise. It is recognised nonetheless that it is difficult in some cases to reach this result, for example, rules which defer until the time of payment accrual deductions where an amount is owed to a non-resident but is not paid until a later period of time in order to ensure that the taxation of the non-resident on a payment basis is matched in timing with the deduction by the payer. As dealings do not require payments it is unclear how such rules are to be adapted under the non-discrimination rule for taxing PEs.

The purchase provision

Under the previous OECD Model even if an enterprise had a PE in a state the profits that were attributable to that PE in respect of mere purchasing activities for the rest of the enterprise were not taxable by the PE state. This is in addition to the exception in the PE definition for an office which is only engaged in purchasing activities. The deletion of this rule in the business profits article is justified on the basis that it contradicts the normal approach of the Transfer Pricing Guidelines of rewarding all activities which contribute value. The policy underlying the purchase rule in the former Article 7, however, goes beyond that policy and adopts the view that a country does not wish to discourage non-residents from purchasing its products.

Although that latter policy may encourage some countries to retain the purchase provision, it should not be too problematic even if it is dropped. It will be necessary, however, to conduct purchasing activities through a geographically and economically separate location in order to attract the exception in Article 5 if there is no additional exception in Article 7.

The apportionment provisions

Paragraph 4 of the former Article 7 was a provision which permitted a global formulary apportionment approach for taxing PEs, that is, by applying some factor or factors to the total profits of the enterprise in order to work out the profits of the PE. This was subject to the condition that the outcome had to be generally in accord with the separate enterprise arm's-length principle. In addition the former Commentary in its discussion of paragraph 2 permitted in cases where the profits of the PE were difficult to calculate the application of a factor or factors to the channel profits, that is, the profit derived by the enterprise overall from the particular transactions conducted through the PE.

The difference can be illustrated by the kinds of regimes which have existed around the world for taxing insurance enterprises. A global formulary apportionment method would be to apply to the total profits of the enterprise on its insurance activities a proportion of premiums collected through the PE to total premiums as a method of calculating the profits of the PE. A channel profits apportionment method would involve, for example, applying some appropriate percentage to the premiums collected by the PE as a rough representation of the profits made by the PE with respect to those premiums. The difference is that the former depends on the global profits of the enterprise whereas the latter only focuses on the activities of the PE.

Deletion of the former paragraph 4 means that the global approach is no longer possible under the new Article 7. In addition the Commentary dealing with an apportionment based on the channel profits has also been deleted which presumably means that such a method is now not acceptable although this is not made explicit. In the case of insurance enterprises there is now Part IV of the Attribution Report dealing in detail with the particular difficulties to which they give rise and applying arm's-length methodologies to determine their profits. Australia continues to include a reservation in relation to the new article 7 to the effect that it will use a special provision in relation to insurance companies.

The PE test

The recent work of the OECD on the attribution of profits to PEs has sought to base outcomes on an economic policy measure of how much profit is produced by a PE. It does so as already noted by extending the functions, assets and risks analysis for associated enterprise to the PE situation, "not constrained by either the original intent or by the historical practice and interpretation." Whatever may be thought of the specifics of this approach, it is hard to quarrel with the use of a direct economic policy measure of contribution to profit. That work makes clear, however, that its approach does not impact on the question of whether there is a PE.[27]

What is the policy of using the PE as the basis for taxing business profits and hence of the PE concept itself? The Commentary on Article 7 says that it is "hardly necessary to argue here the merits" of the PE as the basis and defines the policy as:

> "participating in the economic life of the other State to such an extent that it comes within the jurisdiction of that other State's taxing rights."[28]

The Commentary on Article 5 which contains the PE definition only deals with the broad policy in relation to agency PEs saying:

> "[agency PE] treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned."[29]

Although not mentioned in either place until recently, this policy has both an economic and administrative policy dimension.[30] This is hardly much of a policy guide but it has ever been so with PEs – they have been accepted as the building block of tax treaties from the beginning without much policy elaboration.

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[27] Attribution Report at 9.

[28] OECD Model Commentary on Article 7 para 11.

[29] OECD Model Commentary on Article 5, para 32. The agency PE guidance needs to be treated with caution as the reference to the nature of the activity is a mistaken historical hangover, see Vann, "Writing Tax Treaty History" forthcoming 2010.

[30] The OECD in 2008 provided a lengthy analysis on the policy of the PE concept for taxing business profits in the context of introducing an alternative provision for a services PE, see OECD Model Commentary on Article 5 paras 42.11-42.22 which emphasises economic penetration, administrability and the importance of net basis taxation over gross basis withholding. This work in turn evolved out of OECD, "Treaty Rules and E-Commerce: Taxing business profits in the new economy" in OECD, *E-commerce: Transfer Pricing and Business Profits Taxation* (Paris: OECD, 2005) Pt II.

In contrast to the attribution of profits, the stated policy is not implemented directly in the PE test but rather through the proxies of the fixed place of business and agency rules. That the proxies can deviate from the policy is admitted in relation to insurance in which case it is possible to "do large-scale business in a State without being taxed" under these proxies.[31] Divergence between the stated policy and the proxy tests creates tension with the economic policy base of the attribution rule. If there is a PE but nothing substantial occurring then little attribution of profits occurs under the new attribution approach. If there is no PE but substantial functions etc, then no profit attribution occurs because of the lack of a PE. This asymmetry has been the basis of much business restructuring in the last 15 years.

The OECD began investigating restructures in 2005 both as regards the transfer pricing issues and the PE issues. Part way through that process the transfer pricing project was separated from the PE project and the final fruits of that project appeared in the 2010 Transfer Pricing Guidelines which did not add a great deal to existing guidance and adopted the view that a restructure should not be analysed any differently from a structure originally set up in the restructured form. The same approach has been adopted by the ATO.[32]

The second part of the project is now another separate and larger look at the PE Commentary (that is, no change seems to be proposed to the PE definition). It is likely to be a few years before that work is finalised. The relative disconnect between the PE definition and the attribution of business profits was emphasised in the 2010 Update where there are changes to the PE Commentary arising from another project dealing with telecommunication supplies but nothing said in relation to Article 5 about the 240 pages of the Attribution Report.

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[31] OECD Model Commentary on Article 5, para 39, eg, the recent Canadian Tax Court decisions in *American Income Life Insurance Company v R.* [2008] TCC 306; 2008 DTC 3631, *Knights of Columbus v R.* [2008] TCC 307; 2008 DTC 3648.

[32] TR 2010/D2.

Appendix

New Article 7

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the PE in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the PE referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a PE of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. 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.

Former Article 7

BUSINESS PROFITS

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 PE 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 PE.

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 PE situated therein, there shall in each Contracting State be attributed to that PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

3. In determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including executive and general administrative expenses so incurred, whether in the State in which the PE is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a PE 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 PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the PE 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.