Tax Treaties: The Secret Agent's Secrets

RICHARD J. VANN*

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Abstract

Recently two apparent paradoxes have been revealed about an agency permanent establishment (PE) under tax treaties, first that it is possible to avoid an agency PE by exploiting a difference between civil law and common law on agency (often referred to as commissionnaire structures) and secondly that if the agent is rewarded with a market-value fee there will be no profits to attribute to an agency PE. This article demonstrates that these problems have been present since the origin of tax treaties, and that they stem from a form-over-substance approach to PE tests which relegates the independence test in defining PEs to a secondary role, from the use of a different indeterminate independence test in transfer-pricing rules and from the definition of the firm in terms of common ownership. Underlying the problems have been inconsistent views on how value is generated within a firm. The solution is to settle on a workable theory of value, to apply substance over form, and to realise the significance of independence in defining the boundary of the firm. Under current treaty law, the second asserted paradox is not correct if treaties are interpreted in a sensible manner.

Introduction

THE international dimension of taxation—using that term in its broadest sense to include comparative tax studies—does not receive any mention by Ash Wheatcroft in the statement of objectives in the first number of the *Review* 50 years ago. That omission was quickly remedied. The third number of the first volume modestly promised "a new series on the taxation systems of other countries which are of particular interest to United Kingdom readers" and contained three international/comparative articles.[1]

For tax treaties we have to wait until the second volume of the *Review* in an article appearing very modern in its concerns and suggestions about the interaction of international double taxation and company shareholder double taxation.[2] Contributions

* Challis Professor of Law, University of Sydney, Visiting Professor, Harvard Law School.

[1] See editorials at [1956] BTR 1 and 209, H.G.S. Plunkett, "The Finance Act 1956: The Effect of Residence and Domicile on the Taxation of Employments" [1956] BTR 210, G.S.A. Wheatcroft, "Some Impressions of Taxation in the USSR" [1956] BTR 223 where the author and founder editor notes that the article was written "during a four weeks' visit to Moscow with the British Chess Team playing in the International Team Tournament", E. Long, "Income Tax In Jersey" [1956] BTR 261. As well as articles on various aspects of foreign countries' tax systems, the first comprehensive comparative article appeared in the second year, E.B. Nortcliffe, "Income Taxation in Nine Countries" [1957] BTR 203. In the first editorial of the same year, the debt to the *Canadian Tax Journal* for largely inspiring the *Review* was noted, see [1957] BTR 1.

[2] P. Shelbourne, "Double Taxation and Its Improvement" [1957] BTR 48, 143, though the appearance of modernity is just that as the issue has been a topic of contention since international double taxation

on comparative, international and treaty tax issues have since featured regularly. One John F. Avery Jones wrote his first contribution in the fifteenth year of the *Review* on art but, beginning in 1979, the *Review* commenced publication of a now over 20-plus year series of articles of which he has (usually) been lead author that are classics of comparative, international and treaty scholarship.[3]

From its first volume the *Review* was outward looking, a feature continued to the present day, so that it is regarded outside the UK as an international tax journal as much as a British one. My own country, Australia, made an appearance in the very first number as a country "whose refrigeration methods are very progressive"[4] but readers soon discovered that the same was not true of its tax system.[5] Australians were early contributors on diverse topics.[6]

Although the pages of the *Review* did not mention such matters, this international outlook involved friendships between the founder editor and a host of foreign tax scholars, including Stanley S. Surrey of the US, Ross Parsons of Australia, Leif Mutén of Sweden and J. van Hoorn Jr of the Netherlands.[7] These friends regularly participated in international conferences together around the world.[8]

The problems of agency PEs

The second number of the first volume of the *Review* included a case note on the Court of Appeal decision in the *Firestone* case which was subsequently affirmed by the House of Lords in favour of the Revenue.[9] Fifty years later the very same battles are being fought

first arose, R. Willis, "Great Britain's Part in the Development of Double Taxation Relief" [1965] BTR 270, P. Harris, "An Historic View of the Principle and Options for Double Tax Relief" [1999] BTR 469. The very special tax treaty arrangements that the UK had with "Eire" also were aired in early editions of the *Review*, D.G. Mason, "Income Tax and Surtax in Eire" [1957] 150, 346, "United Kingdom—Eire Double Tax Agreements and Assessments" [1959] BTR 261, 339.

[3] The first article by J.F. Avery Jones *et al* was "The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention" Pt I [1979] BTR 333, Pt II [1980] BTR 13 and the most recent "Treaty Conflicts in Categorising Income as Business Profits caused by Differences in Approach Between Common Law and Civil Law" [2003] BTR 224. Not all of the articles by this group have appeared in the *Review* and several which have are also published elsewhere. Another is due shortly in the *Review*. See also in this issue J.F. Avery Jones, "The Reform of the Tax Tribunals: a Story of Uncompleted Business" [2006] BTR 282.

[4] A.F., "What are 'Travelling Expenses'?" [1956] BTR 89, a case note on a familiar modern problem, a taxpayer travelling with spouse to a foreign country with mixed business and personal purposes at the expense of the company.

[5] Nortcliffe, n.1 at 206 noting how progressive the UK rate schedule was compared to several other countries including Australia, A.G. Davies, "Australia: The Tax Code of a Developing Economy" [1960] BTR 117, 195.

[6] H.A.J. Ford, "Tax Avoidance: The Australian Experience" [1961] BTR 247, D.G. Hill, "Estate and Gift Taxation in Australia" [1964] BTR 317, R.W. Parsons, "An Australian View of Corporation Tax" [1967] BTR 14, "Tax Problems Relating to a United Kingdom Business Operating in Australia" [1968] BTR 177, 242.

[7] R.W. Parsons in the preface to his (Australian) classic text, *Taxation Law in Australia* (Law Book Co, Sydney, 1985) said at vi: "I am very much in the debt of Ash Wheatcroft, the pioneer of legal scholarship in tax in the United Kingdom, who inspired my interest in tax law as a field of legal scholarship."

[8] The 1968 volume of the *Review* carries a number of articles from an early conference in London.

[9] *Firestone Tyre & Rubber Co Ltd v Llewellin* (1957) 37 TC 111; both appeals were noted under the title "Trading 'Within' the United Kingdom" by A.F., [1956] BTR 181 and D.R.S., [1957] BTR 170.

under tax treaties (what is an agency permanent establishment (PE) and what profits are attributable to such PEs). On current indications, the Revenue may well lose.

Specifically, for taxing business enterprises tax treaties typically include several provisions whose relationship is not immediately obvious. In terms of the OECD Model Tax Convention (OECD Model)[10] the provisions of which are generally reproduced in actual treaties, the relevant provisions are Article 5(1), (5), (6), (7), Article 7(1), (2), and Article 9(1). Article 5 contains the PE definition which consists of two types, a fixed place of business of an enterprise in paragraph (1) and an agent which habitually contracts on behalf of an enterprise in paragraph (5), other than an agent of independent status in paragraph (6). Under paragraph (7) associated enterprises do not constitute PEs of each other simply because they are associated but must satisfy the ordinary tests. Article 7 deals with the taxation of business profits and provides in paragraph (1) that an enterprise is not taxable in a country unless it has a PE there and is only taxable in that country on profits attributable to the PE. Under paragraph (2) the attributable profits are those that the PE could expect to make if it were a separate enterprise dealing independently with the rest of the enterprise of which it is a part. Article 9(1) provides that profits that they would expect to make if they were independent enterprises may be taxed to associated enterprises.

With agency as a focus, several questions are raised by these rules arising from the concepts of independence and association including[11]:

(i) When does an associated enterprise constitute an agency PE?
(ii) Can an associated enterprise be an agent of independent status?
(iii) If an associated enterprise constitutes an agency PE, how are profits on an independent enterprise basis to be taxed when two similar rules seem to be applicable, Article 7(2) and Article 9(1)?
(iv) Is the result different when an associated enterprise does or does not constitute an agency PE?

The double reference to secrecy in the title is meant to indicate two surprising suggested results for agency PEs that have been highlighted in recent times. First, there is a difference between civil law and common law relating to undisclosed principals which means that it is possible on the same facts to have a PE in a common law country but not a civil law one (the secret agent). Secondly, even if an agency PE arises involving an associated enterprise, no profits are attributable to that PE in addition to the profit that the associated enterprise would make if it were an independent enterprise and did not constitute a PE (the agent's secret). Considerable tax planning in the form of business restructures has occurred in recent times on the basis of these results but the tax planning and the issues it turns out have a long history.

This article will consider to what extent the suggested results are correct and whether they should be correct. It will start by revisiting two cases decided around the time of first publication of the *Review*. Subsequently it will travel further back in time to the origin of the treaty rules to see if history throws light on these suggested results. Finally it will

[10] OECD, *Model Tax Convention on Income and on Capital* (looseleaf, OECD, Paris, last update 2005) (its commentary is referred to as the Commentary).

[11] The term "enterprise" used in the Model is apt to confuse. It is used to refer to a taxpayer carrying on a business, which in the usual case in international trade will be a company. For the purposes of this article enterprise can be thought of as a company.

fast forward to the present, with a brief stopover in the 1950s again, to the current debate of the issues by the OECD. From that process will emerge some conclusions both as to current treaty law and its interpretation on the issues and potential remedies for problems. One author who has recently investigated similar issues has suggested that the agency PE be abolished.[12] The difficulty with this conclusion is that similar problems that arise for agency PEs are also implicit in fixed place of business PEs. Giving up on the agency PE front has broad implications for PEs generally.

Underlying the discussion are even deeper secrets (hence the plural in the title) arising from a lack of clarity on the policy and nature of the rules. One policy issue is the nature of the firm (to use a common and neutral term); another is the boundary of the firm. The formulation of the rules to give effect to the policies raises familiar issues of form and substance and the usual indecision as to which applies. For the purposes of this article, these policy and structural issues will only be sketched and then raised at appropriate points to indicate the tensions produced by shifting policy assumptions and problems of form and substance. It is possible to make progress on some of the issues involving agency PEs—and international taxation more generally—without developing a full theory.

So far as the nature of the firm is concerned, one possibility is that the whole is equal to the sum of the parts. That is, if the firm is disaggregated into all its components, the total profits of the firm can be explained by positing market value transactions among the components, the profits on which will equal the total profits. This view fails to explain why firms form in the first place and it has long been argued that firms form because they are able to produce greater overall profits than would arise from market value transactions among all their components.[13] If a residual profit above and beyond the value of market transactions is accepted, that residual can be localised by attributing it to the real centre of the firm, several centres of the firm or the firm overall depending on how this additional profit is considered to be produced. A related question is the boundary of the firm. Is the boundary defined by the nature of the business—the point of shift from the firm to the market (which might be paraphrased as the shift from internal to external operations), or in terms of common control—and what are the implications of either choice? Once these policies have been decided, it is necessary to express them in rules. Do the rules fall back on familiar legal concepts—agency, companies, property—or do they try to capture economic substance?

[12] C.H. Lee, "Instability of the dependent agency permanent establishment concept" (2002) 27 *Tax Notes International* 1325.

[13] At one extreme, everything from start to finish is done within a single firm because the firm can make a profit at every stage compared to acquiring from or selling to the market. At the other extreme there is no firm because no profit can be made over and above the price of any market transaction. The real world lies in between. In terms of inputs, the firm acquires from the market up to the point that it cannot produce the input internally and make a profit on it compared to the market price, but the firm expects to make profits on its use of inputs acquired from the market (as otherwise it would leave the next step to the market). In terms of outputs, the firm sells to the market only at the point that it cannot make any additional profit on internalising the sale into the market. This view of the firm is usually associated with R. Coase, "The theory of the firm" (1937) 4 *Economica* 386. Many theories of the firm are possible but the main assumptions for the purposes of this article are that there will be a point where the firm ends for whatever reason based on theory and the market begins, and that point will in part be explained by the ability to earn greater profits by internalising transactions or processes within the firm.

Agency PEs 50 years ago: substance and form

Firestone revisited

To move from the abstract to the very particular, in *Firestone* the issue was taxing profits in the UK of a US parent company, called Akron in the case after the town in Ohio where it was based, and of its UK subsidiary, similarly called Brentford after the suburb of London. Akron entered into agreements with distributors of Firestone tyres throughout the world[14] under which Akron granted distributors the exclusive right to sell Firestone tyres in their assigned regions and the distributors undertook not to sell competing products. The agreements contained terms as to the prices at which the distributor would buy and sell tyres, delivery of and payment for the tyres. The agreements provided that the distributors were not to be agents of Akron, that is, they bought and sold in their own right. Akron provided the distributors with a list of manufacturers of Firestone tyres from which the tyres could be obtained.

Brentford was on this list. It had been incorporated in 1922 originally to sell Firestone tyres manufactured in the US but from 1928 a factory was set up by it in England to manufacture the tyres. Brentford could only sell tyres it manufactured in accordance with agreements with Akron which owned the Firestone trademark that was used by Brentford. Apart from the local UK market, Brentford was authorised to supply tyres to foreign distributors which had signed a distributor agreement with Akron and for this purpose Akron supplied a list of such distributors. Originally Brentford charged Akron factory price (not including overheads) and later was allowed to recover overheads. Following negotiations between Brentford and Akron (which had only one director in common, the founder Harvey Firestone), an agreement was signed in 1936 establishing the terms for the future. In consideration of receiving cost plus 5 per cent, Brentford undertook upon request by Akron to use its best endeavours to fulfil orders obtained by Akron from foreign distributors, with some details about procedures and payments.

