Dear Colleagues:

Thank for your continued support of the IATJ. This is our fourth newsletter with an article written by Hans Pijl, Judge in the Tax Court of Appeals in the Hague, which I am sure you will find of interest.

The 2nd Assembly in Paris in September, 2011 was a tremendous success. Please check our website for the papers presented and other information on the Assembly. The 3rd Assembly is to be held in Munich, Germany on October 18 and 19, 2012, with planning ongoing. We look forward to your continued support and interest in the IATJ.

Kindest personal regards,

E.P. Rossiter
President of the IATJ

The 2011-2012 executive for the IATJ is:

Associate Chief Justice Eugene Rossiter (Canada), President
Judge Philippe Martin (France), 1st Vice-President;
Judge Bernard Peeters (Belgium), 2nd Vice-President;
Judge Friederike Grube (Germany), Secretary-General
Judge Willem Wijnen (Netherlands), Treasurer

executive members at large include: Judge Virgilijus Valancius (Lithuania), Judge Peter Panuthos (U.S.A.), Counsellor João Francisco Bianco (Brazil), Judge Dagmara Dominik-Ogińska (Poland), Justice Richard Edmonds (Australia), Justice Clement Endresen (Norway), Pramod Kumar (India), Judge Manuel Garzón (Spain), President Brahim Zaim, (Morocco), Dr. Manuel Luciano Hallivis Pelayo (Mexico)

Newsletter Vol. IV
December, 2011

****

Significant OECD Developments in International Tax Law
Article 7 OECD Model Tax Convention[1]

Hans Pijl[2]

1. Introduction

Tax treaties for the avoidance of double taxation contain provisions which aim at, inter alia, the avoidance of double taxation for enterprises. The core treaty article is Art. 7[3], which provides that the profits of an enterprise carried on by a resident of a Contracting State (e.g. an individual or an entity) are primarily taxable in the State of residence (Art. 7-1). (The State of residence, as a rule of thumb, being understood as the State where the person is liable to taxation on his worldwide income.) For example, under this article the profits of a BV which is fully liable to tax in the Netherlands are primarily allocated to the Netherlands for taxation.

This will be different if the enterprise carries on business in the other treaty State through a permanent establishment situated in that State. (The term "permanent establishment" (hereafter: PE) is defined in Art. 5.) If the enterprise carries on business in the other State through a PE situated therein, the State where the PE is located may tax the profits that are attributable to the PE. Double taxation is avoided, ultimately, through Art. 23A/B. Art. 7 has been, since its inception in 1963 (the OECD Draft Convention), subject to changes, but has maintained its character through the decades. Art. 7-1 in its 2008 version reads:

- "*The profits* of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, *the profits of the enterprise* may be taxed in the other State *but only so much of them as is attributable to that permanent establishment*."[4]

2. The OECD Art. 7 project

[1] This article is an elaboration on a lecture the author delivered on the 2nd Assembly of the International Association of Tax Judges in Paris, on 10 September 2011.
[2] The author is a shareholder of Deloitte (Netherlands) (before the restructuring: partner) and is a part-time judge at the Court of Appeals in The Hague (Netherlands). He teaches international tax law at the International Tax Center in Leiden (Netherlands), the Wirtschaftsuniversität in Vienna (Austria), the Université de Neuchâtel (Switzerland) and at the International Bureau of Fiscal Documentation. He was a member of the Sub-Committee of Experts for the United Nations, responsible for the rewrite of the UN Commentary to the UN Model Convention. The rewritten UN Commentary was approved in 2011.
[3] As many treaties are shaped after the OECD Model Convention, reference is generally made to that convention.
[4] Italics by the author to indicate the differences from the 2010 version of Art. 7.

