Attribution of Income to Permanent Establishments

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I. INTRODUCTION

1. Article 7 of the OECD Model Tax Convention provides that the business profits of an enterprise of one State may be taxed in another State, but only to the extent that such profits are attributable to a permanent establishment situated therein. The determination of the income attributable to a permanent establishment can give rise, however, to an element of uncertainty. This is why the Committee on Fiscal Affairs decided to examine the rules concerning the determination of the income of permanent establishments in order to clarify their application. The work of the Committee has benefited from the work done by the International Fiscal Association (IFA) at its 1986 Congress in New York, the first topic of which was "The transfer of assets into and out of a taxing jurisdiction". Discussions on this topic focused on the tax consequences of transfers of goods within a single legal entity, *i.e.* between a firm's head office and its permanent establishments located outside its country of residence, or between different permanent establishments of the same enterprise; the IFA general report and recommendation show that this particular aspect of the determination of the income of a permanent establishment is especially troublesome.

2. Discussions within the Committee and in IFA identified the following concerns:

a) The transfer of goods and services between tax jurisdictions may give rise to taxation which is not necessarily based on actual profits.

b) Uncertainty about the taxation of permanent establishments is heightened by the fact that the Commentary on Article 7 of the OECD Model Tax Convention suggests a duality of approach whereby tax authorities may in some instances treat a permanent establishment very much as if it were an independent entity legally separate from the enterprise of which it is part and in other instances treat it simply as a sub-division of one and the same enterprise. In the first instance, internal transfers will be evaluated according to the arm's length principle by attributing to the transferring part of the entity the profit which it might have been expected to make had it been dealing with a wholly independent enterprise. In the second instance it may be considered appropriate to evaluate the transfer by reference only to its historic cost. In principle it may be argued that this duality is justifiable both because of the legal limits of any agreement between a permanent establishment and the rest of the enterprise of which it forms part and by reference to the nature of the particular transaction under consideration. Nevertheless, the fact remains that this duality of approach leads to uncertainty which may in itself lead to results incompatible with the underlying principles of double taxation

agreements (the avoidance of economic double taxation and a fair allocation of taxation rights between countries) where the outward transfer country taxes a given transfer of goods or services on the basis of a price which includes a profit while the inward transferring country takes into account only the residual accounting value or historic cost price (similar problems may arise where the situation is reversed).

The problem is more acute where the country of residence of the enterprise gives relief for the tax levied by the host country of the permanent establishment by exempting those profits from tax. In this situation, the computation of the exempted profits and the computation of the profits as taxed by the host country may be inconsistent, which may lead to either economic double taxation or to under taxation. Where the country of residence of the enterprise gives relief by the credit method, a significant problem will only arise if it takes the view that the host country is levying tax on the enterprise in a manner which is inconsistent with the terms of the relevant bilateral treaty. In such a case, the country of residence may be reluctant to give full credit for the tax levied by the host country and economic double taxation may arise. There is however usually no danger of economic non-taxation since, if the host country levies tax on a more limited basis than the country of residence would consider appropriate, this only results in the reduction of the amount of tax credit which the country of residence has to grant against its own taxes.

c) This uncertainty is accentuated where a permanent establishment (for example, a construction site) has quite a short life so that it cannot therefore be argued that over a period of years the potential distortions favourable or unfavourable to the taxpayer might be offset.

d) The existence of two different methods for eliminating double taxation, the right of each country to define profits earned abroad according to its domestic law, as well as the different approaches to the determination of the timing of the realisation of a gain or loss and to foreign currency translation can potentially result in overtaxation and undertaxation.

e) Lastly, the differences that exist in most countries between the taxation of resident companies and of permanent establishments of foreign enterprises raise the issue of whether the non-discrimination principle is being observed and whether these differences of treatment are in fact due to the special nature of the permanent establishment.

This Report discusses these problems and puts forward proposed modifications to the Commentary on Article 7 of the OECD Model Tax Convention on Income and on Capital. These modifications will be incorporated into the next update of the Model which will be issued early in 1994. The structure of the Report is as follows: Section II discusses the issues that were identified in replies to a questionnaire sent out to member countries and analyses these replies, Section III sets out the conclusions of this analysis and annexes provide separately the questionnaire, the Resolution adopted by IFA at its 1986 Congress and the proposed changes to the Commentary on Article 7.

II. ISSUES RAISED BY THE TAX TREATMENT OF PERMANENT ESTABLISHMENTS

3. The Committee on Fiscal Affairs has addressed the question of the international apportionment of income between head offices and their permanent establishments several times between 1984 and 1986.

4. Following preparatory work carried out for the 1986 IFA Congress and the recommendations adopted at that Congress (see Annex I), the Committee instructed an *ad hoc* group to draw up a questionnaire on the subject. The questionnaire was sent out in February 1989 to all delegates. Seventeen countries replied to the questionnaire and their replies are analysed below.

Analysis of the replies received and comments on them

5. Of the seventeen replying countries, eleven (*Australia, Canada, Finland, Greece, Italy, New Zealand, Portugal, Spain, Sweden, the United Kingdom* and the *United States*) use the credit method of eliminating international economic double taxation and six (*Austria, Belgium, France, Germany, Netherlands* and *Switzerland*) use the exemption method.

A. *The recognition of profits or losses*

6. Part A of the questionnaire attempted to ascertain whether the head office of a multinational enterprise and its permanent establishments are, in a given commercial year, taxed on actual income accruing to the enterprise as a whole or whether notional profits are taxed. To simplify the analysis, only internal transfers of goods were considered since these might be sold to third parties only in subsequent commercial years.

From the replies received, three situations generally arise:

a) When the outward transfer country (a/1)[1] is that of the head office, both the tax authorities of credit and exemption countries are usually

1. These numbers refer to the cases analysed in the questionnaire: see Annex II.

in a satisfactory position. The former take no account of the internal transfer and wait until a profit actually accrues through the permanent establishment. This does not mean, however, that these tax authorities do not take into consideration the book value of the goods as disclosed in the accounts of the permanent establishment, since the profit declared by the permanent establishment will affect the tax credits they will eventually grant.