In practice, both before and after the 1936 agreement, the distributors would order direct from Brentford which would dispatch the goods, invoice the distributors and receive payment all in its own name and account to Akron by money transfers to the US after deducting its agreed amount. The onset of the Second World War changed procedures in that Brentford was subject to government control, required approval for any sale of tyres, could be directed to supply to foreign parties outside the agreement with Akron and could not forward the net proceeds of sales to foreign distributors to Akron. These amounts were treated in its books as loans by Akron to Brentford. Nonetheless Brentford was able to continue supplying foreign distributors in a similar way to the tune of more than £700,000 during the War. After government controls were removed in 1947–1948, the pre-War routines were re-established.

Two alternative series of assessments were raised for the War years in respect of the profits on the tyres supplied to foreign distributors, one against Brentford in its own right and one against Akron through Brentford as agent. These assessments were in addition to assessments on Brentford for its activities as tyre manufacture and local distributor

[14] The distributors seem generally to have been unrelated to Akron. Both Akron and Brentford included "Firestone Ti(y)re & Rubber" in their names whereas the Swedish distributor that was taken as typical in the case was called Aktiebolaget A Wiklunds Maskin & Velocipedfabrik. The terms of the distributor agreements also suggest a contract between unrelated parties.

(which included profits made on its UK trade in the tyres and also the 5 per cent on sales to foreign distributors under the agreement with Akron). The Special Commissioners upheld the second series of assessments and discharged the first. Both sides appealed and Harman J. upheld the Special Commissioners. Thereafter only Akron appealed but lost unanimously in both the Court of Appeal and the House of Lords.

The facts and procedures have been set out at length as they are necessary to an understanding of the arguments and decisions as well as of the treaty discussion below. To uphold the series of assessments on Akron through Brentford as agent, it was necessary to establish first that Akron was exercising a trade within the UK and secondly that it was doing so through its agent Brentford.[15]

The courts all held that the primary or only contract arising from an order was one of sale by Brentford of its own tyres to the foreign distributors because of the procedures that were followed (orders sent by the distributors direct to Brentford, which dispatched the tyres ordered and received payment in its own name without any involvement of Akron in the process).[16] This contract was made in the UK when Brentford accepted the order received from the distributor which constituted an offer to purchase. Some of the judges seemed to consider that the distributor and 1936 agreements contemplated a sale by Brentford to Akron and then a further sale by Akron to the foreign distributors but if so these sales were not borne out by the course of conduct.[17] Some of the judges discussed whether there was a further contract between the distributor and Akron each time an order was posted to Brentford to the effect that Akron would procure the delivery of the tyres (that is, not a sale of the tyres by Akron) or whether Brentford was providing a service to Akron under the 1936 agreement in making the sale.[18]

This discussion of the precise contractual position arose out of arguments for the taxpayer based on the previous case law which gives prominence to the place of contract in deciding if a non-resident is exercising a trade within the UK. Two approaches are evident in the judgments for dealing with the earlier case law; first, to point out that the cases indicate that other factors may be relevant in appropriate cases based in particular on an oft-quoted dictum, "the question is, where do the operations take place from which the profits

[15] Income Tax Act 1918, Sched.D para.1(a)(iii), and General Rule 5. Although these elements have remained in UK law, the law has got more complicated, partly through the application of treaty-like rules to corporation tax in 2003. For current UK law, see J. Tiley, *Revenue Law* (5th ed., Hart Publishing, Oxford, 2005) at 841-842, 1126-1129, 1136-1137. Because the interest of the case for the purpose of this article is its potential application to tax treaties, the subsequent development of UK law can thankfully be generally ignored.

[16] (1957) 37 TC 111 at 121 (Harman J.), 129-130 (Evershed M.R.), 134 (Jenkins L.J.), 137 (Birkett L.J.), 140 (Lord Morton of Henryton, adopting Jenkins L.J.), 143 (Lord Radcliffe). Lords Tucker and Cohen concurred at 143 and will not be further referred to. Harman J. thought that even if there were a sale by Brentford to Akron and then by Akron to the distributor, the result in the case was the same (1937) 37 TC 111 at 121.

[17] (1957) 37 TC 111 at 120 (Harman J.), 126–127 (Evershed M.R.), 136 (Birkett L.J.); at 134 Jenkins L.J. left open what the position would have been and the House of Lords does not seem to consider the issue.

[18] (1937) 37 TC 111 at 121 (Harman J., separate contract), 129–130 (Evershed M.R. leaving the issue of the separate contract open), 134 (Jenkins L.J., service under 1936 agreement). Any such separate contract was made outside the UK as posting the order amounted to acceptance of a standing offer by Akron under the distributor agreement and its current price lists.

in substance arise"[19]; and secondly to note that the important contract of sale in the case was made in England.[20] Neither response, however, directly addresses the problem that the contracts of sale of the tyres were between Brentford and the distributors which suggests that the tax should have fallen on Brentford in its own name under the series of assessments that were discharged, not on Akron under the series of assessments that were upheld.

The two questions pivotal to Akron's tax liability—why was Akron exercising a trade within the UK and why was it doing so through Brentford as agent when the sale contracts for the tyres were made in its own name by Brentford—get relatively short shrift in the judgments. On a general level the judges seem to say that Akron's control of Brentford's trade through both the 1936 agreement and its ownership of the Firestone trademark, its receipt of the bulk of the profit, and the general worldwide integration of the operations of Akron and all its subsidiary companies were enough as a matter of law to support a finding that Akron was exercising a trade within the UK. Further, whether in this case Akron was exercising a trade within the UK was a question of fact and the judges were happy either to accept or fully support the findings of the Special Commissioners which generally cannot be challenged on appeal. Finally as Akron was exercising a trade, it could only be through Brentford as agent as Akron had no presence in the UK in its own right.[21]

Not surprisingly commentators have wrestled with this reasoning as in some sense there seems to be an approach of substance over form. To the corporate lawyer, the *Firestone* case may appear to be one where the judges pierced the corporate veil and in effect attributed the acts of the subsidiary to the parent.[22] The judges seemed to be aware of this possible interpretation and some expressly disclaimed it.[23] The substance over form may well be there but not in the corporate law view of the case as two other areas of the law are engaged, agency and taxation. With respect to agency law, some of the judges sought to deal with the issue by relying on an earlier case to hold that a person can still be acting as agent of another even though selling in its own right. Such an approach seems curious as the general view is that, if an agent is selling goods on behalf of another, title passes from that other to the buyer, not from the agent. While the judges taking this view

[19] *FL Smidth & Co v Greenwood* (1922) 8 TC 199 at 204 *per* Atkin L.J.; see *Firestone* (1957) 37 TC 111 at 121 (Harman J. in the alternative scenario that the tyres were to be regarded as sold by Akron to the distributors), 141–142 (Lord Radcliffe who refers to the stress put on the dictum of Atkin L.J. by Harman J. and Evershed M.R., which is odd as for Harman J. it was a distinctly secondary argument and Evershed M.R. makes clear that he does not need to rely on it).

[20] (1957) 37 TC 111 at 121 (Harman J. on the basis the contract was one of sale made in England); all of the judgments in the Court of Appeal seem to use the place of contract in the sense that they emphasise the contract of sale was made in England and do not rely on the dictum of Atkin L.J. (Evershed M.R. at 131–132 puts the dictum aside in expressly disclaiming reliance on the alternative scenario advanced by Harman J.).

[21] (1957) 37 TC 111 at 121–122 (Harman J.), 130–131 (Evershed M.R.), 134–135 (Jenkins L.J.), 137–138 (Birkett L.J.), 140–141 (Lord Morton of Henryton), 143 (Lord Radcliffe).

[22] The *Firestone* case is often discussed in the lifting-the-veil context by company lawyers but is nowadays treated as a case where Brentford was agent of Akron, see *Halsbury's Laws of England* (4th ed. reissue, Lexis Nexis UK, 2004) Vol.7(1) at para.402, B.M. Hannigan, *Company Law* (Lexis Nexis UK, 2003) at 68, *Palmer's Company Law* (25th ed., Sweet & Maxwell, looseleaf commencing 1992) at para.2.1520, largely following *Adams v Cape Industries Plc* [1990] Ch 433 at 475 (Scott J.), 537 (CA). No explanation is generally given, however, of the difficulties of the agency interpretation.

[23] (1957) 37 TC 111 at 130 (Evershed M.R.), 138 (Birkett L.J.). To confuse matters, all non-UK companies in the Firestone group were treated as one company for the purpose of the appeal, (1957) 37 TC 111 at 113.

may be asserting a contestable proposition in UK agency law, it is also true that contracts and title may not always line up in the agency world.[24] So far as tax law is concerned, the *Firestone* case is generally pigeonholed in the UK as one showing that the place of contract is not an exclusive test for determining where a trade is exercised and the agency issue is left hanging.[25] If it is a case of substance over form in tax law, rather than corporate law or agency, the explanation needs to be that "agent" is used in the tax law in a commercial sense of one person doing acts which contribute to the profits of another, rather than a strict sense of the agent legally binding a principal.

Even if it is accepted that the *Firestone* case involves substance over form, the question remains of what is the substance. Because of the brief analysis on this point in the case, no clear view emerges. In terms of the subsequent discussion, it might be articulated in terms of Brentford not being independent of Akron in its business operations, which seems to best fit the brief comments made. An alternative would be to focus on the ownership link that Brentford was a wholly-owned subsidiary of Akron.

The House of Lords decided the *Firestone* case in 1957 long after the first UK–US tax treaty came into effect on the UK side in April 1945 for assessment of foreign companies on UK profits.[26] As the tax years concerned in the case were 1940–1945 however, the treaty was not relevant. It is unlikely to be a coincidence that the assessments concerned went up to the very day of the commencement of the treaty but no later. Clearly later events were before the courts (the course of dealing after the Second World War) and the case did not reach the Special Commissioners until 1952. It seems likely that the Revenue accepted that it could not sustain assessments on Akron after the commencement of the treaty. Why might that be so?

Australia's Firestone

One possibility is that Akron had no PE in the UK so that taxation was prevented under the business profits article of the first UK–US tax treaty. An Australian decision on similar facts to *Firestone* and from the same period, *Case 110*,[27] strongly supports this view. Australia was no more prompt in getting its appeals underway than the UK. It also took seven years from the income year in question, commencing May 1, 1947, for the case to reach the first level of appeal but the year concerned was just after the commencement

[24] *Weiss Biheller and Brooks Ltd v Farmer* (1923) 8 TC 381 referred to on this basis at (1957) 37 TC 111 at 130-131 (Evershed M.R.), 141 (Lord Morton of Henryton); while agency lawyers might dispute this view of the *Weiss* case, they have difficulty maintaining consistency in all situations involving agency and transfer of title, *Bowstead & Reynolds on Agency* (17th ed., Sweet & Maxwell, 2001) at 23, 29, 298, compare *Firestone* (1957) 37 TC 111 at 133, 134 where Jenkins L.J. seems to have an each way bet. Tax planning is often directed to bringing about variations on this theme (disconnect of contracts and title transfer) without giving rise to an agency such as commissionnaire structures.

[25] *Halsbury's Laws of England* (4th ed. reissue, Lexis Nexis UK, 2002) Vol.23(1) at para.100; Tiley, n.15, at 106, 1129; *Whiteman on Income Tax* (3rd ed., Sweet & Maxwell, 1988) at 199.

[26] Art.XXIII(b).

[27] (1955) 5 Commonwealth Taxation Board of Review (New Series) 656 (hereafter 5 CTBR (NS)); this is a decision of the defunct Australian Taxation Board of Review (now the Taxation Division of the Administrative Appeals Tribunal) which approximate to the UK Special Commissioners. Decisions were and are anonymous but published, unlike the Special Commissioners' decisions of the time which were not published except as part of appeal proceedings. An appeal from the decision of the Board to Australia's highest court was lodged but not pursued.

of the first Australia–UK treaty of 1946.[28] Again it is necessary to pay close attention to the facts and the reasoning.

The taxpayer was a UK resident company which was not registered in Australia as a foreign company (as was required under company legislation if a company carried on business in Australia). The UK company sold its trademarked products to two Australian resident distributor companies both of which were initially unassociated with the taxpayer (each distributor having its own exclusive area of Australia for sale of the products). The distribution agreements were entered into in 1937. Subsequently the taxpayer acquired one of the distributors as a subsidiary. The distributors sold products manufactured in the UK and also manufactured by a company resident in Australia to the order of the UK company. Originally the UK company investigated setting up its own factory in Australia but was able to source the products from the Australian manufacturer. In 1942 the UK company acquired a 10 per cent capital, but not voting, stake in the Australian manufacturer which entitled it to appoint one non-voting director of the company and to receive 10 per cent of its output after a transition period. The Australian distributors thereafter received all of their products with the UK company's trademark from the Australian manufacturer, the Second World War no doubt making supply from the UK difficult. The Australian manufacturer was a company set up in 1935; its shareholders were originally four foreign companies which marketed trademarked goods in Australia.[29] All of its products were sold to its owners or their nominees apparently at cost plus 6 per cent (as it was agreed that prices would be set to allow the company to pay a dividend of 6 per cent of paid-up capital; companies of this kind usually distribute all their profits).

