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THE NEW OECD APPROACH ON PROFIT ALLOCATION: A STEP FORWARD TOWARDS NEUTRAL TREATMENT OF PERMANENT ESTABLISHMENTS AND SUBSIDIARIES

by

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I. INTRODUCTION

One of the vexing questions in tax law is whether or not the legal form should make a difference in taxing companies. This question arises amongst others when companies do business outside their country of residence.

Companies may set up a subsidiary. The subsidiary, being a separate legal person, will in most countries be taxed as a resident company in the state of incorporation and/or in the state in which it has its effective management.¹ It will be taxed as if it acts on an arm's length basis with the parent company and other associated companies.² In case the taxpayer performs its foreign activities without setting up a subsidiary the income derived from these foreign activities may also be taxed in the country where the activity is performed. Most countries tax non-residents on income derived from sources in their country including income derived from permanent establishments situated in that country.³ These countries generally use the concept of permanent establishment both in their domestic law and in tax treaties. A permanent establishment generally is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. PE-profits are determined on the basis of the separate enterprise theory for allocating profits to permanent establishments:⁴ the PE-state taxes the profits which the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. Important exception is the United States. In its tax treaties the United States

1. Some countries use incorporation for determining residency, others use effective place of management.

2. For a historical overview of the U.S. approach to intercompany pricing see Lawrence M. Axelrod, *Intercompany transactions*, Practising Law Institute, Tax Law and Estate Planning Course Handbook Series Tax Law and Practice PLI Order No. 11569, October-November, 2007, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2007*; and Wayne R. Strasbaugh, *Intercompany Transaction Regulations*, Practising Law Institute, October-December, 2008.

3. For a description of the fundamentals of source-based and residence-based taxation see Yoram Keinan, *The Case For Residency-based Taxation of Financial Transactions in Developing Countries*, 9 *Florida Tax Review* 1, (2008).

4. For an overview see the country chapters in I.J.J. Burgers and A. Bakker (ed.), *The Taxation of Permanent Establishments*, IBFD, Amsterdam, loose-leaf.

uses the PE-concept.⁵ However, in its domestic law the United States uses the fixed place of business concept in combination with the “income effectively connected with a trade of business” rule.⁶

This article focuses on the question of whether or not, and if so to what extent, differences in profit allocation may influence a taxpayer’s choice between permanent establishment and subsidiary in case the PE-concept is used. Contrary to the historical reasons for adopting the separate enterprise theory as leading doctrine for allocating business profits permanent establishment and subsidiary are not treated neutral. Recent developments in respect of profit allocation for tax treaty purposes presumably will make the differences smaller as the OECD in 2008 adopted a new approach to the separate enterprise theory and revised the Commentary to Article 7 OECD in as far as the changes required to incorporate the new approach are in line with the text of the present Article 7 OECD. Moreover the OECD published a proposal for a new Article 7 OECD and Commentary on 7 July 2008 which was revised on 24 November 2009. This new approach takes a functional and factual analysis followed by a comparability analysis as starting point for allocating profits to a permanent establishment. In paragraph 224 of the Report on the attribution of profits to permanent establishments of 17 July 2008 the OECD states that the Transfer Pricing Guidelines drafted for determining the arm’s length price in intercompany relations will be applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part.

This article raises the issue of which justification grounds for these differences in treatment can be pointed out and whether the arguments raised by the OECD are solid.

The structure of this article is as follows: In Part II, the historical background of the separate enterprise theory is described. Part III focuses on the recent changes in the OECD approach to this theory and sets out the changes in consequences of the new approach compared to the old approach for the allocation of profits in respect of:

5. For an in-depth discussion see Diane Ring, *The Taxation of Permanent Establishments in the United States*, ¶ 1.1.2 in I.J.J. Burgers and A. Bakker (ed.), *The Taxation of Permanent Establishments*, IBFD, Amsterdam, loose-leaf.

6. The U.S. income tax system is based on the principle of origin instead of the principle of source. The principle of origin, as introduced in the U.S. by Von Schanz, requires economic allegiance. More factors are decisive than in respect of the principle of source, requiring that there is a close connection of the income to the soil of a country (e.g. a factory (PE-income) or physical presence of a worker (labour income)). K. Vogel, *Worldwide vs. Source taxation of income – A review and re-evaluation of arguments*, Intertax 1088, Part I, pp. 216 – 229, Part II, pp. 310 – 320 and Part III, pp. 393 – 402.

1. transfer of goods;
2. internal services
3. management activities
4. transfer of material assets
5. transfer of immaterial assets
6. financing.

Both the view laid down in the 2008 Commentary and the proposal for a new Article 7 OECD will be dealt with.

Part IV shows the new OECD approach still results in a different allocation of profits to permanent establishment then to subsidiaries. Part V addresses the question if there is a justification ground for treating permanent establishments and subsidiaries differently.

Part VI contains the conclusion.