The exemption countries can defer taxing an internal transfer until a profit actually accrues, unless this is excluded by domestic legislation which does not allow for a provision corresponding to the gain to be made. It appears that *Austria* and *France* are not able to allow their resident enterprises to make such provision.

b) As to determining the taxable profit of a permanent establishment belonging to a non-resident enterprise (a/2; b/4), credit countries and exemption countries have identical views. In both cases, the accounting and tax treatment is the same as that of legally independent entities. Neither outward nor inward transfer countries make any distinction between an internal transfer and a sale to a third party (or delivery from a third party).

In case (a/2) – outward transfer country – the question is whether there is not a certain discrimination against non-resident enterprises. Admittedly this may not be so when the internal transaction concerned is actually completed in the course of the same year or, the subsequent commercial year. This would generally be the case when the transferred goods form part of the current assets of the enterprise. But doubts remain when the transfer concerns fixed assets, especially when a permanent establishment is wound up, since profits may be taxed some years before the appreciation that existed at the time of the transfer can be actually realised.

c) When the inward transfer country is that where the enterprise's head office is located or when the internal transfer is between permanent establishments forming part of that enterprise (b/3; c/5), problems can arise in credit countries. The countries in which the permanent establishments operate will levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year (a/2). Consequently, there will inevitably be a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. This means that if the country of residence does not allow tax credits to be carried forward (or offset tax in some other manner), the profit in

question may be overtaxed. From this it can be deduced that the country of residence, too, cannot ignore outward prices as taken into consideration by the permanent establishment country.

By contrast, an exemption country has no particular problem, since it can either accept the notional sum taxed by the permanent establishment country or, in accordance with the principle of economic reality, wait until a profit is actually made. In either case, the profit attributable to the permanent establishment will be exempt.

7. The question then is: what are the practical consequences of the problem that arises when an outward transfer country taxes a profit realised on an internal transfer of goods simply because the goods are leaving its fiscal jurisdiction?

In the opinion of the Committee, the notion of realisation depends mainly on each country's domestic law. It follows that outward transfer countries taxing permanent establishments of foreign countries cannot be expected to defer levying tax on transfers of goods until a profit has actually been made, since in their capacity as hosts to foreign enterprises' permanent establishments they obviously cannot follow what happens to a good once it has been transferred and is no longer in their jurisdiction. Head office countries, however, can trace a transaction from beginning to end by referring to the enterprise's general accounts. Therefore, it is logical in such a case that most countries using an exemption method allow deferral of the taxation of the profit on the internal transfer until it is actually realised; as for credit countries, they cannot do otherwise.

Inasmuch as goods transferred by the permanent establishment form part of the enterprise's current assets and are generally used for the manufacture of other products to be sold or sold as they are, the length of time between taxation on the transfer and actual realisation of the profit on it will be quite short. Thus no serious inconvenience will be experienced by the taxpaying enterprise, since it usually keeps its accounts fairly flexibly and if necessary, will be able to move the dates of the two events closer together so that the transfer of goods and the realisation of the profit accruing are disclosed in the same commercial year.

8. A more serious problem relates to the time lag between the transfer of goods and realisation of profit when a permanent establishment transfers fixed assets or – in the event that it is wound up – its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases – which are fairly unusual – several years may pass between the transfer and the realisation of the profit accruing from it. Nonetheless, for the reasons referred to above, it would be unrealistic to expect that the outward

country would unilaterally defer levying tax until realisation occurred. For that reason, the Committee believes it is up to the head office country to seek a bilateral solution with the outward country where there is serious risk of double taxation.

Another significant problem concerning the transfer of assets arises in relation to international banking. A number of banks have made loans to customers from countries (including the countries themselves) which are experiencing economic difficulties such as to cast doubt on the value of the debt concerned. Such loans may have been made by the head office of the bank concerned or by one of its branches. Such debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Uncertainty arises as to the taxation significance of such transfers. The first question is whether the transfer should be recognised at all for taxation purposes. In the view of the Committee such a transfer should not be recognised where it cannot reasonably be considered that it takes place for valid commercial reasons or that it would have taken place between independent enterprises, for instance where it is undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, a transfer would not have taken place between wholly independent enterprises and therefore would not have affected the amount of profits which a separate enterprise might have been expected to make in dealing independently with the enterprise that has the permanent establishment (paragraph 2 of Article 7).

However, there may be instances in which recognition has to be extended to such a transfer. The arguments for doing so are that there does exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks, for example where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans which had been in former years granted by the head office or other branches to residents of the country where the bank has recently opened that branch.

In the opinion of the Committee, any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. The question however arises as to whether relief should be allowed for the difference between the face value of the debt and its open market value in computing the profits of the transferring part of the bank. In the opinion of the Committee, some relief has to be taken into account in computing the profits of the permanent

establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values. However, the domestic laws of countries differ as to the point at which relief should be given in respect of the loss suffered in relation to a loan the market value of which has fallen below the face value. Some countries pay regard, for tax purposes, to the market value on a year by year basis, others pay more regard to the loss suffered on final disposal of the loan. It should be borne in mind that, at the time when the bank transfers a loan from one branch to another, no actual loss is occasioned to the bank as a whole and the actual loss to the bank will only be capable of precise measurement at the point when the loan is disposed of or repaid. Nevertheless, it will not always be reasonable to keep the liability of the transferring branch undetermined up to the point when the transferred loan is finally disposed of by the bank. In cases where the transferee disposes of the loan after a very short time, the country of the transferor should be entitled to limit the overall relief granted to the bank to the difference between the historic value (generally the face value) of the loan and the amount actually realised on disposal. In such cases, the total loss to the bank as a whole would be relieved in the country in which the transferring branch was situated and there would be no grounds for giving further relief in the country to which the loan was transferred where that country is a country of exemption.

In order that adequate relief for such a loss be granted, the two jurisdictions concerned should reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgement as to debtor's solvency or whether the value at that date did reflect an appropriate judgement of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The

country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country.

B. *Contractual freedom or limited recognition of arrangements concluded between permanent establishments and the rest of the enterprise of which they form part*

9. Part B of the questionnaire dealt with this complex question. At the outset, it may be useful to note that while it is true that the term "contract" can rarely apply to arrangements within a single legal entity, nevertheless, tax authorities frequently require (or allow) accounting records to be presented as if an arm's length transaction had taken place.