The course of dealing in the UK company's trademarked products was covered by a shareholders' agreement among the shareholders of the manufacturer, a working agreement among the manufacturer and its shareholders, the distribution agreements and the taxpayer's internal procedures. The process was similar to that which had been followed before the UK company became a shareholder in the manufacturer when purchasing products from it. Two months ahead of time the manufacturer would send to the UK company care of its director on the manufacturer's board (who was also the chairman of directors of the taxpayer's subsidiary distributor) its upcoming production plan and a request for the UK company's orders for a particular month (within the flexibility and limits provided by the working agreement). The distributors in turn received the request for their requirements from the director and submitted their orders direct to the manufacturing company. The manufacturing company would invoice the products ordered to the UK company in the UK and arrange delivery of them to the distributor companies. The UK company effected insurance and paid transport costs in relation to the delivery of the products to the distributors. The UK company would, from the UK, invoice the products to the distributors at prices determined in a way which left a profit for the distributors and others to whom they sold (the sales prices of the distributors and to the public were also set by the UK company). The distributors paid on these invoices to another Australian subsidiary of the UK company (the payment company) which was otherwise engaged in another line of business altogether in Australia.

[28] According to Art.XV(b) the treaty commenced in Australia for years of tax commencing on July 1, 1946.

[29] A sign of the small size of the Australian market compared to the UK. Foreign companies in the same market segments often do not find it worthwhile to set up their own manufacturing facilities and form joint venture companies to produce locally in Australia.

The payment company in turn paid the invoices sent by the manufacturer to the UK company on its behalf. The payment company did not remit the balances that it held for the UK company to the UK, presumably because of exchange controls. The internal procedures were such that the UK company was nominally involved in these processes all the way—whether it was actually a case of automatic pilot so far as the UK company was concerned is unclear.

Australian domestic law was not framed like UK law in the *Firestone* case. All that was necessary for the UK company to be taxable was that the income be sourced in Australia. For this purpose Australian case law had established various tests which to some extent drew on UK case law on trading within the UK. On the facts here, however, the Board was of the view that the income was sourced in Australia and so would be taxable in the absence of the treaty.[30] The UK company argued successfully that it did not have a permanent establishment in Australia and accordingly was not taxable there on the profits made from the sale of the trademarked products to the distributor companies as a result of the treaty. The PE definition followed the form found in older treaties and in part provided as follows:

> "the term 'permanent establishment' . . . means a branch or other fixed place of business and includes a management, factory, mine or agricultural or pastoral property, but does not include an agency in the other territory unless the agent has, and habitually exercises, authority to conclude contracts on behalf of the enterprise otherwise than at prices fixed by the enterprise or regularly fills orders on its behalf from a stock of goods or merchandise in that other territory."[31]

The separate decisions of the three members of the Board of Review in favour of the UK company canvass several PE possibilities, all of which are rejected for the following reasons:

(i) neither the factory of the manufacturer nor the headquarters of the subsidiary distributor was a "fixed place of business" of the UK company as they were not places of business of the UK company (the fixed place had in some sense to be in the possession of the taxpayer: "something physical and separately identifiable as the place of business of the non-resident enterprise"); a fixed place of business of an agent was not a PE of the principal as agency had to be evaluated separately under the agency PE rules[32];

(ii) there was no management in Australia because the well-established mode of operation did not require a local management, that is, no acts of management of the UK company were done in Australia and in any event it was still necessary to identify a place of management for this purpose[33];

[30] (1955) 5 CTBR (NS) 656 at 666-667 under Income Tax Assessment Act 1936, s.25(1)(b); it is also pointed out there that there were special statutory deeming provisions that might be relevant in the absence of the treaty.

[31] Art.II(1)(j). This definition approximates paras 1, 2 and 5 of Art.5 of the OECD Model but on agency contains a limitation (in relation to prices) and an extension (in relation to delivery) compared to the OECD Model.

[32] (1955) 5 CTBR (NS) 656 at 667, 678–679.

[33] (1955) 5 CTBR (NS) 656 at 668, 673–674, 678–679; two of the Members were clear that the specific words "management" and "factory" had to be interpreted in the light of the general meaning of a branch or fixed place of business.

(iii) the factory of the manufacturer did not qualify as a factory of the UK company as it belonged to the manufacturer[34];
(iv) the payment company was not an agent of the UK company in the relevant sense as it was only an agent to pay and receive money on behalf of the UK company[35];
(v) the subsidiary distributor was not an agent of the UK company in the relevant sense because the prices were fixed by the UK company and in any event it dealt in relation to the products as principal not as agent[36]; and
(vi) neither the manufacturer nor the distributors were agents maintaining a stock of goods for the UK company from which deliveries were made on behalf of the UK company. All companies dealt with the products in their own right and not as agent of the UK company. Further in the case of the manufacturer, there was no stock of goods as the products were manufactured to order.[37]

Because the place of contract was not of central importance, there is not the detailed discussion of the kind found in the *Firestone* case on this point. It will be noted that the order form went direct from the distributors to the manufacturer as in *Firestone*. Nonetheless two of the members were clear that title in the products passed from the manufacturer to the UK company and thence to the distributors, one member expressly doubting whether the order forms played any part in forming a contract with the manufacturer as the UK company was already contracted to buy its share of the output of the manufacturer under the working agreement.[38]

The third member seems to regard the products as being sold by the manufacturer to the distributor.[39] This member at several points also regards the word agent in the treaty as having a commercial rather than a legal meaning[40] but reaches the same conclusion of no PE. The member's reasoning in relation to the two agency PE provisions raises similar kinds of puzzles as the *Firestone* case on agency. He considered there was no PE under the habitually contracting agency rule because of the unusual qualification about the principal setting the prices, which suggests that the distributor would otherwise be regarded as selling the products as agent on behalf of the UK company. Yet there is no PE under the rule about delivering as agent from a stock of goods on the basis that the goods being delivered were held by the distributor on its own account not on account of the UK company (the other two members agree with the latter point). In other words the member seems to take the unlikely view that a person can sell its own goods as agent of another but not deliver its own goods as agent of another.[41]

[34] (1955) 5 CTBR (NS) 656 at 668–669, 674, 678.
[35] (1955) 5 CTBR (NS) 656 at 674, 679.
[36] (1955) 5 CTBR (NS) 656 at 674, 679; at different points in their reasoning, all members referred to the part of the definition not quoted above to the effect that one company is not a PE of another simply because it is a subsidiary of the latter, at 667, 675, 678.
[37] (1955) 5 CTBR (NS) 656 at 669–670, 674, 679.
[38] (1955) 5 CTBR (NS) 656 at 668, 678 and at 669 as to the effect of an order.
[39] (1955) 5 CTBR (NS) 656 at 672–673.
[40] (1955) 5 CTBR (NS) 656 at 674–675. The distributors were called agents in the distributor agreements but this is clearly in the commercial rather than the legal sense as the agreements provided that they dealt in the products on their own account and not on account of the UK company.
[41] (1955) 5 CTBR (NS) 656 at 674. See n.24 and text above in relation to the proposition of selling one's own goods as agent. It cannot be the case here that the habitually contracting agency rule is satisfied

Here form seems to have triumphed over substance; virtually everything happened in Australia but a significant amount of the profit was not taxable there. The substance argument was put to the Board but rejected on the basis that each provision of the PE article had to be interpreted individually to see if it applied. It was not possible to draw some overarching principle out of the article and apply that to hold there was a PE. What the specific nature of the substance was went undefined.[42] It was not necessary to consider in *Case 110* whether there was an agent of independent status because the general agency rules were not fulfilled. In the *Firestone* case, the equivalent UK rule of the time is briefly mentioned as not applicable, apparently on the basis it was self evident on the facts.[43] It is unfortunate that independence did not become a focus as it provides an important guide to what is the substance on the facts of either case.

Returning to whether there would be a PE on the facts of *Firestone*, the answer is likely to be not if the reasoning of the majority in *Case 110* were adopted. Akron had no place of business or management of its own in the UK and the factory clearly belonged to Brentford. Even accepting the finding that Brentford was an agent of Akron, Brentford was not habitually contracting on behalf of Akron as it entered into the contract on its own account, unless, again, it is possible for a person to sell its own goods as agent of another. Even though some judges considered that a separate contract was created between Arkon and the distributor, this contract arose under the distributor agreement from the act of the distributor in posting the order to Brentford, not from any act of Brentford. Some judges, who did not think that a second contract was created, considered that Brentford was fulfilling Akron's obligations under the distributor agreements, but this cannot be described as Brentford contracting on behalf of Akron, rather as providing a service to Akron.

Brentford was delivering its own tyres and so was not delivering on behalf of Akron assuming that the agency delivery rule requires, as part of the agency, delivery of the goods of the principal, although again Brentford was fulfilling contractual obligations of Akron in making the delivery.[44] In any event the delivery rule is not found in most modern UK tax treaties. Finally to remove any PE risk, Akron could have adjusted its contracts and procedures so that title clearly passed from Brentford to Akron and thence to the distributors. In *Case 110* likewise it may have been safer to have the orders sent by the distributors to the UK company and thence to the manufacturer.

In *Firestone* it was necessary to proceed to the next step and work out the profits of Akron that were taxable in the UK. This issue did not arise in *Case 110* because there was no PE. How is that calculation to be done?

Attribution of profits to PEs and transfer pricing

Although not expressly mentioned in any of the judgments, the difficulty in the *Firestone* case of assessing Brentford in its own right seems to have related to the 1936 agreement.

because the distributor purchased the products on behalf of the UK company and the treaty had the usual exclusions in relation to PEs and business profits for purchasing activities.

[42] (1955) 5 CTBR (NS) 656 at 666–667 (generally), 668–669 (on the factory).

[43] Income Tax Act 1918, General Rule 10, (1957) 37 TC 111 at 131 (Evershed M.R.), 138 (Birkett L.J.), 140 (Lord Morton of Henryton), 143 (Lord Radcliffe).

[44] The original UK–US tax treaty definition of PE was similar to that in the original Australia–UK treaty, though lacking the limitation by reference to the prices at which the agent contracted on behalf of the principal, see Art.II(1)(l).

Brentford had already been assessed on its 5 per cent cost plus profit under the agreement. Legally the rest of the proceeds on the sale of the tyres to foreign distributors belonged to Akron under that agreement and was so treated by Brentford. It was apparently unclear if there was power in UK law at the time to adjust prices and there is no suggestion that any such power had been exercised against Brentford.[45] The original assessments on Brentford at issue were for a total of £30,000 and the alternative assessments on Akron for £50,000. No reason for the difference is given. As the round numbers suggest, these were estimates, rather than precise calculations. After the decision of the Special Commissioners, the parties were left to agree the total amount of the assessments on Akron which they did at £72,340. No information is given on how this total is derived and it cannot be readily explained as based on a percentage of turnover—presumably it was derived from the accounts that Brentford kept in respect of the transactions of moneys owed to Akron.

The subsequent appeals essentially concerned whether these assessments were sustainable, apart from the Revenue's quickly abandoned initial appeal against discharge of the assessments on Brentford. Abandoning its appeal created a procedural difficulty for the Revenue: if Akron could demonstrate that any assessments for the profits should have been made on Brentford, the Revenue would lose as the only open issue was the series of assessment on Akron.[46] The courts did not appear to be sympathetic to deciding the case against the Revenue on procedural grounds or difficulties in the then existing law of adjusting transfer prices.[47] To the extent that the final result involved stretching of the law—whether corporate, agency or tax law—it might be explained on the basis that the profit taxable in the UK was the same whether it was assessed to Akron or Brentford, that is essentially it is a transfer-pricing case, not a PE case in treaty terms. Does the fact that the original profit taxed to Akron was higher than the profit taxed to Brentford have any significance on how the case is viewed?

Case 110 may suggest that the difference does have significance. In that case the profits that would be taxable in Australia if the UK taxpayer had a PE were originally conventionally assessed at £20,000 but subsequently agreed between the taxpayer and the Revenue to be £17,663. Again no information is provided of how these amounts were arrived at though the records of the payment company could provide the basic information of revenue and expenses of the UK taxpayer with respect to this side of its Australian business. The 1946 Australia-UK tax treaty contained business profits and associated enterprises articles with the usual wording and Australian domestic law contained various rules that would permit both adjustment of transfer prices between the UK taxpayer and associated Australian enterprises as well as rules for assessing the UK taxpayer directly.[48] One view of these rules is that they simply equate the position of a PE and a subsidiary in

[45] Income Tax Act 1918, General Rule 7 comes close to the case. FA 1951, s.37, which is a recognisably treaty-based transfer pricing rule, was enacted to make the adjustment power in these kinds of cases clear but it was too late for the *Firestone* case.

[46] This problem is noted twice by Jenkins L.J. (1957) 37 TC 111 at 133 and is implicit in other judgments.

[47] Harman J. considered that the 1936 agreement denied Brentford the "normal profits on its trading activities" and after noting that virtually everything involved in earning the profits on sale of the tyres occurred in the UK described the arguments for the taxpayer based on the contractual arrangements as "startling propositions maintained by [counsel for the taxpayer] who performed Blondin-like feats of balance between Scylla on the one hand and Charybdis on the other" (1957) 37 TC 111 at 119; Evershed M.R. echoed and varied the sentiment of the metaphor (or is it a simile) at 129.

[48] See Arts III(3), IV, Income Tax Assessment Act 1936, s.136 (prior to its repeal in 1982); and n.30.

the sense that the same profits are taxable in a country whether a taxpayer operates there through a PE or a subsidiary. On this view the taxpayer could have been attacked on two fronts to the same end—adjustment of the profits of the subsidiary to reflect arm's-length prices or taxation of a PE on the same amount.