Art. 7 has by no means been interpreted consistently by States, and the article and its interpretation (in the Commentary) has been subject to review and discussions since 1963. After the publication of the *OECD Transfer Pricing Guidelines* in 1995, an OECD project was started to bring more harmonization in Art. 7's interpretation. This resulted, amongst other things, in a rewording of Art. 7-1. In the 2010 version of the OECD Model Convention, the article reads:

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

One may, as a pleasantry, perhaps allow oneself the question why the elimination of the article "the" in "the profits" had to take 15 years, but in fact this was a brilliant solution for an undesirable interpretation of Art. 7-1 (2008). The 2008 version of Art. 7-1 provided for an identity between "the profits" of the enterprise in the first sentence (which were the worldwide profits) and "the profits of the enterprise" (2nd sentence) that could be attributed to the PE. According to a minority interpretation that was based on this identity, profits could only be attributed to the PE to the extent they were profits of the enterprise. Hence, at the most the total worldwide profits could be attributed to the PE, but never more than that. As this interpretation, for which indeed a grammatical basis could be found, was not in accordance with how the majority of OECD Member countries construed Art. 7-1, the text was adapted, as is reflected in the 2010 version. The Commentary to the 2008 version explains that this is also how the 2008 text of Art. 7-1 is to be understood. (As a consequence of this approach, it could, under the OECD view, well be that the PE is allocated a positive profit, whereas the enterprise of which the PE is a part, makes a loss.)

OECD's Art. 7 project was completed in 2010 and resulted in the 2010 OECD Report "Attribution of profits to Permanent Establishments". The OECD Commentary of 2010 was one of the other results of this project. There is a full match between the 2010 Report and the 2010 Commentary. The 2010 Commentary is to be fully understood in the light of the 2010 Report, and there are no reservations for this interpretative interaction. The 2010 Report is fully incorporated in the Commentary (2010) to Art. 7 (2010).

The 2010 version of Art. 7 and the accompanying Commentary and Report, however, have a limited impact on the existing tax treaties. The current treaties are shaped on the basis of the texts of Art. 7-1 of the 1963-2008 OECD texts. As the OECD confirms, the 2010 documents are only relevant for treaties that are drafted after the 2010 version of Art. 7, and not for those drafted after older versions. Therefore, the 2010 documents do not apply to pre-2010 treaties.

For these older treaties, which came into existence under the auspices of the 1963-2008 OECD Draft and Model Convention, there is a separate Commentary (the last version of which is dated 2008). There is also a 2008 Report, but contrary to the 2010 Report, the 2008 Report can only be accepted as further explanation of the 2008 Commentary, to the extent it fits into the concepts of the 2008 Commentary. Whether this is the case is left to interpretation and weighing. An example of where there is no full match is internal interest. The 2008 Commentaries exclude internal interest as relevant for the attribution of profits, whereas the 2008 Report sees it as relevant.

Thus, from 2010 onwards, there are two Arts. 7 (2008 and 2010) and two Commentaries (2008 and 2010). Most important for the judicial practice is Art. 7 (2008) and the Commentary (2008), for the simple reason that practically all treaties follow the 2008 Model. The 2008 Commentary is thus of great help (not binding, see part 3 *infra*) for the interpretation of existing treaties, on the lines of the 1963-2008 texts of Art. 7. (The 2008 text of Art. 7 can be easily recognized as it will generally have seven paragraphs). In addition, there is an Art. 7 (2010) and a Commentary (2010) which only applies to new treaties with the (four-paragraph) Art. 7 (2010). For the time being, this new Art. 7 has a high degree of theoretical but not practical importance. This may change in the future.

3. Interpretation: the role of the Commentary

Art. 5 of the Convention on the Organisation for Economic Co-operation and Development reads: “The Organisation may (a) take decisions which ... shall be binding ... (b) make recommendations to Members...” Recommendations are not legally binding, but are politically to the parties addressed in the Recommendation. Tax issues are addressed in Recommendations. The Recommendation relating to OECD Model Convention, regarding its text, binds only the Executive and not the State as a whole, which follows from the clear limitation in the Recommendation’s addressees, the Government and the tax administration: “Recommends to the *Governments* of the Member countries: … that *their tax administrations follow the Commentaries* ... as modified from time to time...”. Therefore, the judiciary is not bound by the Recommendation. The different background as to the binding effect of the Commentary may result in a tension between the interpretations of tax administration, on the one hand, and tax judges on the other hand, as the tax authorities are committed to follow the interpretation of the Commentary, whereas the judges may follow that interpretation, if the Commentary is convincing, but may also reject it, if the Commentary is not.