The principle of arm's length accounting (or computation) seems to be universally accepted when the goods or services transferred are essentially the same as those supplied to third parties by the enterprise as part of its principal activity. In all other cases, a general principle of limited recognition applies to arrangements concluded by permanent establishments with other parts of the enterprise of which they form part. This leads to widely differing approaches, depending on the concept that prevails in each particular case (economic reality, equivalent treatment or purely fiscal technique):

- setting of an arm's length price, notably when the functions performed are comparable in nature and in importance to those being traded between companies forming part of the same group;
- exact attribution of the costs relating to the permanent establishment's functions;
- and apportionment of total profit based on the importance of the parties' respective functions.

R (13)

It seems that limited recognition of arrangements concluded by permanent establishments within the enterprise is often prompted by fear that the application of the arm's length principle and arm's length prices will result in the creation of artificial profits. *Australia's* reply to the questionnaire, for instance, puts this very clearly:

> The recognition of internal contracts can, however, result in the creation of artificial profits or losses and income or deductions, even to the extent that the taxable income of the enterprise as a whole would differ from that that would be calculated if the enterprise was conducting its business from one point. It is considered that this would be contrary to the principles behind the establishment of taxation treaties.
>
> However, as has been mentioned earlier, the strict application of the arm's length principle to transactions between the permanent establishment and its head office could lead to the creation of deductions which have not been incurred or income which has not been

> earned by the enterprise, and in this regard we would not necessarily treat the resident and the permanent establishment in the same manner.

In the opinion of the Committee, such fears are unjustified if one is aware of the role that application of the arm's length price principle within a single legal entity is intended to play. In fact, the purpose of applying that principle should be to determine the tax share of each country in respect of the enterprise's actual profits. The fear expressed by *Australia* is, however, certainly not unfounded if one considers the cases where an enterprise allows itself to be taxed sometimes according to the direct or separate enterprise method and sometimes according to an indirect or apportionment method.

10. The present situation is unsatisfactory both for the corporate taxpayers and the tax authorities involved. Admittedly, enterprises ought to frame their internal agreements more in the light of the functions really performed by the different parties and disclose them in a consistent manner in the head office and permanent establishment accounts, rather than resort to legal artifices that tend to suppose a contractual relationship which in no way reflects economic reality. For instance, an internal agreement could allot to a permanent sales establishment the role of principal (accepting all the risks and entitled to all the profits from the activity) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and receiving a limited share of the resulting income). The opposite situation, too, is conceivable.

It will still, however, be illusory to believe that real functions are being taken into consideration unless this is reflected symmetrically in the accounts of the different parts of the enterprise. It is thus essential that the outgoing valuation in the accounts of the exporting permanent establishment and the incoming valuation in the books of the importing permanent establishment should always correspond exactly – at least in terms of the national currency or the functional currency in which the enterprise records its transactions.

11. The present situation could be improved if all member countries could agree as to when the direct method and when the indirect method should be applied. Once the appropriate method is agreed upon, it should be used by all the countries where the enterprise performs its activities. Such a symmetrical arrangement would be easier to achieve if all countries could base their computations on the national or functional currency used by the enterprise.

Lastly, the Committee confirmed that even if the head office and permanent establishments kept regular and symmetrical accounts, corporate taxpayers would still have to show that those accounts were a true reflection of economic reality.

C. *Principle of a distinct and separate enterprise: arm's length price or allocation of expenses*

12. The purpose of Part C of the questionnaire was to check whether the duality of approach revealed by the Commentary on Article 7 of the Model Tax Convention is in fact reflected in tax authorities' practice.

In general this seems to be so, but there are nevertheless some important exceptions which need to be examined.

C.1 Goods, technology and trademarks, services, financial transactions

13. It would seem that the arm's length price principle is accepted for final transfers of goods when those goods still have a firm market value subsequent to the commercial year during which they are transferred, depreciation allowances being subsequently allowed on the basis of this transfer value. This applies not only to tangible assets in general (raw materials, semi-finished or finished products and industrial equipment) but also to certain intangible assets (know-how, patents and trademarks) – although, of course, final transfer of a patent or of know-how is quite exceptional.

In all other cases, notably as regards central administrative services, the right to use intangible assets, temporary assignment of industrial equipment, transfers of equity holdings and national currency or foreign currency assets (receivables and liquidities), the general rule is allocation of actual (historic) cost. For instance, temporary assignment of equipment will carry a transfer price that generally corresponds to the accounting depreciation of the goods concerned. Most countries therefore exclude royalties or lease payments and even exchange losses or gains on transfers of foreign currency assets.

What, then, are the exceptions to this general trend?

- As regards final transfer of patents, know-how or trademarks, *Australia* allows only the allocation of actual costs;
- *Finland, France, Greece, Italy, Netherlands and Switzerland* allow central administrative services to be invoiced at arm's length prices. However, when the services rendered benefit, to varying degrees, the whole of the enterprise (*i.e.* the head office and all its permanent establishments) and the direct method is administratively impracticable, *France* and *Finland* apportion the actual cost of the services without including a profit margin;
- *France, Greece, Italy and Switzerland* allow rights of use of intangible assets to produce a return at arm's length prices. As regards research and development, *Belgium* allows arm's length remuneration only for services actually rendered, but not for simple accession to rights to use intangible assets;

- *France, Germany, Italy and Switzerland* recognise that industrial equipment may be temporarily assigned at arm's length value;
- *Belgium, Finland, France, Italy, Netherlands, Portugal and Switzerland* recognise that equity holdings and assets expressed in national currency or foreign currency may be transferred at their real value.

However, regardless of the nature of the good transferred or the service rendered, all the outward transfer countries require permanent establishments of foreign enterprises to apply the arm's length price principle (see A/a/2). This is, however, subject to the limitation of this principle in regard to the provision of services which – from the standpoint of the permanent establishment's outward transfer country – are ancillary. The Committee took the view that, in such a case, it is more appropriate to require an allocation of actual costs in accordance with the views expressed in paras. 18-19 of the existing Commentary on Article 7.

14. Given the diversity of replies received, it is not possible to point to a universally accepted method of computing profits and charges applicable both to inward and outward transfer of goods. This is unfortunate, even if satisfactory methods can be arranged to eliminate any resulting double taxation or non-taxation. In the view of the Committee it would be desirable to supplement the existing Commentary on Article 7 by material which makes it easier for member countries to reach agreement on the appropriate methods to use in particular circumstances.