It is difficult, however, to view the case as simply one of transfer pricing as there were considerable obstacles to making adjustments to transfer prices. Recall that one of the distributors purchasing products from the UK taxpayer was not a subsidiary and originally neither of them had been. Similarly the UK taxpayer had purchased products from the manufacturer before it became a shareholder. There is some suggestion from one of the members in the decision that the cost of the products to the UK taxpayer changed when it became a shareholder in the manufacturer, in which case there may have been room for a transfer-pricing adjustment to increase the profit of the manufacturer, but another member suggests that the mode of purchasing from the manufacturer was more or less the same before and after the UK taxpayer became a shareholder.[49] It seems likely that the agreed amount related at least in the main to the profits that would be taxable to the UK taxpayer in its own right if it had a PE, rather than profits transferred to it from associated Australian companies. Moreover, the Board clearly assumed that those taxable profits would be the same whether the PE was constituted by a fixed place of business or agency.

While these cases provide no definitive answers on the amount of profits assessable if an agency PE is an associated enterprise, they are interesting early examples of structures that have become tax planning commonplaces in recent years. David Oliver, in 1993, noted the current relevance of the *Firestone* case "which some would describe as the first United Kingdom case on contract manufacturing."[50] The additional transaction of the sale by the manufacturer to the parent rather than direct to the distributor underlies much of current business restructuring activity and is further discussed below. There is comment in both decisions on the unusual nature of the structures used, but it is unclear if they were the result of tax planning. Certainly they were not cases of treaty planning as both structures were put in place long before the relevant tax treaties came into existence.

Tax treaty origins of taxation of agency PEs

At more or less the same time as the arrangements discussed in *Firestone* and *Case 110* were being put in place, the League of Nations was developing the international consensus in relation to taxation of agency PEs. After the formulation of the original model treaties by the League of Nations in 1927 and 1928, two major issues left-over were when did an agent constitute a PE and how were the profits of a PE to be calculated. Work proceeded on these matters in parallel, rather than jointly, though the outcomes were incorporated together

[49] (1955) 5 CTBR (NS) 656 at 666, 672. The Australian Revenue has long been concerned that in these kinds of incorporated joint venture operations, the joint venture may deal with independent parties as well as its shareholders and potentially produce comparable prices that make transfer pricing adjustments a problem: see further n.72 below. The lack of any significant distinction between a fixed place of business PE and an agency PE in selling goods, especially where it is desired to control prices down the line, is implicitly recognised in Australia's VAT which allows agents to elect to be treated as principals, A New Tax System (Goods and Services Tax) Act 1999, Sub-div. 153-B.

[50] J.D.B. Oliver, "Unilateral Relief: The Issues in *Yates v GCA*" [1993] BTR 201 at 212.

in the various draft conventions produced for the allocation of profits of international enterprises.[51]

Agency PE: the boundary of the firm

The PE concept and its use in tax treaties perform a number of functions. One of these is to define the boundaries of the firm with respect to particular countries. Nowadays the concept is conceived as having two distinct basic rules, the fixed place of business PE under which a single enterprise has its own fixed place of business in the other state and the agency PE under which one enterprise acts for another enterprise in closely defined cases. In the case of a single enterprise, the boundary of the firm in part is defined by the fixed places of business at which the enterprise operates. The agency rules raise a key issue in defining the boundary because they involve a case where the boundary is extended beyond a single legal entity to encompass activities of another entity, the agent.

This way of viewing the PE concept was not inevitable. The development of the PE definition at the League of Nations, particularly the development of the agency PE in what are now Articles 5(5) and (6) of the OECD Model, has been discussed at length by others in the pages of this *Review* and elsewhere.[52] It is not intended to rehearse that part of the history in any detail again but rather to focus on some other parts of the history and to draw out several related points of interest. The agency PE has existed as long as the PE concept itself, both in treaties and in Prussian law where it had its origins. It was part of the basic concept, not an add-on nor later in time, although a reading of the current text of the PE definition might suggest such a view. Indeed, the PE seems originally to have been constituted as a single species, or to put it in terms of modern thinking, the agency PE was one type of fixed place of business PE. The link of the PE to a particular legal entity was not strong, perhaps because of the separate taxes in many countries for taxing business income, called variously real, schedular or impersonal taxes under which tax was levied on income as such rather than taxpayers.

The original idea was expressed in the principles for tax treaties adopted in 1925 as:

[51] The publications of the League of Nations relating to its meetings on tax treaties and its draft models are conveniently collected in Joint Committee of Internal Revenue Taxation, *Legislative History of United States Tax Conventions* (US Government Printing Office, Washington, 1962) Vol.4, "Model Tax Conventions" (hereafter LHUSTC). This volume is available electronically at: *http://setis.library.usyd.edu.au/oztexts/parsons.html* at items 3 and 4. The history of tax treaties in the League of Nations has attracted increasing attention over the years but there is still room for debate about what happened and why.

[52] J.F. Avery Jones & D. Ward, "Agents as Permanent Establishments under the OECD Model Tax Convention" [1994] BTR 341; A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer, Kluwer, 1991) chs 29–35; S. Roberts, "The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View" (1993) 21 *Intertax* 396 (Part One), 488 (Part Two); G. Persico, "Agency Permanent Establishment under Article 5 of the OECD Model Convention" (2000) 28 *Intertax* 66; R.C. Pugh, "Policy Issues Relating to the US Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform" (2000) 1 *San Diego International Law Journal* 1; A. Pleijsier, "The Agency Permanent Establishment" (2001) 29 *Intertax* 167 (Part One), 218 (Part Two), 275 (Part Three); S. R. Lainoff, S. Bates & C. Bowers, "Attributing the Activities of Corporate Agents under US Tax Law: A Fresh Look from an Old Perspective" (2003) 38 *Georgia Law Review* 143. There is also a large practitioner literature on commissionnaires. For a different view of current law based on current practice: see Lee, n.12.

> "the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative."[53]

The reference to head office and branch/establishment suggests to modern eyes a single enterprise and a place but this is not the case for the other elements of the idea. If it is possible for the activities of one person to constitute a PE of another person, the problem is how to draw the boundary in the sense of defining when to attribute the activities to the other person. Early on in the history one possible approach emerged. At the start of the 1920s the UK changed its previous practice and began to tax non-residents operating through independent agents in the UK. UK law was quickly changed and so were treaties to prevent such a result. The first draft model produced in 1927 changed the original idea quite significantly to read as follows:

> "The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bonafide* agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country."[54]

Three changes are noteworthy. First, the emphasis on places has increased, secondly the issue about attachment of a PE to a particular legal entity remains doubtful especially in the reference to affiliated companies and thirdly the exception based on independent status is included. While the problem of the independent agent and the inspiration for its solution in treaties are clearly derived from UK law, what is not so clear is whether the exception was intended to express what was already implicit in the PE concept or to introduce a new development. Its ready acceptance suggests that it was seen by many as implicit in the PE concept.

The main significance for present purposes is that the boundary of the firm is defined in terms of independence, which from the very beginning was said to require legal and economic independence.[55] In terms of the theory of the firm it suggests a point where the firm no longer expects to make additional profits on "internal" transactions and so deals through the market. This view accords with the way the policies underlying the rules are generally expressed. The policy underlying the agency PE is that an enterprise should not be able to avoid a PE by the simple expedient of having its activities carried on for it in a state by a third party. The policy for the addition, whether exception or not, is that an independent agent as defined is carrying on its own business rather than that of the principal in the sense that it is not integrated into the business of the principal.[56]

Nowadays, the addition is interpreted as having only applied to the agency context from the times of its origin but as the PE seemed at the time to be viewed as a single concept, the addition may have been viewed as generally applicable to PEs and establishing when

[53] LHUSTC at 4091.

[54] LHUSTC at 4125; for the UK history: see Avery Jones and Ward, n.52 at 381.

[55] LHUSTC at 4129. The condition in the exception at the time that the agent be rewarded at the ordinary rate for its field of activity may be viewed as a relatively objective negative test of whether it satisfied the independence test as may the modern version that the agent transact in the ordinary course of its business.

[56] For example, see Skaar, n.52 at 463.

firms were regarded as having a PE presence based on the activities of third parties, that is, when those persons were integrated into the operations of the firm and not independent. Nonetheless the problems occasioned by agency led to the continuing work which both firmed up the concept of the PE in terms of fixed places of business and agency, and more importantly answered the question about attachment to a particular enterprise. By 1933 the general part of the definition had evolved to:

> "The term 'permanent establishment' includes real centres of management, branches, mines and oil-wells, plantations, factories, workshops, warehouses, offices, *agencies*, installations, and *other* fixed places of business but does *not include a subsidiary* company."[57]

It will be noted that agency has still not fully separated into a category of its own, and indeed is treated as a type of fixed place PE. The elaborating material, however, clearly treated agency as requiring more definition and the 1927 independence addition was now firmly attached to the agency case and not the general part of the definition.[58]

There was a critical ambiguity from the policy perspective in the agency PE rule which this new definition partly solved: whether "agent" is being used in a legal or commercial sense. If the idea of independence is intended to establish the boundary of the firm generally, the commercial view best serves the policy. Why should tax be avoided simply because an enterprise operates with a subsidiary rather than a branch in a country, if in an economic sense the business of the subsidiary is integrated with the business of the parent. One way to get to this result is to say that whenever one enterprise acts for another enterprise in the sense of contributing to the profits of that other as well as its own profits, it should be treated as an agent as it is not independent in the necessary sense. On this view, a subsidiary would be an agency PE of its parent (and presumably a fixed place of business PE, assuming the subsidiary has a fixed place of business) if its activities were economically integrated with those of its parent. The subsidiary would be part of the same firm as the parent because it is not independent.

The League of Nations came at this fundamental issue from two directions—its discussion of the PE concept and its parallel work on allocation of business profits. The latter work involved a study supervised by Mitchell B. Carroll leading to a five-volume publication and discussions at several League of Nations' meetings from 1929 to 1936. Although in this work the allocation of profits to PEs was the primary focus and occupied most of the voluminous material produced, in the chapter where Carroll presented his conclusions, he began with separate enterprises:

> "It is evident from the tenor of Article 5 and its commentary that the term 'undertaking' or enterprise includes, when referring to a corporation, merely the corporate entity and its own branches, forming a part of the single corporate entity, and does not include subsidiary corporations organised in the same or other countries which are themselves separate legal entities, or affiliated corporations which are not controlled by the first-mentioned corporation itself, but are owned or controlled by the same interests as those which control the first-mentioned corporation. . . . Each of these units is a separate legal entity and should derive a separate income. Each of

[57] LHUSTC at 4246. Emphasis added.

[58] LHUSTC at 4246. For the development of this elaborating material see LHUSTC at 4197–4198, 4206–4207, 4231, 4255 (final 1935 version) and the sources referred to in n.52.

> such units performs functions which might be carried out by a branch of the parent corporation itself. . . . [I]f a corporation manufactures goods at its home factory and sells them to an independent corporation which in turn resells the goods for its own account, the second corporation must pay the first corporation for the goods, and if it does not resell the goods or sells them at a loss, it must bear the loss. If the second corporation is a subsidiary or affiliated company of the former, strictly speaking the situation should be the same. . . . In law, a taxable profit might accrue to the producing corporation if title to the goods were transferred to the selling corporation. In economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders. . . . Economic fact must inevitably give way to the definite principles and provisions of law under which business is conducted. . . . In short, the very fact that a subsidiary company is formed to operate an establishment of any kind within a country gives rise to the necessity of carrying on business subject to the same legal requirements as any other corporate entity within the country. The subsidiary must ordinarily have an adequate capital, and the nature of its activities and its contractual relations with outsiders and other corporate units of the enterprise will determine its income. If its income is diverted to other units of the enterprise in any manner, the tax authorities, as a general rule, have only to examine the inter-company transactions, appraise their terms and results in the light of sound legal and business principles, or by comparison with independent companies engaged in similar activities under similar circumstances, and recapture any profit that may be shown to have been diverted. . . . As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise." [59]

It will be noted that the passage starts with an interpretation of the PE definition which becomes a recommendation at the end—one which gives primacy to legal form in the sense of separate legal entities being treated as separate, even when not independent. Carroll recognises that this is a case of legal fiction overriding "economic fact" but then substitutes another concept of the firm expressed in terms of ownership/control to deal with abuses.

Two rules were adopted to give effect to these conclusions: the first that one enterprise was not a PE of another simply because they were associated (currently Article 5(7) of the OECD Model); and the second that profits of associated enterprises could be adjusted to

[59] M.B. Carroll, *Taxation of Foreign and National Enterprises*: *Methods of Allocating Taxable Income* (League of Nations, Geneva, 1933) Vol.IV at paras 623–628. This volume contains the synthesis and conclusions based on the work in the other volumes and is available electronically at: *http://setis.library.usyd.edu.au/oztexts/parsons.html* at item 5. Vols I-III consisted of descriptions of various countries' systems for taxing business profits and Vol.V was a study of accounting issues. The discussion of this work by the League is found in LHUSTC at 4198–4199, 4207, 4212–4219, 4229–4230, 4233, 4241–4247, 4251–4256, 4261–4263.

the profits that would be expected of independent enterprises (currently Article 9(1)).[60] The way in which the rules were expressed raised issues of the relationship to the idea of independence. Originally the former rule was expressed in terms of a "subsidiary" as in the 1933 draft above and the latter rule in terms of "dominant participation in the management or capital" of an enterprise. These terms suggest a common ownership idea of the boundaries of the firm. Thus it is possible to have cases where enterprises are not independent but not associated on the one hand and enterprises which are associated but independent on the other. The result is that there are differing concepts of the boundary of the firm both within the PE rule and between it and the associated enterprises rule. This led to a number of gaps and tensions in the provisions of tax treaties, and, as will become clear, partly explains why difficulty is felt in fitting the PE definition and attribution rules together for agency PEs.