This effect is increased by the issue of ambulatory (dynamic) interpretation. Indeed, the tax authorities are to follow later Commentaries, even if the treaty under discussion was concluded under an older Commentary: “Recommends to the Governments of the Member countries: … that their tax administrations follow the Commentaries ... *as modified from time to time*...”. The Executive is to interpret treaties according to the most recent Commentary, irrespective of when the treaty was concluded and also irrespective of whether the later Commentary says the opposite of what the Commentary said when the treaty was concluded. Here too, the judiciary is not bound to follow the latest version of the Commentary. The judge may, for instance, see no reason to do so if the latest Commentary shows an important deviation from what the original Commentary stated, which sometimes happens since even the OECD does change its mind now and then. Judged from the aspect of the *State of law*, this judicial freedom is a good thing. As the Commentary, in its changing forms, does generally not pass parliament for approval, judges in many countries are reluctant to take a dynamic approach. Indeed, these changing Commentaries may, as they originate from the executives that determine what happens in the OECD, and as they are not subject to parliamentary control, worsen the taxpayer's position.

As a summary, judges generally take the Commentary that existed at the time when the treaty was concluded, as an interpretative help. When interpreting older treaties, they are cautious about new Commentaries and accept them only if they are a clarification of what was expressed in the earlier Commentary. Whether this is the case, is a matter of careful weighing.

4. Capital attribution in the 2008 Commentaries

In this author's interpretation, under the regime of the 1963 and 1977 Commentaries, the full interest paid by the enterprise to lenders (such as banks) is attributed to the PE if the interest is, regarding its cause or aim, connected to the PE, e.g. if the loan is concluded by the PE's personnel or when the loan is entered into to finance the PE. For example, if the building in which the PE carries on its business is fully financed by a loan, the PE will (fully) carry the related interest. The Commentaries of 1963 and 1977 did not require the PE to be financed by any equity. The 1994 Commentaries, as far as Art. 7 is concerned, were the result of a thorough review of the problems that arose under the 1963 and 1977 Commentary, but did not solve the point of capital attribution. The 1994 Commentaries only suggested starting looking for a solution of the capital attribution problem, but even for banks no agreement could be reached.

The 2008 Commentaries did solve the issue, and introduced the primacy of capital. The question now is whether the new primacy can be reconciled with the older Commentaries, where loans seem to have had primacy. Does capital indeed have to be attributed under pre-2008 treaties? In the view of this author, the answer is in the negative and there is no capital attribution under pre-2008 treaties. But perhaps another interpreter believes that the 1963-1977-1994 Commentaries are rather silent on the matter. In the latter case, it is not so clear in which way the 2008 Commentaries influence the issue of capital attribution.

5. Authorized OECD approach

The various positions the OECD takes on topics related to Art. 7 are collectively or individually referred to as the "Authorized OECD Approach" or AOA. Its general methodology on profit attribution to the PE consists of two steps, the "two step approach". Step 1 is to "hypothesise the PE as a distinct and separate enterprise" and operates through a *functional and factual analysis*, in which it is determined what functions are performed in the PE, based on which a "hypothesised", fictitious *distinct and separate enterprise* is constructed. It is then to be considered whether dealings between the various parts of the enterprise - e.g. between head office and PE - have taken place and whether these dealings may be recognized. Under step 2 the arm's length prices of the possible dealings between the various parts of the enterprise are to be determined.
Step 1 deserves a more detailed discussion. Under the functional and factual analysis the *Significant People Functions* (*SPF*) are to be determined. Once that has happened, assets,

risks and capital are to be allocated to the PE according to three axioms: 1. The risks follow the SPF (the risk is allocated to the PE if the risk is created or managed there); 2. The SPF determine where the economic ownership is, and whether assets are to be attributed to the PE (e.g. does the PE use the assets?); 3. Capital follows assets and risk. As a consequence, the PE is rewarded for the assets it economically "owns" and for the risks it "incurs".