II.HISTORICAL BACKGROUND

The history of this theory can be traced back to the early decades of the previous century. In 1933, M.B. Carroll did a survey of the income tax legislation in 27 countries, and concluded that most countries used - what Carroll called the separate accounting method, but which is nowadays generally referred to as - the separate enterprise theory in their domestic law for determining the amount of taxable profits derived by non-resident countries. Carroll suggested to include in tax treaties a provision reflecting the way these countries determined this source income:⁷

“If an enterprise with its fiscal domicile in one Contracting State has permanent establishments in other Contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions.”

He also proposed that such net income should, in principle, be determined on the basis of the separate accounts pertaining to such establishment.

Carroll formulated the following reasons why this separate accounting method should be regarded as superior to other methods used in those days, such as fractional apportionment where tax is assessed on the part of the total net income of the enterprise that corresponds to the relative economic importance of the local establishment:

7. M.B. Carroll, League of Nations, Geneva, 1933, C.425(b). M.217(a).1933.II.a.

1. the method avoids the taxation of unrealized profits;
2. the information necessary for tax purposes can be derived from sources which were within the jurisdiction of the permanent establishment;
3. in practice separate accounts are kept for branches;
4. the method prevents tax evasion;
5. the method does not interfere with the actual business organization;
6. resident and non-resident enterprises will be treated similarly.

The separate accounting method, as proposed by Carroll, formed the basis for the “business profits articles” in the League of Nations Conventions and the OECD Conventions on double taxation.

Carroll did not formulate any detailed rules concerning the profit allocation. He advised that there is ‘apparently no theoretically perfect rule for determining exactly how much of the income is attributable to each establishment any more than there is an accurate way for apportioning the compensation of an individual workman to his hand and feet, and to his brain which has coordinated all his efforts.’⁸

This lack of guidance both between countries and within countries resulted in many different interpretations of the separate enterprise theory.

In my dissertation⁹ published in 1991 I made a detailed analysis of these different interpretations of the separate enterprise theory in Germany, the Netherlands, the United Kingdom and the United States. I concluded that these interpretations could be categorized into the following five approaches:

- 1.the legalistic functional approach: No fictitious agreements may be assumed for purposes of determining profits attributable to the permanent establishment. No agreements may be concluded between the different parts of a worldwide enterprise. Thus assets, income and expenses related to the PE-activities should be allocated to the PE but internal transactions should not be taken into account;
- 2.the narrow functional approach: This approach does take into account internal transactions but only in as far as identical or in case similar activities are rendered to or received from third parties (for instance internal interest derived by branches of banking enterprises);

8. League of Nations Document c.425(b).M.217(b).1933.II.A, pp. 189 – 190.

9. I.J.J. Burgers, *Taxation and Supervision of Branches of International Banks, a Comparative Study of Banks and Other Enterprises*, IBFD, Amsterdam, 1991.

- 3.the broad functional approach-based on the premise that the various parts of an international enterprise must be remunerated for their function within the enterprise. All internal transactions should be remunerated at arm's length prices.
- 4.the narrow territorial approach: In case this theory is applied profits are allocated to the permanent establishment as if it was a subsidiary. Arm's length fees are charged for most transactions. No fees are charged for activities that would in the case of a subsidiary be referred to as shareholder activities. The permanent establishment is deemed to have its own management and to fulfill all legal obligations that have to be fulfilled by a subsidiary, including a minimum endowment capital
- 5.the broad territorial approach: This theory fully reflects the wording of Article 7(2) OECD. It implies that the permanent establishment is treated as a completely separate enterprise. Contrary to the narrow territorial approach the shareholder relationship is deemed not to exist.

The research showed that each of these five approaches had been applied or advocated in the four countries researched and that the wording of Article 7(2) OECD seems to refer to the broad territorial approach and that of Article 7(3) OECD to the logistic functional approach. My conclusion therefore was and still is that revision of the text of Article 7 OECD would be necessary to create clarity on the issue of which approach should be adopted.

In the same year C. van Raad also made a proposal for a redraft of Article 7 OECD.¹⁰

In 1995, the OECD revised the OECD Commentary by making clear that internal contracts between the permanent establishment and other parts of the enterprise should be taken into account at arm's length and that the arm's length price would equal actual expenses made:

- if a particular property or service would not have been obtainable from an independent enterprise;
- in case a particular property or service is obtainable from an independent enterprise but independent enterprises would agree to share costs.

In order to facilitate the distinction the Committee formulated the following question (hereafter the "borderline question"):

10. C. van Raad: the 1977 OECD Model Convention and Commentary: selected suggestions for amendment of the Articles 7 and 5, Intertax, 1991, no. 11; pp. 497-502.

Is the internal transfer of goods or services (whether temporary or final) one of the same type which the enterprise might in the ordinary course of its activity be likely to have offered to or be requested to supply by an independent third party at an arm's length price (Paragraph 31 of the 1994 Report).

In 2000, 2003 and 2005, new versions of the Commentary were published. The only changes in respect of Article 7 were the inclusion of paragraph 10.1 in 2003 stating that the purpose of Article 7 (1) OECD is to provide limits to the right of a Contracting State to tax the business profits of enterprises that are residents of the other Contracting State, as well as some more reservations and observations to the article.

