Article 7 - New OECD Rules for Profit Attribution of Permanent Establishments

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Overview of presentation

- Background of PE profit attribution project
- The authorised OECD approach (AOA)
- Implementation of the AOA:
  - The Council Recommendation
  - The 2008 Commentary changes
  - The new Article 7
- Issues in drafting the new Article 7
- 2010 version of the Report on the Attribution of Profits
Background of PE Profit Attribution Project
Project began 1998 – to reach a consensus on interpretation of Article 7

Goal – to greatest extent possible, to treat a PE as a hypothetical distinct and separate enterprise, and to attribute profits to it in accordance with the arm’s length principle, applying the OECD Transfer Pricing Guidelines by analogy
Background of PE Profit Attribution Project

- The pre-2008 Model Commentary to Article 7 was largely based on the view of the arm’s length principle found in the 1979 Transfer Pricing Report.
- Thinking on the application of the arm’s length principle has evolved as reflected in the 1995 OECD Transfer Pricing Guidelines.
- And considerable experience has been gained since 1995.
The Authorised OECD Approach (AOA)
Introduction of the AOA

- Report was finalised in July 2008 and has four inter-related Parts:
  - Part I – General Principles
  - Part II – Banking
  - Part III – Global Trading
  - Part IV – Insurance

- All follow “functionally separate entity” approach
- Builds on previous work (1994 update to Article 7 Commentary)
Two-Step Analysis of Authorised OECD Approach (AOA)

- **Step One**
  - Determine the activities and conditions of the hypothetical “distinct and separate enterprise”, engaged in “same or similar activities” under “same or similar conditions”, and “dealing wholly independently” with the enterprise of which it is a part (i.e., describe the PE)
Step One: Hypothesising the PE

How to do Step One:

- By applying the principles of the OECD’s 1995 Transfer Pricing Guidelines *by analogy* to perform a factual and functional analysis:
  - to identify functions performed, assets used, and risks assumed by the PE,
  - to attribute adequate free capital to the PE in light of its risks, and
  - to identify any “dealings” between PE and rest of enterprise
Step One: Hypothesising the PE

- **Attributing assets and risks to the PE**
  - Since legal ownership belongs to the enterprise as a whole, the AOA attributes “economic ownership” to parts of the enterprise by reference to people functions.
  - Similarly, since risk legally belongs to the enterprise as a whole, the AOA determines which part of the enterprise has “assumed” the risk by reference to people functions.
Step One: Hypothesising the PE

- Recognition of “dealings” between PE and rest of enterprise:
  - Per Part I, a dealing is a “real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.)”
  - Taxpayer’s internal documentation potentially useful in establishing and characterising dealings
Step Two: Determining PE’s Profits

- Step Two
  - Determine the profits of the hypothetical separate enterprise by applying the OECD’s 1995 Transfer Pricing Guidelines by analogy to “dealings” between PE and other parts of the enterprise
Implications of the AOA

- The 2008 Report goes further than before in the recognition of intra-enterprise dealings and in the analogy with a subsidiary.

- This raises difficult questions as regards:
  - Source taxation of notional payments analogous to rents/interest
  - The attribution of free capital to PE
  - Relief of double taxation
The Implementation Challenge

- How to deal with fact that the 2008 Report, unconstrained by prior practice, was more rigorous in applying arm’s length principle than some aspects of pre-2008 Commentary? For example, potentially some greater possibility of:
  - Internal royalties
  - Arm’s length compensation of internal services
  - Internal loans outside financial sector
Implementing the AOA

Implementation package designed to reflect a two-track approach:

- Prepare *amended Commentary for existing Model Article 7*, importing as much as possible of AOA as does not conflict with existing Commentary – to provide certainty for existing treaties
- Implement full AOA through *new text for Article 7* of Model, with new Commentary – to provide certainty for future treaties
OECD Council Recommendation of 17 July 2008:

- Political commitment of Member countries to follow 2008 Report in applying treaties based on “old” Article 7 to the extent Report’s conclusions do not conflict with 2008 Commentary.

- Instruction to CFA to prepare a “new” Article 7 for inclusion in 2010 update to Model to allow for full implementation of AOA in future treaties.
First phase of implementation

Revised Commentary on existing Article 7 published as part of 2008 Update to OECD MTC:

- Rejection of the “relevant business activity approach”
- AOA 2-step approach as basis for adjusting the taxpayer’s accounts to an arm’s length result (¶¶ 17-18)
- Documentation encouraged (¶ 20)
- Guidance for dependent agent PEs (¶ 26)
- Guidance for construction PEs (¶¶ 23-25)
- Approaches for the attribution of capital (¶ 45-46)
Second phase of implementation

- Drafting text of *new* Article 7 with accompanying Commentary
  - First draft released July 2008
  - Public consultation held September 2009
  - Second draft released November 2009
  - Final version included in 2010 Update to OECD Model, issued in July
Issues in Drafting the New Article 7
The new Article 7

- Existing Article 7: seven paragraphs
- New Article 7:
  - One paragraph stays the same
  - Two paragraphs are slightly amended
  - Four paragraphs are deleted
  - One new paragraph (on relief of double taxation)
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 that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
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. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are ...
... the profits which it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a distinct and separate and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
Deleted paragraphs

- Old 7(3) (deductibility of expenses incurred for the PE)
- Old 7(4) (use of apportionment method)
- Old 7(5) (no attribution of profits to purchasing function)
- Old 7(6) (required use of same method year by year)

- Old 7(7) remains the same (as new 7(4)): “Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.”
New Article 7(3) on double taxation relief

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
Background on new Article 7(3)

- Replaces the July 2008 draft version which had been limited to relief of double taxation in cases of conflicts of capital attribution only
- Similar to an alternative included in July 2008 draft Commentary
- Based on corresponding adjustment mechanism of Article 9(2)
- Goal: that the combination of Articles 7, 23 and 25 will ensure that all cases of double taxation are eliminated, thereby addressing the main source of concerns expressed in the comments
Need for Article 7(3)?