The acceptance of the separate legal personality of associated companies as a fundamental precept of international taxation which is one of the outcomes of these events had implications for the definition of agency PEs. The legal form approach to associated enterprises made it natural to conclude that agency was also being used in a strict legal sense. Otherwise there would be a substantial overlap with the PE rule about associated enterprises since most associated enterprises would not be independent in the sense used here. Requiring a legal agency gives much more scope for the rule that associated enterprises do not, merely by reason of the association, become PEs of each other. By contrast, reading the agency rule in a commercial sense of not independent would make many associated enterprises PEs especially in view of the agency/delivery rule that was part of the League agency PE definition. The developments in the agency rule during the time of the League moved inexorably in the direction of expressing the concept as one of legal form.

Thus there were apparently three categories of persons for agency PE purposes: those who were agents of the necessary kind and were not independent so that they constituted PEs of their principal; those who were agents of the necessary kind but were independent and so did not constitute PEs; and those who were not agents of the necessary kind and likewise did not constitute PEs whether independent or not. These categories are expressing the boundary of the firm for international tax purposes in relation to agency. In terms of the three categories of persons, legal form came to determine the border between the first and third categories (agency or not), while economic substance determined the borderline between the first and second categories (independent or not). As a result enterprises could use legal form to avoid agency PEs and so did not need to be unduly concerned about the economic substance required to establish independence. More concretely, so long as a subsidiary is not an agent in the legal sense of a parent company, its lack of legal and economic independence from the parent company, which will usually be the case, will not make it a PE. This allows tax planning, in particular, based on the difference between civil and common law: the former does not generally recognise the undisclosed principal and so gives rise to a legal agency in a narrower range of cases (commissionnaire structures and the like).

[60] The term "associated" only appears in the title to Art.9 of the OECD Model. It is used in this article to refer to enterprises with common owners which often will be described (as in some of the early draft models) as parent and subsidiary (companies). Note the critical change in relation to associated companies in the PE definition between 1927 and 1933 from inclusion to exclusion.

Similarly, because of the need to connect the PE to a particular enterprise, the fixed place of business PE is likely to take on a legal dimension—that the fixed place of business must in some sense (such as whether the enterprise had a right to occupy the fixed place) be that of the relevant enterprise, not that of another enterprise. Once PEs are limited to such fixed places and agencies, the provision that a subsidiary is not a PE of its parent solely by reason of their being associated enterprises is seen as a confirmation of the previous PE provisions, rather than being a qualification. The League of Nations did not quite reach this result. It is clear from the League's work that the boundaries of agency PEs in particular were not clear and uniform across countries at this time, even after allowing for differences in the laws of agency.

Case 110 confirms the legal form approach to the interpretation of the PE definition in tax treaties rather than using independence as the basic approach—independence enters only as a qualification in the agency case after the legal form rule. If there is an agency PE the question of the attributable profits still remains.

Attribution of profits and the arm's-length principle: theories of value

While the PE and associated enterprises definitions set out the boundaries of the firm for international tax purposes, they do not provide the method of allocating business income between countries. Carroll's work on allocation deals with both PEs and associated enterprises but only raised, and did not directly answer, the specific question of what profits are attributable to an agency PE.

Immediately following the passage on associated enterprises set out above, Carroll launches into the taxation of PEs recommending that they be treated "in so far as possible as independent entities, in order that the income allocated to a branch may be equivalent to that which would have been derived by an independent enterprise."[61] This is the origin of the current Article 7(2) of the OECD Model setting out the separate enterprise arm's-length principle, just as his immediately preceding treatment of separate enterprises is the origin of Article 9(1). Both base their standard on independent enterprises. It is vital to understand how this independence standard differs from using independence to establish the boundaries of the firm.

Independence in the agency PE definition sets the limit of the firm beyond which the firm is assumed to be transacting in the normal market. In Article 9(1) the boundary of the firm is set by common ownership where there is more than one enterprise. Independence then operates *within* the boundary of the firm in Article 9(1) as the principle to allocate income. As noted in the introduction, market prices for all intra-firm transactions will not usually capture the full value realised by the firm in its dealings with third parties as the very reason for the existence of the firm is to make profits on its inputs. The independence principle applied within the firm, as opposed to determining the boundaries of the firm, is inherently indeterminate as to the allocation of the residual profit among the parts of the firm (whether within a single enterprise or among several associated enterprises). A theory is needed for the allocation of this additional value in the firm. Similar considerations apply to the rule for allocating profits to PEs in Article 7(2).

Carroll was very alive to the issue of the residual and is clear in the theory that he adopts—allocation to the real centre of management:

[61] Carroll, n.59 at para.629.

> "This [separate enterprise arm's length] test is readily applicable in the usual case where an enterprise has its principal establishment in one country and secondary establishment in others. . . . In such cases the real centre of management is probably at the principal establishment. The control and management, financial and technical, are centred there. At the meetings of the directors the decisions are taken which make or break the enterprise. There the risks are centred. The profit or loss results from all the activities of the enterprise taken together, but how can the part attributable to the establishment in each country be most readily measured? If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services." [62]

We might term this the octopus theory of firm value. The firm consists of a productive centre where the bulk of activities and brainpower are situated and a series of tentacles which provide sustenance to the centre. He subsequently applies this theory to the case of manufacture by an establishment in one country and sale of the goods manufactured by an establishment in another country (his example is in the context of a fixed place of business PE as the selling establishment):

> "The simplest method of marketing goods is to consign them to a commission agent, who receives the commission customary in the trade where the goods are sold. The commission represents the value of his services to the consignor. If shipments were made by a foreign enterprise to a local establishment on a consignment basis, to be sold or processed, the determination of the commission or other compensation to the local establishment could be verified by a comparison with what a local independent enterprise would receive for similar services under similar conditions. In many markets there is a customary commission for each particular class of raw materials or finished products that are susceptible of sale on this basis. The fee of course varies in amount with the costs and risks undertaken by the local commission agent." [63]

If a PE constituted by a branch is to be remunerated and taxed on the basis recommended by Carroll, it would seem to follow that if the PE is actually constituted by an agent selling the principal's goods on consignment, the arm's-length commission is all that can be taxed to such a PE as revenue. As this is also the amount either paid to the agent if independent or deemed to be paid to an associated agent under the associated enterprises article, the expense of the PE equals its revenue and no additional profit is taxed to the PE above that taxed to the agent in its own right. Carroll does not draw this obvious conclusion for the agency PE case, perhaps because agency was viewed as a species of fixed place of business PE and so was already included in his general statement, but he does for warehousing (agency/delivery) cases.[64] It is to be noted that the same conclusion is likely to follow for a fixed place of business PE that has contracted out most of its activities to other enterprises, associated or unassociated. Little will be left to tax in the PE state.

[62] Carroll, n. 59 at para.677.
[63] Carroll, n.59 at para.683.
[64] Carroll, n.59 at paras 646–647, which recommend that warehousing should not give rise to a PE.

Carroll adopts this approach, which he calls the remuneration-for-services criterion, in preference to what he calls the sale-between-independents criterion. According to the latter, the head office would be treated as selling the goods to the PE which would subsequently sell them to the third party, instead of a sale by the head office as in his remuneration-for-services approach. He takes this line because of the theory of value outlined and also for the practical reason that income will only arise to the head office when there is an actual sale to a third party rather than when there is a deemed sale to the PE: the opportunity for overreaching taxation by the state of sale in its taxing claim will also be reduced.[65]

It is clear both from Carroll's arguments and from the material that he amassed in his study that in practice most states clearly preferred the sale-between-independents criterion in this case. Carroll claims that there will generally be no difference in result, which is probably true if his theory of firm value and the allocation of the residual is accepted. Clearly, however, countries worked on a different theory of value allocation in this simple scenario—whether a fixed place of business or agency PE was involved, the country would allocate the selling profit to the PE state and the manufacturing profit to the head office.[66] On this theory of value every transaction within the boundaries of the firm is intended to produce a profit over and above the market price of any intra-firm transaction or dealing that operates as an input into that profit and that profit is allocated to all parts of the firm which participate in the realisation of the ultimate profit on the sale to the third party.[67] This approach to firm value is linear in concept and can be compared to a relay or rowing race: each member of the team contributes to the overall profit as they all work together towards the same goal. The residual is not given to the anchor of the relay team or the stroke of the eight.

Profits would be attributable to both a fixed place of business PE and an agency PE on this approach over and above the profit of the agent or suppliers of inputs to the fixed place of business. But the use of independence both for establishing the boundary of the agency PE and for allocation of profit within the firm as so delineated not surprisingly creates a sense of unease in the agency case. If an agency PE is independent, there is no profit to tax in the state of the agent other than the agent's profit. How then can there be a profit to tax when the agent is not independent but is rewarded or deemed to be rewarded on the same basis that an independent agent is rewarded? It is only by realising that independence operates differently in the two cases that attribution of profit to an agency PE can be justified, leaving a residual for the firm where there is no independence but not in the case of independence of the agent (that is, the firm does not capture any additional value from the agent in the latter case).

[65] Carroll, n.59 at paras 685–695.

[66] Carroll, n.59 at paras 416–428, 635.

[67] The intuition underlying this approach can be appreciated most easily in the case of employees of a firm, whether the employees are working at a fixed place of business or constitute an agent for the purpose of the agency PE rule (the League is quite clear, as is subsequent law, that employees can constitute agents for this purpose). We expect firms to make profits over and above the wages of the employees. It would have been possible to draw the boundary of the firm based on independence by using tests of employment law which typically depend on integration of the person into the firm and/or control of the person by the firm. The League of Nations followed existing practice in extending the notion of independence beyond employees. It did so with good reason as the line between employees and contractors is not robust and is the subject of considerable gaming in a number of countries for tax, employment law and other reasons.

Carroll's discussion of associated enterprises is brief. Countries may well have felt that his use of the parallel case of manufacture by the parent and distribution by the subsidiary scenario gave the same result for PEs and for subsidiaries, if PEs were taxed under the sale-between-independents criterion. The parent would sell at manufacturing market value to the subsidiary which would sell at wholesale or retail market value to a third party so that manufacturing profit is taxed to the parent and selling profit to the subsidiary. This produces symmetry in allocation of profits between the countries not only with the PE distributor case (whether fixed place of business or agent) but also with the case of a foreign manufacturer selling to an independent distributor in the selling country.

As already noticed, however, Carroll proposed and the League adopted a legal form approach for the case of associated enterprises in the sense that, for tax purposes, both the separate legal entities would be recognised and the transactions between them. A corollary of this approach as already noted was the use of legal form in determining whether an agency existed in the agency PE test. Reflection on Carroll's view of firm value and the structures used (or attempted to be used) in the *Firestone* case and *Case 110* indicates that what might be regarded as the normal transactions can be altered in the case of associated enterprises so that the tax results are aligned with Carroll's preferred allocation of the residual. Various scenarios are possible but at the extreme, manufacture and sale can occur in the same country with the (artificially large) residual remaining in the parent outside that country. A manufacturing subsidiary is set up as a contract manufacturer which sells to the parent company. That company in turns sells back to the country of manufacture involving another subsidiary in that country but in such a way that the subsidiary is only providing services to the parent and not acting as its legal agent by assisting in the sale to a third party.[68] The contract-manufacturer subsidiary makes only a small profit as does the sales-assisting subsidiary with the bulk of the profit in the parent.

The critical structural feature of these variations is that the subsidiaries supply services to the parent and do not deal with the third parties, at least in a legal sense, though they do in a practical sense, leaving this legal role to the parent. It is not clear if Carroll realised this possible result of his work and whether he would agree or disagree with it. Taxpayers quickly did realise, however, judging by the arguments used for the structures already in place in the *Firestone* case and *Case 110*.

There is another area in which Carroll's work is unclear: whether it is possible to find more than one firm within a single enterprise. He divides PEs into autonomous establishments and dependent establishments. The former category covers enterprises which can be regarded as independent either because they deal entirely with third parties in the state of the PE and not with their head office or because they are regulated in the

[68] In *Case 110*, the UK parent sold to the Australian subsidiary distributor in its own right rather than having the sale direct by the parent with the assistance of the subsidiary not rising to an agency relationship. In this case much of the manufacturing profit was moved to the UK and also part of the sale profit, but presumably leaving a wholesaler's profit to the Australian selling subsidiary. Users of the strategy described in the text would argue that more of the selling profit could have been removed from Australia by avoiding both a distributor and agency relationship, as in a commissionnaire structure where the person assisting the sale is a civil law commissionnaire who does not rise to the level of an agent in the legal sense. It may be very possible to replicate the commissionnaire in common law countries through contractual provisions, again avoiding a PE: see J.H. Momsen, "Double Tax Agreement: Commissionnaire Arrangements" (1997) 5 *Taxation in Australia Red Edition* 185. Carroll, n.59 at para.685 thought the case for the sale-between-independents criterion was strongest in the case of trademarked goods which were the subject of *Firestone* and *Case 110*.

PE state (such as banks, insurance companies, etc) and, in that sense, are insulated from the rest of the enterprise. This group easily fits the independent entity treatment because there is little dealing with the rest of the enterprise or because such dealing is regulated in the PE state. The dependent establishment is one which deals with the rest of the enterprise in such a way that the process of sale to third parties involves operations in more than one state (such as manufacture at head office and sale at the PE). That is the case he is dealing with in the passages extracted in this heading above.