The following internal transactions should be remunerated at arm's length basis according to the Commentaries 1995-2005:

- internal delivery of goods for resale in a finished state or as raw materials or semi-finished goods. In case of a time lag it is up to the head office country to seek on a case by case basis a bilateral solution with the outward country where there is serious risk of over-taxation (paragraphs 15 and 17.3 of the 1995-2005 Commentary);
- internal delivery of services, provided
 - o the trade of the enterprise, or part of it, consists of the provision of such services and therefore there is a standard charge for their provision (paragraph 17.5 of the 1995-2005 Commentary); or
 - o the main activity of the permanent establishment is to provide specific services to the enterprise to which it belongs and these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise (paragraph 17.6 of the 1995/2005 Commentary);
- internal transfer of tangibles, (paragraphs 15 and 17.3 of the 1995-2005 Commentary) in case:
 - o the transfer is not temporary (paragraph 17.3 of the 1995-2005 Commentary) and;
 - o the PE-state's domestic law taxes the profits deemed to arise in connection with such a transfer.

In case of double taxation the head office country should seek a solution (paragraph 15.1 of the 1995 – 2005 Commentary);

- payments of interest made by different parts of a financial enterprise to each other on advances etc. (paragraph 19 of the 1995-2005 Commentary).

A mere deduction of costs takes place in respect of:

- good management (for practical reasons: paragraph 21 of the 1995-2005 Commentary);
- general administrative expenses, such as for a common system of training (paragraph 17.7 of the 1995-2005 Commentary)
- internal transfer of tangibles in case the domestic law of the state does not allow an arm's length transfer (paragraph 15 of the 1995-2005 Commentary) or in case deduction of costs might be appropriate, i.e. in case of temporary use of the asset (paragraph 17.3 of the 1995-2005 Commentary);
- internal transfer of intangible rights as it is difficult to allocate ownership (paragraph 17.4 of the 1995-2005 Commentary)
- external interest paid by a company other than a financial company to finance the activities of the permanent establishment. Payments in the name of interest made to a head office by its permanent establishment are not allowed as:
 - o "from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment;" and
 - o "from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay." (paragraph 18.3 of the 1995-2005 Commentary).

A mutual agreement procedure was suggested for preventing double taxation in attributing profits to a permanent establishment in the case of internal disposals of technology and trade-marks, internal services, questions of under- or overcapitalization of a permanent establishment and in all other cases where a clear distinction between "expenses" and "prices including an element of profit" actually leads to results compatible with the underlying principles of double taxation agreements, i.e. the avoidance of economic double taxation and a fair allocation of taxation rights between countries which hold differing views.

To some extent this revision created more clarity. However, numerous vexing questions still remained unanswered.

In 2001, the OECD started with a new project concerning the change of the Commentary of Article 7 OECD. Practice was asked to give comments on the proposals published on the website of the OECD. At the time of writing this article (August 2009) the project was partly finalized. The OECD published the final Report on the attribution of profits to Permanent

Establishments on 17 July 2008. Part of the ideas on allocation of profits to permanent establishments laid down in this Report have been included in the update 2008 of the OECD Commentary. Other proposals were not included as these were not in line with the present Article 7 OECD. A proposal for a new Article 7 OECD and Commentary were published on 7 July 2008. A revised text was published on 24 November 2009. The intention is to include this article in the 2010 update of the Model.

III. THE NEW OECD APPROACH TO ALLOCATION OF PROFITS TO PERMANENT ESTABLISHMENTS

At the start of the discussions on a new approach to the attribution of profits to permanent establishments in 2001 some states advocated an approach referred to by OECD as the relevant business approach, others the - what is referred to by the OECD as - functionally separate entity approach. The relevant business approach implies that due to the wording of Article 7(1) OECD the attributed profits cannot exceed the profits that the worldwide enterprise earns from the relevant business activity. The relevant business activity is determined either by reference to the profit of the enterprise as a whole or to a particular business activity in which the PE has participated. Such limitation does not occur in the functionally separate entity approach. The functionally separate entity approach implies that a functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the permanent establishment. It should be determined which functions are significant people functions - or in respect of financial institutions key entrepreneurial functions – and which functions are routine functions. On the basis of this determination of functions assets and risks should be allocated. Next a comparative analysis should determine remuneration of any dealings between the hypothesized enterprises.

Consensus was reached that preference should be given to the functionally separate entity approach. In its (Draft) Reports the OECD stresses that this approach should be preferred for the following reasons:

1. the approach is consistent with the arm's length principle as it does not impose any limitation on the profits attributable to the permanent establishment that might affect the determination of the profits attributable to the permanent establishment in accordance with the arm's length principle;
2. it is easier to apply than the relevant business approach as it does not require the host country to determine the enterprise's worldwide profits from the relevant business activity and is thus from an administrative point of view preferable;

3. it is preferred from the perspective of consistency as a similar type of analysis should be undertaken as the one that should take place in case the permanent establishment were a legally distinct and separate enterprise (paragraphs 72 – 79 of the 2008 Report on the attribution of profits to permanent establishments).

The starting point for the evaluation of potential “dealings” will normally be the accounting records and internal documentation of the permanent establishment. Conditions are as follows:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer’s documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer’s documentation does not violate the principles of the authorized OECD approach” (hereafter: AOA approach) “by, for example, purporting to transfer risks in a way that segregates them from functions” (paragraph 39 of the 2008 Report on the attribution of profits to permanent establishments).