To some extent the problem derives from the need to reconcile paragraphs 2 and 3 of Article 7 of the Model Tax Convention. It has sometimes been suggested that this reconciliation can create practical difficulties as paragraph 2 requires that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element.

In the view of the Committee, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar

conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate entity principle of paragraph 2. In general, independent enterprises will seek to realise a profit and when transferring property or providing services to each other will charge such prices as the open market will bear. Nevertheless, there are circumstances where a particular property or service would not have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate entity principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether such an internal transfer, whether of a temporary or final nature, is similar to one for which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, *i.e.* by normally including in the sale price an appropriate profit. It is convenient to consider this question separately in respect of each of the headings of paragraph 13 above:

R (13)

a) Goods

Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods then it will normally be appropriate for the provisions of paragraph 2 of Article 7 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. As indicated in paragraph 13 above, there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material, *i.e.* in the case of a plant, the depreciation costs suffered while the plant is in use in particular parts of the trade.

It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment so that no question of attribution of profit arises in such circumstances.

b) Technology and trademarks

As between associated members of a group, there are normally two methods of dealing with intangible costs and rights. The members of the group may agree on some cost sharing mechanism whereby the historic costs of creating the intangible rights are shared between the members of the group. Alternatively, the costs may be borne by one member of the group in which case it is appropriate that other members of the group be expected to pay to the owning member an appropriate royalty etc. having regard to the value of the rights being used. Between non-associated enterprises, a royalty payment is the norm although cost sharing arrangements are used in certain areas.

Similar conditions should, in principle, apply in allocating the profits of a single entity. However, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the historic costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. It may be objected that intangible rights may have been created and paid for before parts of the enterprise, *e.g.* an overseas branch, came into existence but equally it may be that costs of the creation of intangible rights are attributed to a permanent establishment which goes out of existence before the fruition of the rights which it has helped to create. In general therefore it seems that the best solution will usually be an allocation of actual historic costs as they incur. In doing so, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise. An alternative which was discussed by the Committee is to consider only the divisions that actually created the intangibles as the respective owners and, therefore, also as the exclusive bearers of the said risks. These divisions would consequently be entitled to a risk compensation. But, it is of a greater importance that

whatever solution is reached is agreed between the competent authorities of the country of residence and the host country.

c) Services

The area of services is one in which it is often difficult to determine whether in a particular case a service should be charged between the various parts of a single enterprise at its actual historic cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. At one extreme, it may be that it is the trade of the enterprise as a whole to provide services to third parties and that, while in the form a service is provided to another part of the enterprise, in practice it is being provided to an outside customer. In such a case it may be wrong to consider that the service has been provided to another part of the entity.

In more normal circumstances, part of the trade may consist of the provision of such services and there may be a standard charge for their provision. An example might be the financial services provided by banks which may be provided to other parts of the enterprise on exactly the same basis as they are provided to an outside customer. In such a case it will usually be appropriate to charge a service at the same price as is charged to the outside customer.

However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case, it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on a historic cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise. This border line may be difficult to determine precisely. In the view of the Committee, it is more important that the taxation authority of the country of the provider of the services and that of the recipient reach an agreement to deal with such services on a mutually consistent basis than it is to decide on which side of the line between the arm's length basis and the historic cost basis the service should properly fall.

d) Financial assets

As to exchange gains or losses on the occasion of an internal transfer of financial assets, the Committee considered that this raises specific questions mainly concerning banks and financial institutions which should not be considered in great detail in this report because the problems are both complex and of a very specialised nature. Some problems relating to the

transfer of financial assets are considered in the report on multinational banking enterprises included in a previous publication entitled “Transfer Pricing and Multinational Enterprises – Three Taxation Studies”, and nothing in this report is intended to deviate from the views expressed on these various questions in that report. One special problem which is not discussed therein relates to the transfer of debts from one part of the bank to another and is discussed in paragraph 8 above of the present report.

The other main problems dealt with in that previous report were the recognition or non-recognition of charges made in connection with the transfer of funds between various parts of a banking enterprise and the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of members on these questions and this report would merely emphasise the desirability of agreement on mutually consistent methods of dealing with these problems.

15. In summary, the Committee judged that the main necessity was for a fiscally neutral approach which avoided both economic double and non-taxation by reason of differences between the approach to these questions adopted by the member countries. The Committee considered whether fiscal neutrality could be achieved by advocating universal application of an arm’s length price including normally but not invariably a profit element but for the reasons given above, did not consider that such a universal application, displacing the allocation of costs basis indicated by paragraph 3 of Article 7, was always appropriate. In general terms, the arm’s length principle by which a charge for goods, services etc. is based on the price which would have been charged to a third party is generally applicable but there are a large number of cases where the application of such a test leads to the conclusion that as between unrelated parties acting at arm’s length, the agreement which would have been reached between them would have been to allocate a particular expense on the basis of historic cost without regard to which of the two unrelated parties actually incurred the cost initially.

C.2 Attribution of a capital endowment, capital raised from external sources (borrowing) or own funds in the form of interest-bearing loans

16. Part C.2 of the questionnaire discusses the question of remuneration for internal borrowing. The rule indicated in the Commentary on the Model Tax Convention is followed by most countries, so that remuneration of internal borrowing is usually not allowed. As a result, interest payments on loans purely for the benefit of a permanent establishment can be deducted for tax purposes only from the income declared by that permanent establishment. In

all other cases interest payments are broken down between the head office and all its permanent establishments (the *United States* employs only this indirect method).

Countries seldom have any precise rules on the capital endowment of permanent establishments, so capital varies from one instance to the next and may be quite modest or even non-existent (except for *Australia*). However, in other countries (*e.g. Netherlands* and *Switzerland*), capital will, in fact, not depart from what is usual for comparable enterprises operating in the same line of business. *Finland, Italy* and *Switzerland* normally allow internal loans to yield a return. *France*, on the other hand, does so only if the internal financing concerned stems from a commercial relationship. Special problems in this area related to banks are discussed in paragraphs 8 and 14 above.

17. As regards countries which levy a tax on net wealth, it seems that deduction of liabilities is always allowed, insofar as those liabilities result from a transfer for which the tax authorities require, or tolerate, an arm's length price; this means that a corresponding value must appear among the permanent establishment's assets. These liabilities are consequently treated in the same way as accounts payable to suppliers.