The distinction between autonomous and dependent PEs suggests that Carroll is defining the boundary of the firm (within a single enterprise and in the context of a fixed place of business) in part at least based on an independence test,[69] compared to common ownership. The terms in which the PE attribution rule is expressed do not need to address the choice directly; they simply apply the independent pricing standard to the single enterprise with a PE. In terms of the previous discussion, it is important to note that there are again two possible ways in which independence is being used. If common ownership is the test of the firm within a single enterprise, clearly there will only be one firm except in highly unusual cases.[70] If the PE is genuinely independent in the sense of the agency rule and that is the relevant test for fixed places of business, it would be possible to have two firms within one enterprise, that is, the head office and the independent (autonomous) establishment. In this case, a market value test applied to dealings with other parts of the enterprise would accurately measure PE income because there would be no residual over and above the market transaction. On the other hand, if the PE is not independent in this sense and the independent price standard is being used to allocate profit intra-firm (as contrasted to intra-enterprise), there is a residual to capture, and again a theory is needed to supply the way in which to deal with the residual.[71]

[69] Autonomous is just another word for independent. Carroll, n.59, at paras 630–631 is using the term it seems in relation to fixed place of business PEs. In the League of Nations discussions, the independent agent is often referred to as an autonomous agent.

[70] For example, where shares are divided into classes and particular classes in effect confer ownership on the shareholder of specific assets of the company, as occurs in some cases where apartment buildings are owned by a company and apartments within the building are bought and sold through various classes of shares.

[71] Intra-firm needs to be distinguished from intra-enterprise if it is possible to have more than one firm within a single enterprise based on the independence test. In terms of PEs this analysis is also relevant to one question that rarely gets a direct answer. If an enterprise has several places of business or dependent agents in a jurisdiction, is there one or several PEs? Independence as the boundary of the firm can be used to answer this question. To the extent that the PEs are or form part of businesses (firms) that are independent in the agency sense, they should be treated as separate PEs and profits calculated accordingly, even though under domestic law they are aggregated to one overall profit of the enterprise. On the other hand if they are not independent, it is considered that they constitute one PE and should be taxed accordingly. In some of the League draft models it seems to be assumed that there will only be one permanent establishment even though there are a number of places or agents that satisfy the definition, see LHUSTC at 4246, 4255: "When the term 'permanent establishment' is used with reference to a particular State, it includes all the permanent establishments, whatever their form, which are situate within such State." In (the third) *National Westminster Bank Plc v United States* 69 Fed Cl 128 (2005), it was held that the six, physically-separate, branches that the taxpayer had in the US were one PE apparently on the basis of US past practice. The OECD Commentary to Art.5, paras 5.1–5.4, 27.1 inserted in 2003, seems to regard each place as a separate PE but a place may include several locations that are commercially and geographically coherent. This is different from using the independence test to determine the boundaries of each PE.

The same point can be made about associated companies defined by common ownership. Sometimes they will be independent in the sense of the agency test, and there would be no residual over and above the market value of their transactions. The common ownership test that clearly applies in this case distracts attention from the fact that there are two senses of independence at play which are relevant to whether there is a residual that needs to be allocated above the market prices for transactions. In terms of the previous discussion, this is the crux of *Case 110*. If the subsidiaries were all independent of the UK taxpayer even though owned in whole or part by it, which was possible on the facts for the manufacturer and the distributor, only transfer pricing was an issue. If they were not independent, there would be additional profits potentially liable to tax in Australia, but it would be necessary to find a PE to tax those additional profits.[72] This is a case in the author's view where operations were integrated and so there should have been additional profits to tax in Australia.[73]

Although Carroll's work was accepted in the sense that the League adopted model provisions for the arm's-length, separate enterprise principle that are the predecessors of the modern Articles 7(2) and 9(1) of the OECD Model, it seems likely that the implications of his value analysis were not generally accepted at the time despite this adoption. The

[72] Australia did not like the result in *Case 110* and went on a frolic of its own to try to deal with it, completely confusing independence and control and producing defective treaty provisions as a result. When the second Australia-UK tax treaty was signed in 1967, it contained two provisions that seem clearly designed to produce a different result. Art.4 provided in part: "(5) A person acting in one of the territories on behalf of an enterprise of the other territory (other than an agent of independent status . . .) shall be deemed to be a permanent establishment of that enterprise . . . (c) if in so acting he manufactures or processes in that first-mentioned territory any goods for the enterprise. . . . (8) Where an enterprise of one of the territories sells to a person in the other territory goods manufactured, assembled, processed, packed or distributed in the other territory by an industrial or commercial enterprise for, or at, or to the order of, that first-mentioned enterprise and (a) either enterprise participates directly or indirectly in the management, control or capital of the other enterprise; or (b) the same persons participate directly or indirectly in the management, control or capital of both enterprises, then for the purposes of this Agreement that first-mentioned enterprise shall be deemed to have a permanent establishment in the other territory and to carry on trade or business in the other territory through that permanent establishment." The first provision expresses the test of whether the manufacturer or processor is independent, but by using the agency provision limits the operation of the provision to legal agency situations. The second provision uses the common ownership test. Accordingly it begs the question of what profit is attributable to the deemed PE if the commonly-owned enterprise is in fact operating independently. What the drafter seems to have intended is that Australia would capture the profit made when the deemed PE is not independent in the sense used in the text. This would include the profit over and above the arm's-length reward to the enterprise constituting the deemed PE in its own right. If so, although there is some diversity in the provisions in Australia's treaties that derived from the 1967 treaty, none of them seems to have hit the target. This includes Art.5(3)(c) of the third Australia-UK treaty of 2003 because, although it has overcome the agency issue and dropped the common ownership test, it does not have the independence test attached to it. There are similar problems for the efficacy of the still common agency delivery provision implicit in this discussion generally, namely that in making deliveries a person must be acting as an agent in the legal sense of having power to bind the person whose goods are being delivered in relation to third parties. Most persons making deliveries are simply providing a service, and have no power to bind anyone legally. The provision is included in the agency rule to attract the independence exception but it also includes the legal agency approach.

[73] The fact that the subsidiaries were not independent would mean that even if the prices for the transactions with them were arm's length, a residual existed within the firm which on the facts clearly belonged to Australia.

sale-between-independents criterion was clearly the dominant approach to determining the profit of a selling branch PE, as is evident from the large amount of information that he collected on countries' tax systems. Carroll's proposed article for allocating profits for branches does not seem to have appeared in a treaty until 1942 (Canada-US treaty, Article III), although the first draft was published in 1933. By contrast the associated enterprises entity article appears even before then in the France-US treaty of 1932 (Article IV). There remained several issues to resolve in the operation of the taxing rules.

1950s

Some, but by no means all, of the issues hanging over from work before the Second World War were resolved shortly afterwards. In terms of the PE definition, the removal of the delivery/agency PE and the addition of the exception for preparatory and auxiliary activities (including the delivery case) appeared in the 1958 draft PE article of the OECD's predecessor.[74] In addition that draft clearly separated the agency PE from the fixed place of business PE. In combination these changes confirmed that the agency rule is clearly premised on the legal sense of agency, not the commercial sense. Carroll had effectively argued for these developments as regards delivery/agency and preparatory and auxiliary activities. The main argument was that the activities listed did not contribute significantly or in a way that was measurable to the profits of the firm. Removal of them from the PE concept ensured that countries could not attempt to attribute profits in such cases.[75] These changes were more consistent with the theory underlying the sale-between-independents criterion than Carroll's theory of value underlying the remuneration-for-services criterion. According to the sale-between-independents criterion, only the ultimate product delivered to third parties is directly in the chain of production and distribution and so only the direct contributors in that value chain were rewarded with shares in the profits including the residual. In metaphorical terms in the sale-between-independents criterion, no profits were attributed to the coaches and entourage of the relay or rowing team, only to the team members. Carroll had generally supported these changes on practical grounds rather than in terms of theory, though the change to delivery was justified by him in part by reference to the remuneration-of-services criterion.

More significantly, the work on attribution of profits to PEs published in 1960 clearly adopts the sale-between-independents criterion in determining the profits of a PE which sells goods manufactured elsewhere. The Commentary refers to the "sale" from head office to the PE but, more subtly, the "rules" on denial of deductions for notional payments in relation to interest, royalties and management services are explained in terms which fit with the direct chain of value theory which distributes the residual to the parts of that chain.[76] Carroll was in agreement with this treatment of interest at least, but again on practical grounds rather than in terms of theory. Surprisingly, however, it was only in 1994 that this theory was clearly articulated in the Commentary,[77] by which time it was in

[74] Organisation for European Economic Cooperation (OEEC), *The elimination of double taxation* (OEEC, Paris, 1958) in LHUSTC at 4445.

[75] The purchasing office exclusion also appears in this draft for the same reason. Although it was common in actual treaties and was discussed by the League of Nations, it was not included in League drafts.

[76] OEEC, *The elimination of double taxation: third report* (OEEC, Paris, 1960) at LHUSTC 4565.

[77] OECD Commentary on Art.7 at paras 17–17.2. By contrast, the remuneration-for-services criterion thinking is reflected in another change made at that time in para.12.1.

the process of being supplanted. As with Carroll's work, attribution of profits to agency PEs is not explicitly addressed, but the changes to the PE definition generally, especially the rules excluding PEs where the contribution to profit was marginal or difficult to measure, clearly signalled that the existence of a PE would normally give rise to real taxing rights.

The other significant changes at this time had to do with the elaboration of the common ownership approach to the definition of the firm in what became Articles 5(7) and 9(1). Variants of the term "control" are introduced into the provisions for the first time in draft models and, on their own, could be read as another way of referring to lack of independence, that is, if an enterprise is not legally and economically independent of another, there is a control relationship between them. It is likely, however, that this is not the intended meaning of control—the basic idea is of the members of a corporate group and looks to a body of common owners who share the ultimate economic risks of the group.

The definition of "associated enterprises" in the associated enterprises article from this time refers to cases where "persons participate directly or indirectly in the management, control or capital of an enterprise." The only commentary from the League said the provision applied to parents and subsidiaries and the Commentary to the OECD Model added a reference to common ownership by a third person (which had always been clearly covered by the draft provisions). The League drafts contained the word "dominant". This word was deleted from subsequent versions but it seems to be accepted that more than a portfolio holding of shares in an enterprise is necessary, even though such a holding is a participation in the capital of an enterprise.[78]

The differences between management, control and capital are not explained. The facts of *Case 110* demonstrate some of the issues. Was the significant bargaining power that the UK company had with the manufacturer before it acquired any interest in the company enough to make the enterprises associated? Was the acquisition of 10 per cent non-voting stock, or the right to nominate a non-voting director, or the shareholders' agreement singly or cumulatively enough? The structure of Article 9 may be thought to be against merging the ideas of independence and control. It provides in paraphrase that if enterprises are associated as defined and if they deal with each other in ways that independent enterprises would not, profits can be adjusted to what would be expected of independent enterprises. As explained above, there is a shift in meaning in independence in the provision from the agent of independent status, but even so it would be odd to read the two conditions for the operation of the article as saying that, if enterprises are not independent in the agency sense and if they do not transact on the basis that independent entities would, certain consequences follow. On the other hand the agent of independent status concept in effect has a requirement that the parties deal independently as well

[78] For the League of Nations provisions, see LHUSTC at 4247, 4337, for the OEEC, see LHUSTC at 4606, for the OECD, see Commentary on Art.9 at para.1, *Transfer Pricing and Multinational Enterprises* (OECD, Paris, 1979) at para.7, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, Paris, loose-leaf commencing 1995) Introduction at para.11. None of these provides any real guidance. A number of other provisions of the OECD Model and actual treaties use varying language, Art.10(2)(a) is expressed in terms of a significant (25) per cent of the capital of a company and many actual treaties, particularly of common law countries, change this to 10% of the voting interest in the company. Art.24(5) of the OECD Model and most treaties use the variation "the capital of which is wholly or partly owned or controlled, directly or indirectly". Relief articles of actual treaties often contain other expressions to similar effect. The overall impression is one of common ownership, understood in a broad sense, rather than control divorced from any ownership.

as be independent. The precious little of commentary that there is to give guidance is referring to common ownership (parents and subsidiaries) and that will be assumed for the purposes of discussion to be the meaning.[79]

If so, there is a gap in Article 9(1) in that it does not cover cases where enterprises are not only not associated but also are not independent. Australia extends its domestic transfer-pricing rules to cover such a case. Does the limit in Article 9(1) mean that Australia is denied the right to exercise its more extensive domestic power? In terms of Article 9(1) on its own, it is thought that the answer is no because the Article is expressed in permissive language. In terms of the non-discrimination article in relation to deductions, Article 24(4) of the OECD Model, there may be a significant problem as that article does not limit itself to associated enterprises (unlike the immediately succeeding paragraph of the non-discrimination article).[80] It would be desirable from this viewpoint to read Article 9(1) as adopting an independence test for associated enterprises instead of common ownership.

The other treaty provision relevant to this discussion, Article 5(7) about whether associated companies form PEs of each other, is now expressed in terms of "control" of or being "controlled" by an enterprise without reference to capital or management or to common control by a third person. There is more Commentary on this provision and it again is suggestive of common ownership, rather than independence, as the relevant test. Even if it were adopting independence as the test, the view that the provision simply confirms that it is necessary to establish a fixed place of business of the enterprise or an agency PE means that the independence test would be subsidiary as in the agent of independent status and would not contribute greatly to achieving a policy objective of reading the PE definition in terms of economic substance.

The lack of comment on the meaning of associated enterprises in Article 9(1) is odd when compared with the amount of material on the independence of agents, or, for that matter, on Article 5(7). It is indicative of the fact that the concept of the firm and its boundaries have not been thought through in relation to separate enterprises. It is, however, consistent with the apparent lack of concern in the 1950s about the detailed operation of the transfer-pricing rule for associated enterprises. In this regard, as with Carroll in the 1930s, the use of the arm's-length, separate enterprise principle is regarded as so straightforward that it seemed "to call for very little comment." Modern

[79] The issue was discussed at the 2003 Annual Congress of the International Fiscal Association where varying country practice was noted. The Technical Explanation to the US Model Income Tax Convention of September 20, 1996 says the provision requires "effective control" which means all types of control "whether or not legally enforceable and however exercised or exercisable" in K. van Raad, *Materials on International & EC Tax Law* (ITC, Leiden, 2005) Vol.1 at 490.