6. Capital attribution to the PE

If one would follow the OECD in its view that a PE should have sufficient capital to start with (either under the treaties on the lines of the 2008 Commentary, or if an interpreter believes that the pre-2008 Commentaries do not necessarily prevent capital attribution (see part 4 *supra*)), the question is how to attribute this capital. Within the OECD, there was, as a consequence of the various tax cultures represented, no consensus on one specific method. After some years of inconclusive discussions, a judgment of Solomon was made: not one but two methods would be acceptable: the *capital allocation method* and the *thin capitalization method*. Under the capital allocation method, a pro rata part of the enterprise's capital (pro rata assets and risks) is attributed to the PE. Under the thin capitalization method an arm's length amount of equity (how do other comparable enterprises capitalize themselves?) is attributed to the PE. (Thin capitalization in this context has little to do with the fixed-ratio thin capitalization legislation we know. One should rather think of another type of domestic thin capitalization method that disallows interest to the extent the amount of capital is below the arm's length standard.)
As a consequence of this option, the OECD leaves the method of capital attribution undecided, and leaves the Member countries the choice for the method that fits best into their traditions, if existing in this area. (If a domestic tradition is lacking, the OECD Member country may make a choice as to how to develop a future domestic approach, judicially or by law.)

Naturally, no method is free of disadvantages. A plea against the capital allocation method might be supported by the following arguments: when the PE conducts a very different type of business compared to enterprise as a whole, the capital allocation method does not lead to an appropriate amount of capital. The same holds when the enterprise is extremely thinly capitalized. And what to do with certain balance sheet items, such as war chests and temporary cash surpluses?

But the thin capitalization method is not spotless either: some companies are highly geared and others are not as a mere consequence of shareholders' appetites, so that it may be difficult to find comparable companies adjusted for such shareholder motives. In addition, the consequence of the thin capitalization method may be that the PE capital might become larger than the equity of the enterprise. (In this author's view, this latter argument cannot be taken seriously, as the AOA is based on the distinct and separate enterprise fiction, which attributes profits to the PE regardless of the profits of the enterprise as a whole.)

A disadvantage of allowing different methods is the risk of double taxation. This would e.g. emerge if a PE is relatively highly capitalized under the method in the PE State (thus, little interest expense for the calculation of the arm's length profit for purposes of taxation in the PE State), but is regarded as more less highly capitalised in the State where the enterprise is a resident. In the residence State this would lead to a lower profit for double taxation relief than what was taken in the PE State for levying purposes. The 2010 Model Convention (Art. 7-3) and the Commentary to the 2008 Model Convention have anticipated this and contain methods to solve such issues.

7. Interest attribution to the PE

As for capital attribution, the OECD was not able to select one method only for the attribution of interest expenses. Here as well, the OECD accepts two methods as AOA, and leaves the choice of interest attribution to the Member country and its traditions. Under the *fungibility method*, only externally paid interest (e.g. to banks or related group companies) is taken into account. Under that method, the external interest is allocated to the PE according to a formula, e.g. a pro rata allocation based on the level of PE debt versus the debt of the enterprise as whole. Thus, the fungibility method is based on a mathematical allocation of interest. And, under this method, generally a pro rata part of the total interest the enterprise incurred (and which may be a mix of various interest percentages on various loans entered into) appears on the PE's profit and loss account.

Under the *tracing method*, interest is allocated on a historical basis instead: the interest on the specific debt entered into for PE purposes is allocated. For example, if a loan was entered into to finance the purchase of the PE's office, only the interest on that debt is relevant.

8. Internal interest

Under the OECD Commentaries 1963-2008, internal interest (i.e. interest on loans between parts of the same enterprise, e.g. from head office to PE, or vice versa, or from PE to PE) is not recognized, unless the banking industry is involved. In other words, there is no allocation to the PE of interest on a loan provided by head office. Under the 2010 Commentary, this has changed: internal interest may be recognized, if, in brief, there is sufficient substance in the part of the enterprise that grants the loan. Internal interest is recognized if the part of the enterprise that provides the funds undertakes the Significant People Functions relevant to the economic ownership of those funds. The interest charge in such a case should naturally be at arm's length, which could be a reward for treasury activities, such as a service fee, or an additional interest margin.

9. Illustration of the effect of various combinations

In this part, the author considers an enterprise that carries on activities in the other State through a PE situated therein. The first two columns (in the row under "enterprise") reflect the enterprise's balance sheet (including the assets and liabilities of the PE). The row under Permanent Establishment shows the PE's balance sheet, of which only the assets are given. It is assumed that debt 1 was historically entered into to finance the PE's business. It is further assumed that the provision does not relate to any of the PE's assets. (It therefore relates to the head office's assets.)