18. In the context of this survey, the main point is not so much whether debtor/creditor relationships are admissible within the same legal entity as whether arm's length interest rates can be charged. This question arises essentially for two reasons:

- from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is a formal act incompatible with the true legal nature of a permanent establishment;
- 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 be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

In business, an enterprise's head office and its permanent establishments may have recourse to borrowing. If debts were used solely to finance the borrower's activity, the problem would be reduced to one of thin capitalisation. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments.

19. The approach suggested in the Commentary on Article 7, namely the direct and indirect apportionment of actual debt charges, is open to criticism because it can often cause difficulties.

It is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties, since accurate computation is possible only if the average annual status of assets and liabilities in every part of the enterprise can be ascertained. Furthermore, a computation of this nature presupposes that the whole enterprise is engaged in the same activity. What material value could a proportional allocation of interest charge payments have if no distinction were made among the different activities of a highly decentralised firm? Distortions of the taxable results will most likely follow. It is also well known that the direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.

20. After long discussions, the majority of the member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organisation and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks discussed in paragraph 14 d) above. If a permanent establishment were undercapitalised, it would be up to the head office country to avoid any risk of double taxation by allowing a deduction for the part of the interest payments that the permanent establishment had not been able to deduct from its taxable income. If a permanent establishment were overcapitalised, it should be entitled to deduct a fair amount for deemed interest and such remuneration of the financing function would be for the head office a compensation for not investing the amount in long-term loans. The answer to the question as to whether a permanent establishment is under- or over-capitalised will, in principle, depend on the rules and practice of the host country, unless there is a divergent mutual agreement under Article 25 of the Model Tax Convention.

D. *Taxation of actual profits; consolidation*

21. The principal purpose of Part D of the questionnaire was to see whether there was any possibility, when taxing a permanent establishment, of taking due account of the worldwide profits of the enterprise of which that permanent establishment was a part. This problem obviously arises when one or the other permanent establishment realises a loss or, *a fortiori*, when the whole company realises an overall loss.

Replies make it very clear that countries hosting permanent establishments of overseas enterprises tax only profits arising by or through those permanent establishments. Consequently, it is for the country of residence of an enterprise, and for that country alone, to take into consideration the enterprise's worldwide profits or losses. On this point there is hardly any difference of opinion between credit countries and exemption countries, although:

- *Belgium*, when it is the country of residence, takes into consideration the losses suffered by certain permanent establishments overseas only if those losses exceed gains by other overseas permanent establishments belonging to the resident enterprise concerned;
- *France* applies the territoriality principle to both losses and gains overseas; however, companies resident in France may opt to be taxed under the worldwide profit or consolidated profit system.

22. The above considerations once more raise the difficulties that can occur when permanent establishments are taxed on internal transfers before the profits on those transfers have actually been realised. In some cases, serious risks of overtaxation can be avoided by adopting bilateral arrangements (see paragraphs 7 and 8 above). Nonetheless, the Committee firmly upholds the principle whereby the permanent establishment country has an absolute right to levy tax on profits realised on its territory or, more broadly speaking, on profits attributable to that permanent establishment. There is thus no question of a permanent establishment being allowed a deduction, even provisionally, in respect of any loss suffered by the rest of the enterprise of which it forms part, or of that permanent establishment's being exempted from tax if the company to whom it belongs makes an overall loss. Consequently, if an exemption country takes no account of losses suffered by overseas permanent establishments of a resident enterprise, it is not in any way violating the territoriality principle. However, since most exemption countries do take into account losses suffered by overseas permanent establishments, there is a potential risk of double deduction of such losses, unless the country of residence has the legal possibility to make the necessary retroactive adjustments (*e.g. Netherlands* during 8 years and *Switzerland* during 7 years).

E. Special cases

23. Part E of the questionnaire dealt with special cases and while it is impossible to summarise the solutions suggested under this heading, it is worth noting that all the replying countries recognised that special cases ought to be treated in the light of the arm's length price criterion.

F. *Attribution of profits and principle of non-discrimination*

24. Part F of the questionnaire dealt with this question. It is hard to tell whether the permanent establishments of overseas companies are treated, overall, as favourably as resident companies, for where one difference of treatment may be seen as discriminatory, others may, in taxpayers' eyes, be seen as favouring permanent establishments. Furthermore, some differences derive from the real nature of permanent establishments. The principal question is whether this real nature is taken into consideration in a neutral and consistent manner, or whether the patchwork of concepts that exists at present does not require a review of the Commentary on Article 24 (Non-discrimination) as regards permanent establishments.

25. The Committee intends to examine this issue in the context of future work, in particular with respect to provisions that prevent permanent establishments from claiming deductions or exemptions in respect of returns on shareholdings and tax-free allocations to different funds.

G. *Methods for the elimination of double taxation*

26. Part G of the questionnaire examined the ways in which credit and exemption countries eliminate double taxation. Descriptions by the credit countries of the methods they use to eliminate double taxation may be summarised as follows:

- *Australia*: Worldwide basis, but divided into three income classes. Excess foreign tax credits are transferable within wholly-owned company groups for set-off against Australian tax payable on other similar class of foreign income derived by another group company in the same year;
- *Canada*: Country by country; any unused foreign tax can be carried back three years and forward seven years;
- *Finland*: Country by country with no carry forward or carry-back of excess credits;
- *France*: In case of an optional derogation from the territoriality principle (*cf.* paragraph 21), overall credit with carry forward for five subsequent years;
- *Greece*: Country by country with no carry forward or carry-back of excess credits;
- *Italy*: Per country limitation with no carry forward or carry-back of excess credits;
- *New Zealand*: Country by country with no carry forward or carry-back of excess credits;
- *Portugal*: Country by country with no carry forward or carry-back of excess credits;

– *Spain*: The foreign tax credit basis is referred to the income derived from each single operation and coming from the same country with no carry forward or carry-back of excess credits;
– *Sweden*: Overall credit with carry forward for three subsequent years;
– *United Kingdom*: Item by item with no carry forward or carry-back of excess credits;
– *United States*: Worldwide basis, but separately for different types of income (baskets); excess foreign tax credits can be carried back two years and forward five years.