[80] Art.24(4) requires any adjustment to deductions to be done in accordance with Art.9(1) if the denial of deduction rule does not apply equally to resident enterprises under domestic law. Australian law extends to the case where two otherwise unrelated parties enter into more than one transaction and alter the prices of both and gain a tax advantage: see Income Tax Assessment Act 1936, s.136AD which covers cases where as a result of "any connection between any 2 or more of the parties to the agreement or . . . any other relevant circumstances, . . . the parties to the agreement, or any 2 or more of those parties, were not dealing at arm's length with each other". To date Australia has avoided problems as its only two non-discrimination articles are subject to domestic anti-avoidance rules which include the transfer-pricing rules. Other possible gaps in the treaty rules arising from the bilateral nature of treaties can be noted at this point. It is unclear whether and how Art.7(2) and Art.9(1) cover cases where a PE of one enterprise in a country deals with an associated enterprise resident in the country of the head office or a third country.

transfer-pricing approaches for associated enterprises were still 20 years in the future for the OECD (the publication of the original transfer-pricing guidelines in 1979).[81] There could have been some concurrent consideration of the relative treatment of branches and subsidiaries in the 1970s but if so it did not deal with potentially differing theories of the firm and its boundaries, and of the generation of value in the firm. In the work from the 1950s until the 1990s there is little sense of policy tension among the rules affecting agency PEs and associated enterprises.

Recent (re)thinking on taxation of agency PEs

Articulation of the apparent paradox that an agency PE will give not rise to any taxable profit if rewarded on arm's-length terms has become explicit from the 1990s.[82] The timing was not an accident. Permanent establishments were back in vogue after some decades of a shift in focus to associated enterprises (parent and subsidiaries). As barriers to international operations of banks came down, many more financial institutions operated cross-border in the form of PEs. International financial markets became more integrated, partly made possible through technology advances leading to global trading. Technology itself raised questions of what constituted a PE—e-commerce and the server PE debate. Services became increasingly important in international trade and many service firms operated through PEs.[83] Finally tax planning using structures similar to those in *Firestone* and *Case 110* and commissionnaires became prevalent. In the early 1990s the OECD was also revising its transfer-pricing guidelines in relation to separate enterprises. Once that work was concluded, it was always proposed to move on to the related issue of attribution of profits to PEs, but the process was spurred on in part by the renewed interest in PE issues.

As a result there were several parallel investigations by the OECD of what a PE is and what profits are attributable to PEs. In this case the investigations were more fragmented than in the 1930s and the studies have not reached a final conclusion. Once again two of the sticking points are what constitutes an agency PE and attribution of profits to agency PEs.

[81] See works of OEEC and OECD referred to in n.78.

[82] The author's first recollection of the argument was a query at an OECD meeting by a delegate from what was then Czechoslovakia in the early 1990s. PE issues loomed large in the former Eastern bloc because the legal forms in which foreign companies could do business were ill defined in many cases (the issue of legal form in domestic law being of little importance under central planning) until the commercial and corporate laws were clarified. Non-residents ran various arguments with the tax authorities as to why they were not taxable there, of which this was apparently one used in appropriate cases. The argument has since become common: see, for example, Momsen, n.68 at 192, Lee, n.12.

[83] Individuals providing professional services were previously dealt with separately in Art.14 of the OECD Model on independent personal services. The Commentary to that provision in effect provided that similar principles applied to professional services as to the business profits of PEs. As a result of this redundancy and various technical issues with the article, it was removed from the OECD Model in 2000 so that professional services are now dealt with directly by Arts 5 and 7 of the OECD Model. One significant difference is that Art.14 did not explicitly contain an agency provision. Moreover, the article was often raised in the context of professional firms operated in the form of partnerships. The OECD concluded that the fixed base in Article 14 could be attributed to all partners of the partnership on the basis of the agency which commonly exists between partners. This was one case, however, where it was necessary to have a fixed place of business to operate agency concepts. See *The Application of the OECD Model Tax Convention to Partnerships* (OECD, Paris, 1999) at 33, *Issues Related to Article 14 of the Model Tax Convention* (OECD, Paris, 2000) at 14.

Agency PEs

In recent years the OECD Commentary on agency and the position of associated enterprises as PEs has been altered as a result of three separate exercises undertaken by the OECD: a general review of the PE Commentary,[84] consideration of the status of computer servers as PEs[85] and reaction to the Italian decision in the *Philip Morris* case.[86]

Some of the changes are statements of what may be thought obvious from the modern drafting of the provisions. An agent must be a person separate from the enterprise said to have a PE, hence a website cannot constitute an agency PE. Similarly, an agency PE is separate from a fixed place of business PE and so the agent need not be a resident of the state or itself have a PE there, though the requirement of regularity in contracting as agent means that usually the agent will have its own PE if not a resident of the country. It is surprising that it has taken so long for this statement to be made clearly but the issue still lingers in some countries.[87] In relation to the position of associated enterprises as PEs, the changes strongly reinforce the separate legal status of associated enterprises and indicate that it is not generally possible to pierce the corporate veil and attribute the acts of one associated enterprise to another on the basis of a *deemed* agency or place of business. Further the revisions reinforce that the question of whether an agent is of independent status is different to the question of whether the principal and agent are associated enterprises.[88]

The general thrust of these changes has reinforced the legal form approach to the necessary agency for a PE and the separateness of associated enterprises. This direction may be thought to be different to the changes in the area of the fixed place of business PE. For some time it has been at least implicit, as evident from *Case 110*, that the fixed place of business must be that of the enterprise and not of another enterprise. The connection between the place and the enterprise could be defined in terms of legal form in the sense of requiring some defined legal types of rights to occupation or some kind of economic substance. The Commentary has long referred to the place being "owned or rented by or otherwise at the disposal of the enterprise" which in the last case goes beyond legal form but exactly what "disposal" required was explained by way of example, rather than

[84] "Issues Arising under Article 5 (Permanent Establishment) of the Model Tax Convention" in *2002 Reports Related to the Model Tax Convention* (OECD, Paris, 2002) incorporated into the Commentary in 2003.

[85] "Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on Article 5" in *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (OECD, Paris, 2002) at 79 previously published electronically in draft and final form 1999–2000 and incorporated in the Commentary in 2003.

[86] *Philip Morris GmbH* (2002) 4 *International Tax Law Reports* 903 which held that participation in Italy in negotiation of contracts was sufficient to create an agency PE there, see Proposed Clarification of the Permanent Establishment Definition: Public Discussion Draft, April 12, 2004 incorporated into the Commentary in 2005.

[87] One result is that commercial travellers may give rise to a PE which was not clearly the case under the League Models. Germany, it seems from its observation on the Commentary in this area, still prefers to view agency PEs as involving a fixed place of business of the agent, which also finds support in German case law: see Skaar, n.52.

[88] Mexico adds additional text in its tax treaties to the independent agent provision to require that the agent deal at arm's length but without any reference to being associated enterprises. This would cover cases of the kind referred to in n.80 and text where the principal and agent are not independent and not associated. It is not clear what it adds to the independence test: see n.55.

defined, and so was susceptible to the requirement of some form of legal property right. The difficult case is one where there is in some real sense dual occupancy of the same fixed place. The 2003 changes to the Commentary have been thought to extend the kinds of cases where a PE can arise, both in terms of adopting a more expansive definition of the "place" as commercially and geographically coherent and by giving examples which involve a more tenuous legal right to the place (the painter example) so extending PE cases involving dual occupancy. Inevitably this raises the possibility of a fixed place of one enterprise being the fixed place of another associated enterprise, although the issue extends beyond associated enterprises.[89]

In addition, the 2003 changes raise issues of tax avoidance in relation to fixed place PEs and give some room for domestic anti-avoidance doctrines, partly in line with the controversial changes to the Commentary on Article 1 dealing with tax avoidance generally. Again the concerns often involve associated enterprises. The Commentary has for many years dealt with activities to avoid agency PEs[90] but the most recent changes on agency PEs seem to move more to form and do not give the same scope for avoidance doctrines as for fixed place PEs. Given the extent of tax planning currently being undertaken, the OECD is further examining the issue. The major question not yet tackled is the extent to which commissionnaire structures and variations on *Firestone* and *Case 110* may be used to strip profits from countries. Most recently this was highlighted at the OECD Second Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring, "There was general agreement that it would be useful to do further work in clarifying and perhaps re-examining the role of the dependent agent definition."[91] It is understood that such work is underway.[92]

Perhaps a shift will occur as a result of this work effectively to expand agency PEs as seems to have been happening to fixed place of business PEs, either through the anti-avoidance route or more generally. The tension between form and substance for agency PEs will no doubt be a major factor in the debate. The agency PE issue is much more of a risk for associated enterprises than expansion of the fixed place PE as it is usually possible to avoid dual occupancy problems for fixed places.[93]

[89] The Commentary on Art.5 para.4.1 now says that no formal legal right is required and that illegal occupation is sufficient. The examples involving dual occupancy are controversial with, among other cases, a painter working on a single project for a sufficient period of time giving rise to a PE (with which Germany disagreed in a 2005 observation) but regular use of a docking bay by a truck not giving rise to a PE. The possibility of a subsidiary giving rise to a PE of a parent on a dual occupancy theory was recognised in 2003 in para.4.3 but may have been reduced in significance by the 2005 changes in paras 41–42.

[90] The Commentary on Art.5 has sought to prevent, for many years, a mere signature or approval in head office being sufficient to avoid an agency PE but the response to the *Philip Morris* case in Commentary changes in 2005 emphasises form over substance. Compare paras 18 and 27.1 added in 2003 in relation to fixed place of business PEs.

[91] Meeting held on January 26–27, 2005; a summary of proceedings from which this quote is taken, is available at: *www.oecd.org/document/20/0,2340,en_2649_201185_34535252_1_1_1_1,00.html*. Business restructures were also considered at the 2005 Annual Congress of the International Fiscal Association.

[92] Mary C. Bennett, Head of Tax Treaties, Transfer Pricing & Financial Transactions Division, OECD Centre for Tax Policy & Administration, "Current International Tax Activities at the OECD" Powerpoint presentation to National Foreign Trade Council, Tax Committee Winter Meeting, Savannah, GA, USA, February 17, 2006.

[93] See n.89.

Attribution of profits to agency PEs

Like Carroll, the OECD in the last decade of its reconsideration of the arm's-length, separate enterprise principle started with associated enterprises and then moved onto branches. The "problem" of attributing profits to agency PEs was first signalled by the OECD in a 1997 draft report and 1998 revision on global trading of financial instruments.[94] The resolution of the issue did not appear until 2003 with publication of the revised version of this report which had meantime been folded into the general project on attribution of profits to PEs.[95] The latest version of the response which applies generally and not just to global trading is contained in the revised version of the general principles on attribution published in 2004. It states:

> "269. In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities—the dependent agent enterprise (which is a resident of the host country) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises, e.g. commission paid to dependent agent enterprise based on volume of product sold, were conducted on an arm's-length basis.
>
> 270. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (i.e. as a result of activities which have been carried out by the dependent agent enterprise on the non resident enterprise's behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident enterprise where the functions performed in the host country on behalf of the non-resident enterprise meet the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to operations performed through the dependent agent PE in the host country.
>
> 271. . . . On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient free capital to support those assets and risks. The authorised OECD approach then

[94] *The Taxation of Global Trading of Financial Instruments* (OECD, Paris, 1998) at 58–61. This report was produced by the Special Sessions on Innovative Financial Transactions which is a group of tax experts established by the Committee on Fiscal Affairs in 1994 to review the tax policy and administrative issues raised by financial innovation. The OECD earlier published a report on *Taxation of New Financial Instruments* (OECD, Paris, 1994) which had been concerned in part with transfer-pricing issues and led to the insertion of a transfer-pricing rule that could be incorporated into Art.21 in the Commentary on that article. The Special Sessions arose from this work.

[95] *Discussion Draft on the Attribution of Profits to Permanent Establishment: Part III Enterprises Carrying on Global Trading in Financial Instruments* (OECD, Paris, 2003) at 54. By this time the work had passed from the Special Sessions to Working Party 6 which deals with transfer pricing. The draft is available online at: *www.oecd.org/dataoecd/13/56/2497694.pdf*

attributes profits to the dependent agent PE on the basis of those assets, risks and capital. . . .

273. In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm's-length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's-length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above (and illustrated in the example below) the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE. . . .

282. . . . suppose that previously the enterprise operates as a full-fledged distributor (i.e. it buys and sells on its own account) and assumes and subsequently manages the inventory risk, including the risk that inventory may become obsolete. Suppose further that there is a business restructuring under which this enterprise converts into a dependent agent enterprise . . . Assume finally that the functional analysis shows that the personnel that used to perform the key entrepreneurial risk taking functions in respect of inventory risk are still employed in the dependent agent enterprise and are still performing those functions, albeit now on behalf of the non-resident enterprise. This would mean that the 'economic ownership' of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach to the dependent agent PE. And, of course, under the authorised OECD approach, so is the associated profit or loss."[96]

One immediately noticeable feature of the passage is its jargon which may make the meaning less than clear to those uninitiated in the rites of the transfer-pricing specialist. The "authorised OECD approach" is to apply the transfer-pricing guidelines for separate but associated enterprises (parent and subsidiary, etc) by analogy to branches. The guidelines and the modern transfer-pricing analysis begin with a functional analysis to identify the functions undertaken by various entities in the relevant corporate group in the light of the assets used and risks assumed by each of them. The pricing of transactions is subsequently undertaken based on this analysis which is designed to identify the value drivers as a means of allocating profits among the members of the group.