Documentation is not decisive in case booking practices are inconsistent with the functional and factual analysis. The documentation requirements imposed in connection with intra-enterprise dealings are not intended to be more burdensome than in case of intercompany dealings. Moreover documentation requirements should not impose disproportionate costs and burdens on taxpayers both in respect of permanent establishments and subsidiaries (paragraph 40 of the 2008 Report on the attribution of profits to permanent establishments). As to paragraph 39 of the 2008 Report accounting records and contemporaneous documentation that meet the requirements of symmetry constitute a useful starting point for the purpose of attributing profits to a permanent establishment.

In respect of the comparability analysis by analogy the same factors should be taken into account as applied in respect of intercompany dealings:

- functional analysis
- characteristics of property or services;
- contractual terms;
- economic circumstances; and
- business strategies (paragraph 92 of the 2008 Report on the attribution of profits to permanent establishments).

A. The 2008 Commentary

The conduct of parties is used as proof for the allocation of risks. Economic principles that govern relationships between independent enterprises should be applied (paragraph 98 of the 2008 Report on the attribution of profits to permanent establishments).

Paragraphs 17 and 18 of the 2008 Commentary explain the functionally separate entity approach. However, only those conclusions that do not conflict with the 2005 version have been incorporated in this Commentary (paragraph 7 of the 2008 Commentary).

Similar to the 1995-2005 Commentaries the 2008 version of the Commentary remunerates the following internal transactions at arm's length basis:

- internal delivery of goods by the permanent establishment to other parts of the company. Like the 1995-2005 Commentary the 2008 Commentary recommends the time lag problem should be solved on the initiative of the head office state (paragraph 21 of the 2008 Commentary). Minor change to the 1995-2005 Commentary is the change in wording of parts of the paragraph:
 - o "Many States consider that there is a realization of a taxable profit" has been changed into "There may be a realization of a taxable profit;" and
 - o "business property of a permanent establishment situated within their territory" has been changed into "within a State's territory."

This change in wording no doubt has not been intended to have practical consequences, but only to bring the wording of the treaty in line with the actual situation that the tax law of some countries does not identify a realization of a taxable profit upon a transfer of an asset from a permanent establishment to other parts of the enterprise;

- internal delivery of services, provided
 - o the trade of the enterprise, or part of it, consists of the provision of such services and therefore there is a standard charge for their provision (paragraph 35 of the 2008 Commentary); or
 - o the main activity of the permanent establishment is to provide specific services to the enterprise to which it belongs and these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise (paragraph 36 of the 2008 Commentary).;
- internal transfer of tangible assets from a permanent establishment to another part of the enterprise, in case:

- the transfer is not temporary and;
- the PE-state's domestic law taxes the profits deemed to arise in connection with such a transfer.

In case of double taxation the head office country should seek a solution. (paragraphs 21 and 22 of the 2008 Commentary);

- payments of interest made by different parts of a financial enterprise to each other on advances etc. (paragraph 37 of the 2008 Commentary).

As regards deduction of costs changes concern internal transfer of intangible rights and interest deduction. A mere deduction of costs takes place in respect of:

- good management (for practical reasons: paragraph 38 of the 2008 Commentary);
- internal transfer of tangible assets in case the domestic law of the state does not allow an arm's length transfer (paragraph 21 of the 2008 Commentary) or in case deduction of costs might be appropriate, i.e. in case of temporary use of the asset (paragraph 33 of the 2008 Commentary);
- general administrative expenses, such as for a common system of training (paragraph 32 of the 2008 Commentary);
- internal transfer of intangible rights as it is difficult to allocate ownership (paragraph 34 of the 2008 Commentary). The wording has been slightly changed compared to the 1995-2005 Commentary: "In such circumstances it would be appropriate to allocate **between the various parts of the enterprise** the actual costs of the creation or acquisition of such intangible rights, **as well as the costs subsequently incurred with respect to these intangible rights**, any mark-up for profit or royalty" (bold parts added in 2008 and made bold by this author);
- external interest paid by the company to finance the activities of the permanent establishment. The argument for denying internal interest payments remained similar to that raised in the 1995-2005 Commentary (paragraph 41 of the 2008 Commentary). In new paragraphs 43 – 48 of the 2008 Commentary it is explained that interest expenses actually incurred by an enterprise relating to the activities of the permanent establishment are deductible. However, the permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. The OECD allows the following approaches for attributing free capital:

- o *the capital allocation approach*. This approach allocates free capital on the basis of the proportion of assets and risks attributed to the permanent establishment. If on the basis of a functional analysis 10% of the enterprise's assets and/or risks is attributed to the permanent establishment, 10% of the enterprise's free capital should be attributed;
- o *the economic capital allocation approach*. This approach has as starting point that all types of risk should be taken into account (including e.g. developmental risk), instead of - e.g. in the banking field - only the risks taken into account by the regulators; and
- o *the thin capitalization approach*. This approach should not be confused with the thin capitalization approaches applied in the domestic law of several states as an anti-abuse measure (requiring a minimum debt-to-equity ratio). The thin capitalization approach that is considered to be an AOA Approach requires that the permanent establishment has the same amount of free capital as an independent enterprise carrying on the same or similar activities under the same or similar conditions in the host country of the permanent establishment by undertaking a comparability analysis of such independent enterprises.