From these answers, it is impossible to tell with any certainty whether a credit system can always prevent double taxation. Even supposing that the tax base on which a credit is granted is materially the same in both the countries concerned, there will still be a difference due to exchange losses or gains. Obviously, if all taxes paid in the permanent establishments countries were to be credited in the head office country and the system entitled the taxpayer to a long enough carry back or forward, complete elimination of double taxation could be guaranteed. But a country-by-country credit system, especially one that comprised no carry back or carry forward entitlement, cannot offer such a guarantee.

27. As regards the exemption countries, it may be said that the tax base in the permanent establishment country and the exemption base computed by the head office country are sure to correspond as long as exchange rate fluctuations are taken into account in calculating the sum eligible for exemption. The two bases also correspond if all exchange rate gains and losses which appear in the overall result of the enterprise expressed in the national or functional currency are systematically taxed or borne by the country of residence (in the case of *the Netherlands*, for example). Furthermore, experience has shown that a per country exemption produces accurate results whereas an overall exemption sometimes leads to distortions. When the territoriality principle is strictly applied, the enterprise concerned – even in the long term – will not always escape being overtaxed. Some countries, *e.g. Belgium*, mitigate the consequences of the territoriality principle by the way losses abroad are taken into account (*cf.* paragraph 21 above).

28. Taxes finally levied by the source countries are not usually offset by credits on the tax due by permanent establishments. Even when there is no doubt at all that the income concerned is attributable to those permanent establishments, this practice apparently remains unchanged. There are, however, some notable exceptions: *Belgium, Germany* and *the United States* as a general rule, *the United Kingdom* for the permanent establishments of banks only and *France*, depending on the provisions of its treaty with the source country.

29. However, as this question has already been dealt with in the context of the report of the Committee on “Triangular Cases” (published in 1992 under the title “Model Tax Convention: Four Related Studies”), there is no need for the Committee to make additional recommendations in that respect.

III. CONCLUSIONS AND SUGGESTIONS

30. It is the Committee’s opinion that the criteria governing the taxation of permanent establishments could be made clearer and more consistent if the Commentary on Article 7 of the Model Tax Convention were modified in the light of the considerations put forward in this report concerning:

a) the recognition of taxable profit and losses giving rise to deductions for tax purposes (paragraphs 7 and 8 above);

b) the account to be taken of real functions and symmetrical accounting in respect of them, as well as the application of one and the same method by all the countries concerned (paragraphs 9 to 11 above);

c) the interaction of the separate and independent enterprise principles put forward in paragraph 2 of Article 7 of the Model Tax Convention with the cost allocation method found in paragraph 3 of the same Article (paragraphs 14 and 15 above).

The Committee therefore recommends that the Commentary on Article 7 be amended along the lines of the detailed proposals contained in Annex III.

31. With respect to the above point 30(c), the Committee is of the opinion that the following question is relevant in order to reconcile the arm’s length and the cost allocation principles:

> 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?

The answer to this question will be in the affirmative if the expense was initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. The answer will be negative if, on the basis of the facts and circumstances of a specific case, it appears that the expense was initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.

Consequently, in applying this test, member countries should take into account the distinctions suggested in paragraphs 13 to 20 above and should bear in mind that in the absence of a clear dividing line, it is more important

that an agreement be reached in particular cases on a method of dealing with problems on a mutually consistent basis than it is to reach unilaterally decisions of principle which are to be universally adhered to despite differences of opinion with other jurisdictions. The mutual agreement procedure provided by Article 25 of the Model Tax Convention should be used where possible to arrive at satisfactory solutions in cases where countries hold differing views whether based on domestic law or on unilateral interpretations of relevant double taxation agreements.

32. As regards international consolidation of profits and losses (paragraphs 21 and 22), special cases (paragraph 23), neutral tax treatment of branches and permanent establishments (paragraphs 24 and 25) and the degree of success achieved by methods for the elimination of double taxation (paragraphs 26-29), the Committee, for the reasons already stated, makes no suggestions.

ANNEX I

XL IFA CONGRESS, NEW YORK 1986

Subject I: Transfer of assets into and out of a taxing jurisdiction

RESOLUTION (original version: French)

The XL Congress of IFA meeting in New York, as a result of its discussions, arrived at the following Findings:

1. The physical and non-physical transfer of assets, current or fixed, between tax jurisdictions, whether or not they are the result of a legal transfer of property, may give rise, sometimes even in a third country, to taxation in the absence of real profits. This is mainly the case where, as a result of the transfer, accrued appreciation is recognised although no realisation has occurred. Such taxation jeopardises tax neutrality, having an undesirable impact on business decisions, and hampers free physical and legal circulation of goods even among countries in the process of integration. The reason for this lies in the concern of the countries that taxable substance which they consider as attributable to them would be removed from their control and would ultimately escape taxation.

2. These problems are aggravated when the outgoing and incoming valuations, which are, respectively, the measure of the accrued appreciation for the departure country and which supply, for the country of entry, the basis for the ultimate taxation of capital gain and for amortisation, are not the same. During the debates, it appeared that, whereas the departure country generally applies, for its valuation, the arm's-length criterion, the country of entry uses other methods, such as historical cost reduced by amortisation. This prevents an equitable sharing of taxable substance between the two countries and may lead to double taxation.

3. The examples which have been dealt with in the discussions have shown that these distortions may be particularly disturbing in the case of short-term establishments, such as construction plants and maritime oil rigs.

4. It appeared, first from the report, then in the discussions, that these problems are of little interest to those countries which both in their internal law and in their treaties, apply worldwide taxation with a credit relief system ("credit countries"). For those countries, as a rule, there is taxation only when the transfer occurs between legal entities. Then these countries tax the entire capital gain, even that part of it which is attributable to the period during which the asset remained in the departure country. Thus, when the transfer

occurs between two credit countries, the first one makes no claim to levy tax on the gain, whereas, if the transfer occurs from a country with a territorial or exemption system ("exemption country") to a credit country, the available credit cannot always prevent the double taxation which may result from aggregating partial taxation in the departure country and total taxation in the country of entry.

In this respect, it was also noted that, by virtue of the consistent application of their own tax rules throughout, the credit countries benefit from the tax sacrifice which may have been made by the departure country for the development of its economy, unless special rules provide otherwise.

5. The discussions highlighted the particular situation where the business of a permanent establishment of a foreign company is contributed in return for shares in a subsidiary in the country of the permanent establishment. Irrespective of whether the taxation method in either country is the credit or the exemption system, the taxation of the accrued appreciation should be deferred in such a way that the right to taxation is safeguarded, until the appreciation is effectively realised.