The functional analysis assumes an even more central place in the authorised OECD approach for branches as the first step is to take the fixed place of business or agency which constitutes a PE and analyse exactly its activities to determine the functions, assets and risks deployed by the various parts of the enterprise (usually a company) which has the PE. In the case of separate companies the dividing lines between the various enterprises

[96] (Revised) *Discussion Draft on the Attribution of Profits to Permanent Establishments: Part I General Considerations* (OECD, Paris, 2004) at 60 available at: *www.oecd.org/dataoecd/22/51/33637685.pdf.* The next step in the process that is currently underway is a consultation between Working Party No 6 and Working Party No 1 (which deals with the OECD Model treaty) to see how the OECD authorised approach can be implemented by changes to the OECD Model or to the Commentary. It is difficult to capture fully the OECD reasoning on this issue in a short extract.

in a group is clear at least in concept because they are legally separate and can enter into legally valid transactions with each other. In the case of a PE the dividing lines are unclear and the functional analysis performs the additional task of delineating the parts of a single enterprise which are to be treated as a separate enterprise under Article 7(2) of the OECD Model for attributing profits to the PE.[97] In the second step in the OECD authorised approach for PEs, the transfer-pricing guidelines for separate enterprises are then applied by analogy to the PE as the separate enterprise hypothesised in the first step—"by analogy" as the PE cannot enter into actual transactions with other parts of the same enterprise. In the second step "dealings" between various parts of the enterprise identified by the functional analysis are treated as transactions to which the guidelines are applied.

There is a third theory of firm value implicit in this passage which is spelt out elsewhere in the current OECD work, the code being the reference to "key entrepreneurial risk taking functions" (KERT) understood as the "people" functions "which require active decision making with regard to the most important profit generators of the business."[98] KERT functions are deployed in a number of ways to allocate the residual profit. Among other things they are used to determine which part of a single enterprise will be treated as having the ownership of specific assets. In the case of the simple example often used above of manufacture of goods by head office and sale by a PE, it will depend on which part of the firm manages the risk with respect to sale of the goods as to how the profit of the PE is determined. If the PE manages that risk, the PE will have the sale profit under a sale-between-independents approach. If the PE does not manage that risk, the PE will be rewarded on a remuneration-for-services basis. Searching for a metaphor for this theory of value, the author needs to resort to the realm of myth and legend—the hydra theory of value. The hydra was a fabled beast with several heads which is the critical feature for present purposes. Like Carroll, value under the hydra theory is seen essentially in terms of brainpower, but, unlike Carroll, there is no *a priori* assumption as to the location of the brainpower, it is where you find it (one of the problems of this approach is the exercise of brainpower is not easily observable).

It is not intended here to offer a comprehensive critique of pros and cons of the hydra theory of value, but rather to make three points. First, there is a shift from the theory underlying the treatment of attribution to PEs for many years which should be recognised and debated, rather than going by default. Secondly, the OECD approach in the quoted

[97] There is a potentially serious disconnection between the process of delineating the PE and attribution of profits, if it is possible to keep functions outside the fixed place of business or agent or to avoid a PE altogether. This kind of issue has deliberately been avoided in the PE attribution work by the OECD. It is raised most clearly by the connected work on whether a server constitutes a PE (see n.85) and the virtually nil profits that will usually be attributable to such a PE, see "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" in *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions*, n.85 at 102. Nonetheless in related e-commerce work the OECD concluded that current treaty constructs were still generally appropriate: see "Part II Treaty Rules and E-commerce: Taxing business profits in the new economy" in *E-commerce: Transfer Pricing and Business Profits Taxation* (OECD, Paris, 2005) at 69.

[98] It is understood that OECD work subsequent to the 2004 draft may lead to the removal of the example in the last paragraph of the quote and the KERT terminology, without however changing the underlying reasoning. It is that reasoning which is of concern to the author. For a similar approach to the OECD on attributing profits to agency PEs, see Australian Taxation Office, *Attributing profits to a dependent agent permanent establishment* available at: *www.ato.gov.au/large/content.asp?doc=/content/64343.htm*

passage does not cohere well with the PE definition generally which was refined in the 1950s to produce generally significant taxing rights when the PE threshold was crossed. The interpretation adopted flows from a view of transfer pricing which sees it largely divorced from its treaty context, which is an inappropriate approach to interpreting treaties. Thirdly, and similarly, the OECD view makes the independence test in relation to agency PEs irrelevant. The common ownership view of the firm has been unwittingly applied instead. In the passage above whether profits are attributable does not depend on whether the agent is independent or not but rather on the functions undertaken by the agent. In the author's view this clearly is not the intended operation of the agency PE rule. Giving importance to independence need not contradict the hydra theory of value. The agency independence principle is that some profit is intended to be taxable to an agency PE based simply on the functions performed by the agent which constitutes the agency PE *because* the agent is not independent. Some of the residual belongs with the agency PE. Whether the bulk is to be siphoned off by KERT functions should be another matter.

The problem of the OECD reasoning is demonstrated in the example given in the concluding paragraph in the passage quoted above. The example involves a common form of restructure under which a subsidiary distributor owning inventory is turned into an agent PE not owning inventory. In an unlikely version of the restructure, the agent continues to manage the inventory risk as it had done when it was a distributor and had title to the inventory. On this basis, the risk arising from ownership of the inventory is still located in the PE jurisdiction as a result of the agent's activities. As the agent no longer owns inventory, this is a risk of the principal located in the jurisdiction, not a risk of the agent, and gives rise to profits attributable to the agency PE. While conceptually possible, the reasoning is implausible. It implicitly rejects the view that a person can make a profit out of the activities of another which have been rewarded at arm's length; or at least for some unexplained reason locates such profits not where the activity that gave rise to them occurred. Yet this view is accepted as a matter of course with fixed place of business PEs. Further, it means that attribution is easily avoided for agency PEs by ensuring that functions which can be attributed as *additional* functions to the principal are not undertaken by the agent which gives rise to the PE. It is unlikely that the PE agency definition was formulated simply for the unusual case contemplated in the example. As should be clear from previous discussion, it is the profit of the principal on the actual activities of the agent as such which is attributable to the agency PE. This profit is additional to that made by the agent. There is no need to find *additional* functions of the principal arising from the agent's activities to attribute profits to the agency PE. It is enough that the agent is not independent to cause attribution.

The reasoning adopted by the OECD here is equally applicable to fixed place of business PEs. If *all* inputs to such a PE were supplied by persons independent in the agency sense, the author would agree that there is no profit to be attributed to the PE for reasons explained earlier. Such a scenario is likely impossible. If, however, some of the suppliers are not independent, value is being generated in the PE in addition to the market values of inputs. If all or virtually all of the inputs are provided by associated enterprises which are not independent and prices set or adjusted with those associated enterprises to market prices, there are still profits taxable to the fixed place of business PE. The OECD reasoning in the passage extracted above could be deployed to argue that no profits would be found in such a PE as no additional functions are being performed by the PE. The OECD has contemplated no effective attribution of profits to a fixed place of business PE

in the case of a computer server based on an analysis using KERT functions. It is a small step to the same result for many other forms of fixed place of business PEs. Again it is considered such a result flies in the face of a sensible interpretation of tax treaties.

Making PE taxation ineffective or easily avoided, as the proposed OECD approach does, has potentially serious results for the international tax system as the author has elaborated elsewhere.[99] As with the discussion above of Carroll's original work, however, it may be that rescuing PE taxation on the attribution of profits front is not enough. There are two further problems. One of them relates to the legal form approach that applies to the interpretation of agency PEs and possibly fixed place of business PEs. If a PE is avoided on legal form grounds even though not independent, it is necessary to have recourse to the associated enterprises article to capture profits in the country of the alleged PE. The second problem relates to the value analysis in the OECD passage quoted above which reflects the approach that was developed by the OECD for transfer pricing involving associated enterprises. It is possible under this approach to use the legal form based on separate legal entities and the respect for transactions to shift the residual more or less at will (taking care to relocate a bit of brainpower at the same time). Variations on the structures in *Firestone* and *Case 110* abound.

It is unlikely that these issues can be solved without a change in approach to at least one of the rules and theories of value creation. If PEs could be created on an economic substance approach (based on independence for the boundary of the firm) with real profits attributed to them for significant activities in a country regardless of playing with risk between associated enterprises, the residual might end up where it seems to belong. Alternatively if transactions between associated enterprises were less sacrosanct then they are now and a realistic value approach were taken to allocation of residual profits, again it would be more likely that profits align with reality. The issues surrounding agency PEs are not isolated questions. They involve fundamental issues about the OECD Model and its future effectiveness in international business taxation.

Conclusion

Unlike the past and recent history of fragmented consideration of the core issues of PEs and the profits taxable to them, hopefully the opportunity will be taken in the current consideration of commissionnaire structures and the like to look at all the relevant issues together. One of the significant problems in the recent OECD work on attribution of profits is that the relationship of attribution to other areas of tax treaties is constantly recognised as an important issue but then regarded as off-limits for the attribution work. The time has arrived to conceptualise more fully the policy and purpose of the total treaty constructs in the area of PEs, associated enterprises and business income.

While the OECD recently concluded that the current treaty framework is generally suitable to the conditions of the modern economy, that work did not sufficiently recognise

[99] R.J. Vann, "Reflections on Business Profits and the Arm's-Length Principle" in B.J. Arnold, J. Sasseville and E.M. Zolt (eds), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, Toronto, 2003) at 133. Those who favour removal of agency from the PE definition (see Lee, n.12) might note that agency is not included in the parallel definition in OECD, *Model Estate, Inheritance, and Gift Tax Convention* (OECD, Paris, 1982) Art.6 but this is on the basis that agency will not be relevant in this context (Commentary on Art.6 para.13), presumably as no property of the taxpayer will be owned by an agent. By contrast for taxes on capital under Art.22 of the OECD Model, agency PEs are relevant.

the current technical and policy inconsistencies in the framework, of which the agency PE discussed in this article is an important example. Resolving these inconsistencies does not necessarily require radical departure from the current treaty framework, but it does require better articulation of the underlying policy of the rules and an interpretation that produces a consistent implementation of the policy, giving preference to substance over form. The OECD has recently made controversial changes to the Commentary on tax avoidance in 2003 but that work has had little effect in the areas of concern here. The Committee for Fiscal Affairs of the OECD should address these issues before it is too late. In retrospect, it was an error to allow transfer pricing to be sidelined from broader tax treaty interpretation for so long.

Specifically, three areas of concern are identified in this article. Firstly, the independence criterion should be used to conceptualise the firm and its boundaries. Although there was a brief moment in the 1920s when this was possible, the recognition of separate legal entities in international taxation and the concept of the firm based on common ownership has been the source of much confusion since; independence has been relegated to a secondary role to legal form. Moreover, use of the same term "independence" in the different context of associated enterprises which are not independent has disguised the policies at stake. It may be possible to reverse the current position by reinterpretation of treaty provisions.

Secondly and relatedly, the use of legal form to oust economic substance needs to be recognised and addressed. It is natural, indeed often necessary, to express economic policies in legal language and concepts to obtain the requisite degree of legal certainty. As a corollary of the first concern, independence can be made concrete by treating associated enterprises in the sense of common ownership as PEs of each other unless it is established that they are legally and economically independent. In this way, legal form would not stand in the way of substance but would rather assist it. It would again be possible, though more daring, to reach this result by treaty reinterpretation. The PE definition could be regarded as incorporating a concept of independence. Both the fixed place of business and agency PE provisions could be interpreted in this light. The provision on associated enterprises not constituting PEs would only apply if the enterprises are in fact independent.

Thirdly, the theories of value that underlie the way in which international business profits are allocated need to be articulated. At the moment differing theories have been present without clear expression or realisation of their consequences. None of the three theories of value discussed in this article is convincing. It is likely that no single theory will provide all the answers and in any event theory needs to be modulated by implementation issues. The author is more attracted to the rowing or relay team than the octopus or hydra. More could be said on this front, but that is work for another day.

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Tax professionals of all kinds are fond of tax history as attested by the many historical articles that have appeared in this *Review* in the last 50 years. Yet the history of the times rarely seems to intrude.[100] The *Review* was founded at the height of the Cold War but the former USSR was presented by the founder editor like any other country across the

[100] The *Firestone* case itself is an exception. Evershed M.R. noted that it was apparently the first case in which the Inspector of Taxes was a woman: see (1957) 37 TC 111 at 138. *Case 110* was the first significant treaty case in Australia. These cases were chosen for analysis because they date from the time of founding of the *Review*. There are similar agency cases in other countries with the same kinds of issues about form and substance.

Channel. At the time that the League of Nations was considering agency PEs and Carroll wrote his great work, the Great Depression was at its height. During the current OECD work on attribution of profits to PEs we live in an era of fear of terrorism.

It is hoped that this article gives an historical sense of the agency PE debate and uses history appropriately to suggest that the OECD has headed down the wrong path.

Fifty years before the founding of the *Review*, Joseph Conrad noted the problem of *The Secret Agent*:

> "A secret agent who throws his secrecy to the winds. . . and flaunts his achievements before the public eye, becomes the mark for desperate and bloodthirsty indignations."