- New Commentary expressly states that if each State recognizes that the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, they should both refrain from making any adjustment to the profits in order to reach a different result under paragraph 2 (¶ 46).

- Principle should reduce need for relief mechanism.

- Expectation: the cases where it will be necessary to have recourse to paragraph 3 are fairly limited.
Need for Article 7(3)?

- **Situation 1:**
  - Both States agree that the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, then:
  - Neither State should make an adjustment to the profits, no need for paragraph 3
Need for Article 7(3)?

- Situation 2
  - A State (PE State or head office State) determines the profits attributable to a permanent establishment in a way that is not in conformity with paragraph 2:
  - Taxpayer may use the available domestic legal remedies (courts) and the mutual agreement procedure to address the fact that it has not been taxed by that State in accordance with the Convention; no need for paragraph 3
Need for Article 7(3)?

- **Situation 3**
  - The taxpayer has not determined the profits attributable to the permanent establishment in conformity with paragraph 2. One State makes an adjustment in order to ensure conformity with that paragraph.
  - Paragraph 7(2) permits the other State to make a reciprocal adjustment but …
Need for Article 7(3)?

**Situation 3**

- The domestic law of that other State (e.g. the State where the permanent establishment is located) may not allow it to make such a change, or
- That State may have no incentive to do it on its own, or
- The two Contracting States may adopt different interpretations of paragraph 2 and it is not possible to conclude that either interpretation is not in accordance with paragraph 2
Need for Article 7(3)?

- **Situation 3**
  - Paragraph 3 addresses these concerns
  - It requires the other State, to the extent that there is indeed double taxation and that the adjustment made by the first State is in conformity with paragraph 7(2), to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States.
  - This is similar to the corresponding adjustment mechanism of paragraph 2 of Article 9
Need for Article 7(3)?

**Situation 3**

- If the other State, however, does not agree that the first adjustment is in conformity with paragraph 2, it will not consider that it has to make the corresponding adjustment.
- In such a case, the issue of which State has not complied with its treaty obligations (i.e., is the initial adjustment by the first State contrary to the treaty, or is there a failure by the other State to comply with paragraph 3?) can be addressed by a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25.
Some features of new Article 7(3)

- Paragraph 3 only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment.
- The combined application of Articles 7 and 23 already requires each State to use arm’s length prices and methods; paragraph 3 is only relevant to the extent that States adopt different interpretations of what the correct arm’s length price/method should be.
Some features of new Article 7(3)

- Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable income on which tax will be levied in each State for a given taxable period may be different given differences in domestic law rules.

- Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3.
As was the case in the July 2008 Discussion Draft, an alternative provision has been included in the Commentary for States that prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure without any deference being given to the adjusting State’s preferred position as to the appropriate arm’s length price or method (¶68).
Other issues in the new draft

- Documentation
  - Paragraph 26 has been expanded to clarify that it is generally not intended that more burdensome documentation requirements be imposed in connection with dealings than apply to transactions between associated enterprises (but considering the nature of a dealing, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing)
Other issues in the new draft

- Domestic law restrictions on deductions
  - Clarification of paragraph 30 on the relationship between paragraph 7(2) and domestic law restrictions on the deduction of expenses, e.g. domestic law rules that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2
Other issues in the new draft

- **Notional payments**
  - Paragraph 28 continues to state that “separate and independent enterprise” fiction does not create notional income PE State can tax under the Model (e.g., for purposes of Article 6 or 11)
  - Paragraph 29 allows States with policy concerns about that to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11
Some less cited aspects of new Article 7

- Clearer requirement of “free” capital in the PE
- Clearer approach to treatment of documentation
- Clearer approach to attribution of profits to dependent agent PE’s
- Allowance of profit attribution to purchasing function
- Very limited recognition of notional interest beyond banks
- Ability not to recognize dealings of type that could give rise to withholdable payments
- Neutrality of the arm’s length approach
- Clearer obligation of double tax relief
2010 Version of Report on Attribution of Profits to Permanent Establishments
A new “sanitized” version of the 2008 PE Profit Attribution Report (updated to delete references to old Article 7 and to update references to latest version of Transfer Pricing Guidelines) was also released in July 2010 – no changes to the conclusions of the 2008 Report.

2008 version of Article 7 to be used, together with 2008 version of PE Report, to interpret treaties based on the old Article 7.

2010 version of Article 7 to be used, together with 2010 version of PE Report, to interpret treaties based on the new Article 7.

Both versions to remain in print for ease of reference.
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