On the basis of these findings the XL Congress of IFA in the present stage of the study of these problems,

Recommends that:

I. To the extent that the right of the departure country to tax appreciation which has accrued under its jurisdiction in recognised:

a) taxation should be deferred until realisation; this can be achieved for example by providing for a reserve equal to the accrued appreciation, such reserve to be dissolved upon disposal of the goods, or, as to amortizable goods, as amortisation progresses;

b) the outgoing and incoming valuations should, to the extent possible, be fixed by applying the same criterion, which should be the arm's-length principle.

II. These objectives may sometimes be achieved internally, by administrative and judicial interpretation on the basis of general principles of tax law, and, internationally, by mutual agreement procedures. Time lags between taxation in the two countries may, as recalled by the resolutions of the 1981 XXXVth Congress in Berlin, require waiver of the statute of limitations. In cases that cannot be so ruled upon, legislation should be amended to satisfy the above objectives, either by harmonised unilateral measures, particularly among countries in the process of integration, by means of directives or model provisions, or by supplementing, preferably on the basis of additional provisions in the model conventions, the double taxation avoidance treaties.

III. In all these respects, it is desirable that this research subject be further pursued in future IFA works. Particularly mergers and other similar cross border reorganisations would be a worthwhile subject for IFA.

ANNEX II

QUESTIONNAIRE ON THE ISSUES RAISED BY THE TAX TREATMENT OF PERMANENT ESTABLISHMENTS

A. The recognition of profits or losses

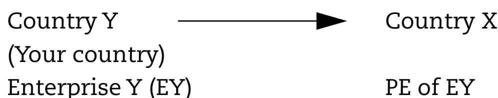
General remarks

- It is assumed that the goods and services will be sold or made available to third parties in subsequent commercial years;
- It is also assumed that the transactions are made in the normal course of business of the enterprise and at arm's length (Section C. deals with the actual practices);
- Please answer each question on the assumption that you represent country Y.

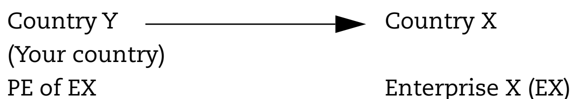
What are the accounting and tax law implications for your country when it is:

a) The outward transfer country

1. In the case of the transfer of economic goods and services from the head office in country Y (a country Y enterprise) to the permanent establishment maintained by the same enterprise in country X.

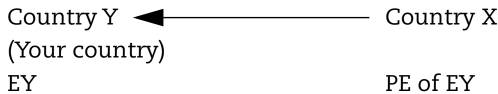


2. In the case of the transfer of economic goods and services from the permanent establishment maintained by enterprise X (a country X enterprise) in country Y to the head office located in country X.

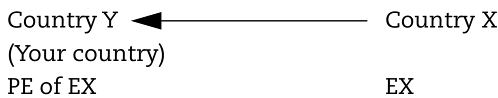


b) The inward transfer country

3. In the case of the transfer of economic goods and services from the permanent establishment maintained by enterprise Y (a country Y enterprise) in country X to the head office located in country Y.

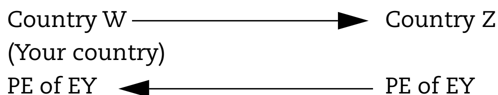


4. In the case of the transfer of economic goods and services from the head office in country X (a country X enterprise) to the permanent establishment maintained by the same enterprise in country Y.



c) The country of residence of the head office (enterprise of country Y) which is not directly involved in the business transactions

5. In the case of the transfer of economic goods and services between the permanent establishments maintained by enterprise Y (a country Y enterprise) in countries W and Z.



B. Contractual freedom or limited recognition of arrangements concluded between permanent establishments and the rest of the enterprise of which they form part

What importance do you attach to internal arrangements between the head office and the permanent establishment? In your view, can contractual freedom be applied to business transactions between the parent company and its permanent establishments, or between permanent establishments within a single company? Or does your country apply a general principle of limited recognition (*i.e.*, taking account of the economic reality of the transaction) with regard to arrangements concluded between permanent establishments and the rest of the enterprise of which they form part?

C. Principle of a distinct and separate enterprise (Article 7, OECD Model Tax Convention); arm's length principle for intra-company transfers of economic goods and services or allocation of expenses to permanent establishments and head office or also splitting of turnover (or profit) derived from outside transactions (in the case of split business *i.e.*, where both the head office and the permanent establishment take part in a specific economic activity)

1. Assuming that the imported economic goods or services received should clearly be attributed from an economic and functional standpoint to either the permanent establishment or the parent company, what are the criteria you use to appraise the final transfer or temporary assignment of the following economic goods and services?

Goods

- Transfers of raw materials and semi-finished products;
- Transfers of finished products;
- The transfer of assignment of industrial equipment (this also raises the question of accounting depreciation);
- The transfer of assignment of other economic goods.

Transfer of Technology and Trademarks

- The transfer or assignment of patents;
- Assignment of know-how;
- Common research centre services.

Certain intra-group Services

- Central administrative services.

Loans and other financial transactions

- Transfers of equity holdings;
- Transfers of national currency or foreign currency assets.

2. The attribution of a capital endowment, capital raised from external sources (borrowing) or also own funds in the form of interest-bearing loans raises various questions:

- Domestic law requirements (deemed capital);
- The treatment of interest directly or indirectly paid to independent lenders;

- The treatment of liabilities emerging from transactions between permanent establishments and head office (deduction in computing the taxable net wealth);
- Other specific questions.

Describe the practice in your country – or if experience is insufficient – the approach you would advocate in the matter.

D. Taxation of actual profits; consolidation

1. As the country of residence of a company (head office), are you required by law or in practice to take account of the company's worldwide profits or losses?

2. As the country of residence of the permanent establishment, are you required by law or in practice to take account of the company's worldwide profits of losses?