In the third column a possible liability side of the balance sheet is drawn up if the capital allocation method were to be used. If it is assumed that the PE's risk profile does not substantially differ from that of the rest of the enterprise, the assets would determine the capital allocation. In this third column, obviously the book value of the assets is taken in numerator (50) and denominator (100) of the fraction to allocate the capital: 50/100 * 20 = 10. (The OECD documents leave in the middle whether the book value is the proper unit to allocate capital: it could also be the fair market value or even the original purchase price.) Under the capital allocation method, debt would be the remainder of the PE's balance sheet (50 – 10 = 40). And that would be it, as capital allocation is concerned. The effect of the capital allocation on the profit and loss account is still to be determined. Under the fungibility method assumed in the third column, this would lead to a pro rata allocation of the total external interest amounting to (10% * 10 plus 1% * 40 =) 1.4. This total amount of 1.4 would then be allocated on a pro rata basis to the PE: 40/80 * 1.4= 0.7. As a justification of including the provision in the total debts (denominator 80) it could be put forward that economic science usually sees provisions as debts.

An alternative calculation for the third column would be to take the provision as an adjustment to the enterprise's assets (100 – 30 = 70), and take the 70 as the denominator. This would probably lead to a more balanced capital (and debt/interest) allocation. The capital attributed would then be 50/(100 - 30) * 20 = 14.3, and the PE debt would be (50 – 14.3 = 35.7). The relevant interest for the PE would then be 35.7/(10 + 40) * 1,4 = 1.

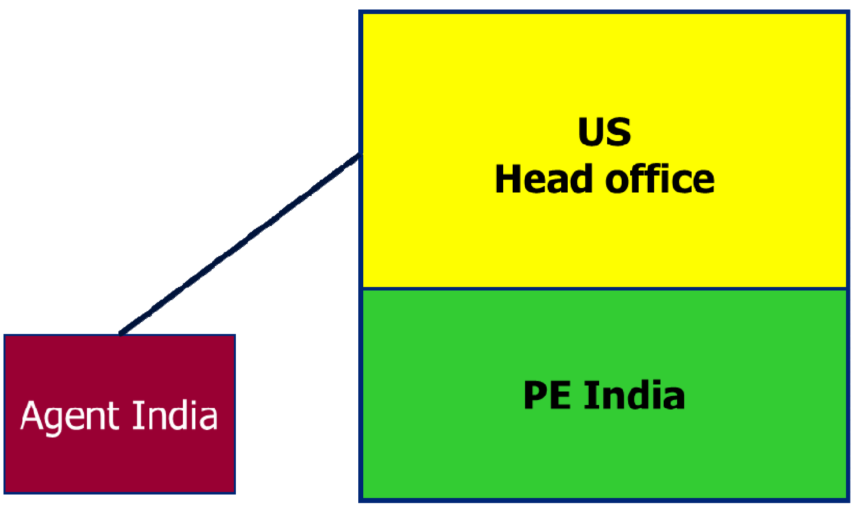
Balance sheet *assets*	Balance sheet *liabilities*	Capital allocation + Fungibility	Capital allocation + tracing	Capital all. + Fungibility or thin cap + Internal interest
Enterprise				
Assets 100	Capital 20 Debt 1 (10%) 10 Debt 2 (1%) 40 Provision 30			
Permanent Establishment				
Assets 50	Capital	Capital 10 Debt (Unspec) 40	Capital 10 Debt 1 10 Closing entry 30	Capital 10 Debt 1 10 Internal Debt 30

In the fourth column the tracing approach is used to allocate the interest. Under the tracing approach, only that interest is allocated to the PE that is historically connected to the PE, which is debt 1. The PE balance sheet therefore shows the item "debt 1", and the profit and loss account would accept an interest expense of 10% * 10 = 1. The closing entry is 30. As this closing entry cannot be traced to an external debt, under the tracing approach any remuneration on this closing entry would be irrelevant for interest allocation purposes. Under the pre-2010 Commentaries, it would not play a role if the closing entry is regarded as a loan from head office: as discussed in part 8 *supra*, under those Commentaries interest on internal loans is not taken into account.