As practical solution to prevent double taxation in case states use different methods the OECD Member States agreed the state of residence must adopt the same approach as the PE state in case:

- o the difference in capital attribution between the two states results from conflicting domestic law choices of capital attribution methods; and
- o states agree that the state in which the permanent establishment is located has used an authorized approach to the attribution of capital, producing a result consistent with the arm's length principle in the particular case.

Compared to the 1995-2005 Commentary the 2008 Commentary contains new remarks on:

- services performed by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Paragraph 24 stresses that close attention must be paid to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment;
- dependent agents: paragraph 25 of the 2008 Commentary stresses that the dependent agent and the enterprise on behalf of which it is acting

- constitute two separate potential taxpayers;
- documentation: paragraph 20 of the 2008 Commentary explicitly mentions that accounting records and contemporaneous documentation that are prepared symmetrically on the basis of internal agreements and reflecting the functions performed by the different parts of the enterprise constitute a useful starting point for the purposes of attributing profits to a permanent establishment.

Summarizing, with a few minor exceptions, the 2008 Commentary reads similar to the 1995-2005 Commentary. It merely contains some clarifications to the previous version. Thus the application of this version of the treaty does not necessarily result in a different allocation than the application of the 2005 Commentary.

B. The Proposal for a New Article 7 OECD

In line with the dynamic approach of interpretation advocated by the OECD in paragraphs 33 – 36 of the Introduction to the 2008 Commentary the OECD stressed that a redraft of Article 7 OECD is required in order to provide maximum certainty and remove the potential for different interpretations based on the Commentary and practices in the Member States. The new OECD approach to the attribution of profits to a permanent establishment, as laid down in the 17 July 2008 Allocation Report, is reflected in all aspects in the new Article 7 OECD. This proposed article no longer includes provisions similar to the present Article 7(3), 7(4) and 7(5) OECD.¹¹ The 2008 version contained a new proposed Article 7(3)

11. The 2008 proposed article reads as follows:

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that State.
2. For the purposes of this Article and Article (23 A)(23 B) the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
3. Where

concerning the attribution of “free” capital. This proposal is not included in the 2009 version. Alternatively a corresponding adjustment provision, which in the 2008 version was included in the Commentary, is provided for in the 2009 Article 7(3).

The 2009 proposed article reads as follows:

1. “Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that State.
2. For the purposes of this Article and Article (23 A)(23 B) the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks
 - a) in one Contracting State, the amount of “free” capital that is used for determining the interest that is deducted in computing the profits that are attributable to a permanent establishment situated in that State of an enterprise of the other Contracting State is determined using a method of attributing capital to the permanent establishment that is provided by the domestic law of the first-mentioned State and both States agree that the application of that method produces an arm’s length result in conformity with paragraph 2 in that case; and
 - b) that method is different from the method provided by the domestic law of the other State and used by that State to attribute capital to the permanent establishment and, as a result of this difference, part of the profits of the enterprise are charged to tax in both Contracting States, and, in the absence of this paragraph, Article 23 would not apply to eliminate the double taxation of these profits, the other State shall, in determining the profits attributable to the permanent establishment for the purposes of Article 23, use the amount of “free” capital derived from the application of the capital attribution approach used by the first-mentioned State. For the purposes of this paragraph, “free” capital means capital that does not give rise to a return in the nature of interest that is deductible in the first-mentioned State.
4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.”

assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provision of those Articles shall not be affected by the provisions of this Article.”

Paragraph 19 of the 2009 Commentary to the proposed Article 7 OECD explains that the functional and factual analysis will lead to:

- the attribution to the permanent establishment of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks and the attribution of risks to the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognized;
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

Paragraph 20 sets out that for the comparative analysis the 1995 Transfer Pricing Guidelines should be used by analogy to dealings between the permanent establishment and the other parts of the enterprise.

Paragraph 24 stresses that documentation requirements may not be more burdensome than in connection with such dealings that apply to transactions between associated enterprises and should not be applied in such a way as to impose on taxpayer's costs and burdens disproportionate to the circumstances.

Paragraph 26 explains that the separate enterprise fiction does not change the nature of the income derived by the enterprise: for instance notional interest may be taken into account for the application of Articles 7

and 23 OECD, but should not be regarded as income from immovable property, unless states adopted in their tax treaties provisions according to which such charges be recognized for the purpose of Article 6 OECD, thus putting the permanent establishment at a par with the subsidiary.

Paragraph 28 points out that the issue of whether expenses are deductible is a matter of the domestic law of the Contracting States.

Paragraph 30 explains a time lag might be inevitable.

Paragraph 33 clarifies that in respect of building sites or construction or installation projects “it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment.

Paragraph 53 of the 2008 Proposal introduced the corresponding adjustment mechanism for PE-situations as a provision that states might include in their bilateral treaties. In the 2009 Revised Draft, such provision is included in the revised Article 7 (3).