E. Special cases (excluding those mentioned in Article 5, paragraph 4 of the OECD Model Tax Convention)

Attribution of profits in the following circumstances:

- Permanent establishments primarily performing a support function relative to the head office (repair and maintenance workshops, permanent assembly plants, coordination services in the case of a "turn-key" contract where the head contractor is a non-resident, permanent establishments performing administrative functions for the account of the head office);
- Construction sites (during the construction years and/or at the liquidation);
- Permanent establishment having the sole function of manufacturing the products which are sold by the head office and the other permanent establishments of the company; permanent establishment having the sole function of selling the products manufactured by the other permanent establishments and the head office of the company;
- Persons having authority to conclude contracts in the name of the enterprise (Article 5, paragraph 5, OECD Model Tax Convention), *e.g.*, the agent of an insurance company;
- Other special cases.

F. Attribution of profits and principle of non-discrimination

Does your country treat the permanent establishments of foreign companies invariably as favourably as resident companies (*e.g.*, with respect to the carrying forward of losses, with respect to tax rates, foreign tax credit)?

G. Methods for the elimination of double taxation

- Please describe briefly the method (credit, exemption) you use to avoid double taxation and provide one or two numerical examples.
- On what basis is the credit or exemption granted?
- The treatment of third country withholding tax on income which is effectively connected with a permanent establishment.

ANNEX III

PROPOSED MODIFICATIONS TO THE COMMENTARY ON ARTICLE 7 OF THE MODEL TAX CONVENTION[2]

It is proposed to:

1. Delete the last two sentences of paragraph 2 and replace them by the following :

> ***However, since such problems may result in unrelieved double taxation or non-taxation of certain profits, it is more important for tax authorities to agree on mutually acceptable methods for dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25, than to adopt unilateral interpretations of basic principles to be adhered to despite differences of opinion with other States. In this respect, the methods for solving some of the problems most often encountered are discussed below.***

2. Replace paragraph 11 by the following new paragraph 11:

> 11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. ***This corresponds to the 'arm's length principle' discussed in the Commentary on Article 9.*** Normally, ***the profits so determined*** would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. ***The arm's length principle*** also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions ***or amend paragraph 2 to read as follows***:
>
> > ***Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and***

2. Changes to the existing Commentary appear in ***bold italics***.

independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. Replace paragraph 12 by the following new paragraphs 12, 12.1 and 12.2:

12. In the great majority of cases, trading accounts of the permanent establishment – which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches – will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (*cf.* paragraphs 24 to 28 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasised that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a

limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal.

12.2 In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (*cf.* paragraphs **17.1** below and following).

4. Replace paragraph 13 by the following new paragraph 13:

13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with ***the arm's length principle (cf. paragraph 2 above)***. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this ***principle***, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

R (13)

5. Replace paragraph 15 by the following new paragraphs 15 to 15.4:

15. ***Many*** States consider that there is a realisation of a taxable profit when an asset, ***whether or not*** trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated ***below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.***

15.1 Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent

commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or – in the event that it is wound up – its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, 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 overtaxation.

15.2 Another significant problem concerning the transfer of assets, such as bad loans, arises in relation to international banking. Debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Such transfers should not be recognised where it cannot be reasonably considered that they take place for valid commercial reasons or that they would have taken place between independent enterprises, for instance where they are undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, the transfers would not have been expected to take place between wholly independent enterprises and therefore would not have affected the amount of profits which such an independent enterprise might have been expected to make in independent dealing with the enterprise of which it is a permanent establishment.

15.3 However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks. An instance of such a transfer might be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values (this question is further discussed in the Report of the Committee entitled "Attribution of Income to Permanent Establishment", which will be published in 1994).

15.4 Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgement as to debtor's solvency or whether the value at that date did reflect an appropriate judgement of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country.

6. Replace paragraph 17 by the following paragraphs 17 to 17.7:

17. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions, whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus,

whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

17.1 In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, i.e. by normally including in the sale price an appropriate profit.

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17.2 On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.[3]

3. Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have already been dealt with in a separate study entitled *The Taxation of Multinational Banking Enterprises* (published in 1984 under the title *Transfer Pricing and Multinational Enterprises – Three Taxation Issues*) and which are the subject of paragraphs 19 and 20 below.

17.3 Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph (2) to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material, e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (sub-paragraph 4 d) of Article 5) so that no question of attribution of profit arises in such circumstances.

17.4 In the case of intangible rights, the rules governing the relations between enterprises of the same group (e.g. payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate 'ownership' of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences of any research and development activity (e.g. the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge.

17.5 The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer.

***17.6** Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case.*

***17.7** However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.*

7. Replace paragraph 18 by the following new paragraphs 18 to 18.3:

***18.** Special considerations apply to payments which, under the name of interest, are made to a head office by its permanent establishment with respect to loans made by the former to the latter. In that case, the main issue is not so much whether a debtor/creditor relationship should be recognised within the same legal entity as whether an arm's length interest rate should be charged. This is because:*

- *from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is a formal act incompatible with the true legal nature of a permanent establishment;*
- *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. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.*

***18.1** If debts incurred by the head office of an enterprise were used solely to finance its activity or clearly and exclusively the activity of a particular permanent establishment, the problem would be reduced to one of thin capitalisation of the actual user of such loans. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain*

extent, the rest of the money borrowed providing basic capital for its permanent establishments.

18.2 The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.

18.3 Consequently, the majority of member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organisation and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below (this question is further discussed in the Report of the Committee entitled 'Attribution of Income to Permanent Establishments', which will be published in 1994; cf. also the report on Thin Capitalisation published in 1987 in the series 'Issues in International Taxation' [no 2]).

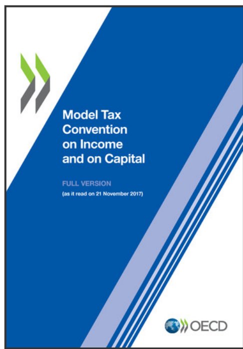
8. Replace paragraphs 19 and 20 by the following new paragraphs 19 and 20:

19. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the transfer of financial assets, are considered in the report on multinational banking enterprises included in the OECD 1984 publication entitled 'Transfer Pricing and Multinational Enterprises – Three Taxation Studies'. This Commentary does not depart from the positions expressed in the report on this topic. One issue not discussed in the report relates to the transfer of debts by bankers from one part of the bank to another; this is discussed in paragraph 15.2 to 15.4 above.

20. The above-mentioned report also addresses the issue of the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of member countries on these questions and the

present Commentary can only emphasise the desirability of agreement on mutually consistent methods of dealing with these problems.

9. At the beginning of paragraph 21, replace the words "The third case" by "***Another case***".



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