This is otherwise in the fifth and last column. The assumption of this column is that internal interest may be taken into account, e.g. that a treaty is in place to which the 2010 Commentary applies. Therefore, if the head office's economic ownership of the 30 is substantial enough to regard 30 as an internal loan, the interest on the 30 (say the arm's length rate is 5%) becomes relevant for the PE. However, it must be taken into account that only under the tracing approach this leads to a true interest allocation on the 30 internal debt (which would be 5% * 30). As the core characteristic of the fungibility approach is to only take the externally paid interest into account, the recognition of internal loans would lead to nothing as the internal interest is concerned. In other words, under the fungibility method, the interest on internal loans would not be relevant, and the allocated interest would be the same as under the fourth column.

10. Dual or single taxpayer approach

In the final part of this article, the issue of the *dual* or *single taxpayer approach* is discussed. If an enterprise carried on by a resident of the United States makes use of an agent ("agent India") in a treaty State (there is a treaty USA-India), that agent may cause an agency PE of the enterprise under Art. 5-5 and 5-6 ("PE India"). It is assumed here that the agent operates in such a way that the conditions of these paragraphs are indeed fulfilled, and that a PE in India results.



The question then is according to what methodology profits are to be allocated to the agency PE. This is a disputed issue. Under the *single taxpayer approach*, if the agent in India is remunerated on an arm's length basis, there is no room for further profit attribution to the agency PE. This is how the Indian Supreme Court looked at the matter in the well-known *Morgan Stanley* decision[5]. This is, however, not the way the OECD approaches the matter under the OECD authorized *dual taxpayer approach*. That

[5] H. Pijl. Morgan Stanley: Issues regarding Permanent Establishments and Profit Attribution in Light of the OECD View. In: Bulletin for International Taxation, May 2008, pp. 174-182.[(Also in a Japanese translation in: The Journal of the Japan Tax Association, no. 712 (February 2009), pp. 210-229.]

approach entails that when an agent, by its actions in India for the US enterprise, fulfils Significant People Functions in the PE State, this makes the enterprise's assets and risks follow those functions under the three axioms (see part 5 *supra*). As a consequence, these assets and risks are in the Indian PE and should be remunerated there accordingly.

Expressed in terms of profits: let us assume that 8 is an adequate arm's length profit for the agent's function to manage US head office's risks (where the agent itself does not carry those US risks contractually, and merely manages them on behalf of the US enterprise). Let us also assume that 7 is an adequate arm's length profit for the US enterprise's assets and risks drawn to PE under the three axioms. Thus, accepting that the PE has its own arm's length income for the assets used and risks assumed, there are two taxpayers, the agent and the enterprise (through its PE), and this is where the term "*dual taxpayer approach"* comes from.

Therefore, a total of 15 in profits may be taxed in the PE State under Art. 7. The amount of 15 is (under most domestic tax systems) taxed in the hands of two taxpayers, and the formalities are completed by two assessments (8 for the agent, 7 for the US enterprise). This method of taxation is not a treaty issue, but an issue of domestic law. States are free to tax the whole 15 as they please. They can indeed issue two tax assessments, but may also tax the whole in the hands of the agent. (The term "dual taxpayer approach" regards the treaty attribution of profits to the agency PE, and is unrelated to the way the tax is levied under domestic law.)

11. Conclusion

This article gives a concise sketch of the 2011 status of profit attribution to a permanent establishment[6]. For certain phenomena, such as capital attribution, the treaty analysis starts with the question whether, under pre-2008 treaties, capital allocation is mandatory. When capital attribution is accepted, the question which method is used, capital allocation or thin capitalization, arises. States are free to select the desired method and its further modalities. The same applies to interest attribution: the OECD leaves the Member countries the freedom to select the fungibility method or the tracing method. Additionally, when treaties are concluded after the 2010 Model Convention and Commentaries, internal interest becomes relevant in the attribution of profits.

Finally, the OECD embraces the dual taxpayer approach, which entails the separate attribution of profits to the agency PE, in addition to the arm's length remuneration of the agent. It is left up to domestic law how the tax that results from this attribution will levied (in the hands of two taxpayers, or one): this is a domestic law, not a treaty issue.

[6] A more elaborate discussion can be found in: H. Pijl, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, 65 Bull. Int. Fiscal Documentation, 6 (2011), Journals IBFD.