Contrary to previous versions of the Commentary to Article 7 OECD neither the 2008 nor the 2009 version of the proposed Commentary to a new Article 7 OECD provide an overview of the most important consequences of applying the functionally separate enterprise approach, but simply refer to the 2008 Report that “provides a detailed guide as to how the profits attributable to a permanent establishment should be determined” (paragraph 17 of the Commentary). It is submitted such an overview would make the (proposed) Commentary more user friendly and transparent, as without such overview the user has to search in extensive 2008 Report.¹² As the overview provided below shows, in this Report the most important remarks on attribution of the different assets, risks and functions are widespread.

According to the 2008 Report:

- assets will be attributed to the part of the enterprise which performs the significant people functions relevant to the determination of economic ownership:
 - o for financial assets the creation and management of such assets and their attendant risks is the significant people function relevant to determining the initial economic ownership of the assets (paragraph 23 of the 2008 Report);
 - o for tangible assets use is decisive (paragraph 104 of the 2008 Report)
 - o for intangible assets the extent to which the intended user performed the significant people functions relevant to the determination of economic ownership of the intangible asset, i.e. by taking the initial decision to develop the intangible or

12. The general part I contains 73 pages.

undertaking the active management of the R&D Programme is decisive. This is further specified as follows:

- in respect of internally developed trade intangibles the part of the enterprise that undertakes the active decision-making with regard to the taking on and active management of the risks related to the creation of the new intangible performs the significant people function is decisive (paragraph 122 of the 2008 Report)
 - in respect of acquired intangibles should be traced where within the enterprise the significant people functions related to active decision-making relating to the taking on and management of risks are undertaken (paragraph 125 of the 2008 Report);
 - in respect of marketing intangibles the functions associated with the initial assumption and subsequent management of risks of these assets should be traced (paragraph 128 of the 2008 Report);
- the significant people functions relevant to the assumption of risks (including inventory risk, credit risk, currency risk, interest rate risk, market risks, product liability and warranty risks, regulatory risk, etc.) are those which require active decision-making with regard to the acceptance and/or management of those risks (paragraphs 27, 97 and 98 of the 2008 Report). The division of risks and responsibilities within the enterprise will have to be deduced from the parties' conduct and the economic principles that govern relationships between independent enterprises (paragraph 1.28 of the Transfer Pricing Guidelines):
- o for excess inventory risk initial assumption by the part of the enterprise which makes the active decisions related to inventory levels determines the allocation;
 - o credit risk initially is allocated to the part of the enterprise which initially decides to conclude a sale to a particular customer after having reviewed the creditworthiness of the customer.
- capital follows risk. Capital must be allocated to the part of the enterprise that performs the significant people functions relevant to the assumption of risks would be attributed the capital necessary to support these risks. It should be determined on the basis of the capital allocation approach, the economic capital allocation approach or the thin capitalization approach or - though not an AOA approach – on the basis of a safe harbour approach such as quasi thin capitalization/regulatory minimum capital approach (paragraphs 28,

- 122 and 155 – 172 of the 2008 Report);
- the permanent establishment should have sufficient capital to support the functions it undertakes (paragraph 31 of the 2008 Report);
 - the Transfer Pricing Guidelines' comparability factors will be applied:
 - o directly (characteristics of property or services, economic circumstances and business strategies) or
 - o by analogy (functional analysis, contractual terms) (paragraph 47 of the 2008 Report);
 - accounting records and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits (paragraph 39 of the Report).

The following transactions will be remunerated at arm's length in case the treaty parties apply the approach laid down in the proposed Article 7 OECD and the Commentary to this article:

- any dealings through which one part of the enterprise performs functions for the rest of the enterprise including assistance in day-to-day management (paragraph 36 of the Commentary to the proposed Article 7 OECD);
- internal delivery of goods by the permanent establishment to other parts of the company (paragraph 220 of the 2008 Report);
- internal delivery of services (paragraphs 222 and 251 - 256 of the 2008 Report). First it should be determined whether or not both parties would have contracted for the provision of the service. Next an arm's length price should be determined. Similar techniques can be used as for associated enterprises. Costs may be charged in case a cost-benefit analysis does not justify the costs and administrative burdens of determining an appropriate arm's length price. However an arm's length price should be determined in case the provision of the service is a principal activity of the associated enterprise, the profit element is relatively significant or direct charging is possible;
- internal transfer of tangible assets: at fair market value or – if that is arm's length because the dealing reflects a cost contribution arrangement – at cost (paragraphs 229 – 234 of the 2008 Report);
- internal transfer of intangible assets (paragraph 221 of the 2008 Report). Again fair market value or a dealing reflecting a cost contribution arrangement should be taken into account. The notional royalty is only relevant for attributing profits, not for other articles in the treaty (paragraph 238 of the 2008 Report);
- payments of interest made:
 - o by different parts of a financial enterprise or

- by another enterprise for the purpose of rewarding a treasury function being the function of determining economic ownership of the cash or financial asset (paragraphs 187 and 188 of the 2008 Report).

A mere deduction of costs takes place in respect of:

- internal services in case a cost-benefit analysis does not justify the costs of determining arm's length prices (paragraphs 251 – 256 of the 2008 Report);
- internal services comparable to services provided by a parent or centralized service provider of a MNE group (paragraph 255 of the 2008 Report);
- internal transfer of tangible or intangible assets in case cost reflects an arm's length amount (paragraphs 232 and 246 of the 2008 Commentary);
- general administrative expenses, such as for a common system of training (paragraph 32 of the 2008 Commentary);
- external interest paid by the company to finance activities of the permanent establishment in the absence of treasury dealings. It proved not possible to develop a single approach for determining the amount of attributable interest expense. Therefore the OECD allows:
 - the tracing approach: internal movements of funds provided to a permanent establishment are traced back to the original provision of funds by third parties;
 - the fungibility approach: each permanent establishment is allocated a portion of the whole enterprise's actual interest expense paid to third parties on a pre-determined basis;
 - the big ticket approach: tracing for big tickets and fungibility for the rest of the assets (paragraphs 189 – 191 of the 2008 Report).

IV. DOES THE NEW OECD APPROACH RESULT IN DEEMING THE PERMANENT ESTABLISHMENT AS SUBSIDIARY?

Summarizing, the new approach remunerates more “dealings” at arm's length than the present approach. The new OECD approach allows an arm's length remuneration for the following transactions for which the present approach only allows deduction of costs:

- internal delivery of services not comparable to services provided in the trade of the enterprise or part of it nor being part of the main activity of the permanent establishment;
- internal transfer of intangible assets;

- payments of interest made by a part of a non-financial enterprise fulfilling the treasury function to another part of the enterprise;
- assistance in day-to-day management (not including head office services similar to those provided by a parent or centralized service provider of a MNE group).

Thus for each of the dealings that may take place between a permanent establishment and a subsidiary a similar analysis is made as for transactions between subsidiaries and the other members of the group of which it is part, no matter what is their nature, and whether or not similar dealings take place with third parties.

For the allocation of capital and allocation of funding costs it is not possible to make a similar analysis. Therefore, a practical solution had to be found for the lack of a contract, thus that economic substance is reflected and abuse prevented. In order to provide more certainty on this issue a new Article 7(3) OECD was proposed in the 2008 Draft. In the comments received by OECD practice expressed their concerns about this provision. During the IFA-Congress in Vancouver, September 2009 the panel for Seminar F, *Something Old, Something New: Redrafting Article 7* suggested to replace this proposal by a much wider provision providing for corresponding adjustment so that all cases of double taxation will be solved. This proposal was accepted.

Though the functional analysis to be made is the same for permanent establishment as for a subsidiary and the mechanism chosen for solving cases of double taxation is also similar the OECD stresses in the 2008 Report that a permanent establishment is not the same as a subsidiary as it is not in fact legally or economically separate from the rest of the enterprise. Besides the difference mentioned above in respect of determining the amount of capital the OECD mentions the following differences:

- unlike in the case of parent-subsidiary relations, in pricing dealings between a permanent establishment and the rest of the enterprise the same creditworthiness should be taken into account for the permanent establishment as for the rest of the enterprise (paragraphs 36 and 132 of the 2008 Report);
- there is no scope for a guarantee fee (paragraphs 36, 134 and 135 of the 2008 Report);
- greater scrutiny of documentation is necessary (paragraphs 37 of the 2008 OECD Report).

Remarkably - considering the importance of this explanation for providing transparency on this issue - neither the 2008 nor the 2009 version of the Discussion Draft of a New Article 7 of the OECD Model Tax Convention contain these remarks.

V. JUSTIFICATION GROUNDS FOR NOT DEEMING A PERMANENT ESTABLISHMENT AS SUBSIDIARY

In paragraphs 36, 132, 134 and 135 of the 2008 Report the following justification grounds for not deeming a permanent establishment as subsidiary are mentioned:

- the permanent establishment shares the creditworthiness of the worldwide enterprise (paragraphs 36 and 132 of the 2008 Report);
- as the permanent establishment is part of the worldwide enterprise the rest of the enterprise cannot enter into a legally binding agreement to guarantee the creditworthiness of the permanent establishment nor can the permanent establishment enter into an agreement to guarantee the creditworthiness of the rest of the enterprise (paragraphs 36, 134 and 135 of the 2008 Report);
- dealings between a permanent establishment and the rest of the enterprise have no legal consequences for the worldwide enterprise and therefore to prevent abuse a threshold needs to be passed before a dealing is taken into account on the same basis as a transaction between third parties (paragraph 36 of the 2008 Report).

These arguments were also raised in the 2004 and the 2006 Draft. In previous Drafts more arguments were raised, which have not been included in the 2008 Report, to wit:

- the legal form chosen, permanent establishment or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. Thus, it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilization, risk diversification, economies of scale etc. (paragraph 55 of the 2004 Draft Report);
- capital and risks are not segregated from each other within a single legal enterprise and therefore there is no basis for guarantee fees (paragraph 96 of the 2004 Draft Report);
- if the same functions were carried on through a subsidiary in the host country, the subsidiary may be required by thin capitalization rules to have some equity or “free capital.” Therefore the permanent establishment needs a certain amount of free capital (paragraph 149 of the 2006 Draft Report).

It is submitted other arguments can be raised why the permanent establishment should not be deemed as subsidiary for profit allocation purposes such as the following arguments that I raised in my dissertation:

- minimum endowment capital requirements or solvency requirements are not posed separately for permanent establishments;
- a permanent establishment does not have its own shareholders and should not be deemed to organize its own meeting of shareholders.

These arguments were the reason why in my dissertation I gave preference to what I called the broad functional approach to the separate enterprise theory and what the OECD calls the functionally separate enterprise theory.¹³

All arguments mentioned above can be summarized into one broad argument:

legal requirements posed to subsidiaries that have nothing to do with people functions should not be deemed to apply to permanent establishments.

Due to these differences in legal requirements the determination of the tax base for permanent establishments differs from that of subsidiaries. The most important other legal difference, to wit the fact that a contract is not available for internal delivery of goods, services and assets, should not result in a different determination of the tax base as this difference concerns the performance of people functions. The people functions performed, associated risks and capital required to perform these people functions are the same whether performed by a permanent establishment or by a subsidiary. Like the OECD advocates functions should be analyzed and internal dealings should be remunerated at arm's length. Moreover a certain amount of capital should be allocated to the permanent establishment, not because legal reality requires so but because economic reality is that functions cannot be performed and risks cannot be taken without capital.

Thus the answer to the research question of whether or not the choice between permanent establishment and subsidiary may be influenced by differences in taxation of profits is affirmative. Differences in legal requirements caused by differences in legal form may result in a different economic reality that is not the result of people functions and therefore should not be neutralized. The functionally separate enterprise theory only requires similar treatment of permanent establishments and subsidiaries in respect of people functions and the risks inherent to significant people functions, as well as the allocation of assets used for fulfilling the functions. It does not require to deem legal requirements that apply to subsidiaries and

13. I.J.J. Burgers, *Taxation and supervision of internationally operating banks, A comparative study of banks and other enterprises*, IBFD, Amsterdam, 1991, Chapter 22.

not to permanent establishments and that have nothing to do with people functions to apply to permanent establishments.

This argument, however, is not the only argument why it is submitted that the research question should be answered in the affirmative. There is another argument, which was raised in the 2004 Draft Report, but for reasons not clear to me, was not included in later (Draft) Reports. Paragraph 55 of the 2004 Draft Report reads: "it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilization, risk diversification, economies of scale, etc." Perhaps the OECD decided not to include this argument in later versions because of lack of proof. The fact is that if this argument is true it will result in differences in tax base in case similar activities are performed by a permanent establishment or by a subsidiary.

VI. CONCLUSION

As the analysis above shows the answer to the research question is that it may make a difference for tax payers to perform their activities through a permanent establishment instead of through a subsidiary. In case the functionally separate entity theory as advocated by OECD will be applied permanent establishments and subsidiaries will be treated neutral as far as the functional analysis and comparability analysis is concerned. People functions are remunerated in a similar way.

The OECD however does not deem the permanent establishment as subsidiary for two reasons:

- **legal requirements for permanent establishments differ from those for subsidiaries, a difference that is not directly related to people functions performed by permanent establishments or subsidiaries and the assets and capital needed to perform these functions and therefore should not be neutralized in applying the functionally separate enterprise theory;**
- **a permanent establishment may be more profitable because of possibilities of efficient capital utilization, risk diversification, economies of scale, etc. and therefore the comparability analysis may result in differences in prices to be taken into account for similar functions performed by permanent establishments and subsidiaries.**

The OECD summarizes the reasons why they did not choose for deeming the permanent establishment as subsidiary in paragraph 84 of the 2008 Report as follows:

“it should be noted that the aim of the AOA approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. **There are generally economic differences between using a subsidiary and PEs. Application of the authorized OECD approach will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits**” (bold added by this author).

It is submitted this explanation is not precise enough. The sentences made bold above (“There are generally economic differences ... taxable profits”) should in my view be rephrased along the lines formulated above:

“It should be noted that the aim of the AOA approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. **Legal requirements for permanent establishments differ from those for subsidiaries, a difference that is not directly related to people functions performed by permanent establishments or subsidiaries and the assets and capital needed to perform these functions and therefore should not be neutralized in applying the functionally separate enterprise theory. Moreover, a permanent establishment may be more profitable because of possibilities of efficient capital utilization, risk diversification, economies of scale, etc. and therefore the comparability analysis may result in differences in prices to be taken into account for similar functions performed by permanent establishments and subsidiaries.**”

It is recommended that this clarification to the difference in treatment of a PE and a subsidiary will be included in the final version of the Commentary to the new Article 7 of the OECD Model Tax Convention.

Moreover it is recommended that in order to improve the transparency of the consequences of the functionally separate entity approach

the Commentary to the new Article 7 OECD would not only include a reference to the 2008 Report for a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of (the proposed) Article 7 (2) OECD (see paragraph 17 of the 2009 Draft), but would also provide for an overview of the most important consequences of applying the functionally separate enterprise such as the overview provided in paragraph 4 above.