Summary of the Proceedings of an Invitational Seminar on the Attribution of Profits to Permanent Establishments

Introduction

1. In February 2001 the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD) released a Discussion Draft on the Attribution of Profits to Permanent Establishments (the “Discussion Draft”). The Discussion Draft was prepared by the Steering Group on the Transfer Pricing Guidelines of Working Party No. 6. It is intended as a first step in the development of a consensus among the member countries of the OECD concerning the application of the Transfer Pricing Guidelines to permanent establishments in the context of Article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model Convention).

2. On June 22, 2001 a small group of Canadian government officials, tax practitioners, and academics met in Toronto to consider the Discussion Draft and to make constructive comments on the Draft for the benefit of the Steering Group.

3. Participants took part in the seminar as individuals rather than as representatives of their firms or organisations. No formal presentations were made at the Seminar. The discussions were free-flowing and unconstrained by a highly structured agenda. Comments made during the Seminar have not been attributed to particular participants.

Summary of seminar discussions

Introduction

4. The Seminar began with a brief introduction by Alain Castonguay of the Department of Finance. He described the background work of the Steering Group since 1997 leading to the publication of the Discussion Draft and explained that the Draft was a work-in-progress. Several issues remain unresolved, including the proper treatment of dependent agent PEs and the testing of the Working Hypothesis to global trading and to non-bank financial institutions such as insurance companies (to be Chapters III and IV of the

1. Please note that comments received on the “Discussion Draft on the Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions” are also included in this document, as these comments may also be of interest when examining Part I of the Discussion Draft on the Attribution of Profit to a Permanent Establishment.

2. By Brian J. Arnold, Goodmans LLP. He would like to Marc Darmo of PricewaterhouseCoopers LLP for his assistance in the preparation of this summary.
Discussion Draft). The Steering Group is very interested in comments from the public on the Discussion Draft before completing its work.

5. The first question addressed in the seminar was whether the Working Hypothesis set out in the Discussion Draft was the correct approach in theory and principle, putting aside, for the moment, issues of practical implementation and application. On this question there was unanimous agreement that the Working Hypothesis was the correct approach in theory and principle to the attribution of income to a PE. According to the participants, not only does article 7(2) require the application of the arm’s length principle to PEs, but it is also desirable in tax policy terms for Articles 7 and 9 to operate similarly to the maximum extent possible.

6. Underlying the analysis in the Discussion Draft is the assumption that foreign branches and foreign subsidiaries should be treated similarly from a tax policy perspective. There was an extensive discussion about this assumption. Despite significant differences between the tax treatment of branches and subsidiaries in most worldwide tax systems, some participants suggested that these differences did not justify or require any difference in the way their income is computed. Others argued that the only significant difference between branches and subsidiaries is the absence of any documentation for the dealings (transactions) of branches. In contrast, the relationships between associated enterprises are usually governed by legally binding contractual arrangements.

7. This line of discussion led quickly to the concept of dealings between a PE and other parts of an entity, which was agreed to be the key aspect of the Working Hypothesis. It was suggested that the Working Hypothesis made it necessary to provide rules for a PE with respect to matters that a subsidiary could decide itself. Thin capitalisation rules were cited as an example. Under the tax laws of many countries, the capital of a subsidiary of a non-resident corporation can be established with any amounts of debt and equity subject only to a safe harbour debt/equity ratio for purposes of the domestic thin capitalisation rules and possibly the arm’s length standard in Article 9 of the Model Convention. With respect to a branch, it would be necessary to ascertain the respective amounts of its debt and equity by reference to the capital structure of similar independent enterprises. The discussion returned to the key element of dealings later in the seminar.

The proper interpretation of Article 7 of the OECD Model Convention

8. Having agreed that the Working Hypothesis was the correct approach in principle, there was a spirited debate concerning the proper interpretation of the existing provisions of Article 7 and whether, without amendment, it could accommodate the Working Hypothesis. On these issues there was a surprising range of views. The divergence of views confirms the lack of consensus, noted in the Discussion Draft, on a common interpretation of Article 7 and, arguably at least, provides evidence that Article 7 requires amendment.

9. Several issues arose concerning the wording of Article 7(1), which is set out here for convenience:

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.
10. First, some participants questioned how the wording of this provision could be interpreted to support the “relevant business activity” meaning set out in the Discussion Draft. Under this interpretation, the phrase “profits of an enterprise” means the profits that the entity earns from the particular type of business, broadly or narrowly defined, part of which is carried on by the PE. It was pointed out that the actual phrase in Article 7(1) is “the profits of an enterprise of a Contracting State,” that “enterprise of a Contracting State” is defined in Article 3(1)(d) to mean an enterprise carried on by a resident of a Contracting State, and further, that by virtue of Article 3(1)(c), the term “enterprise” applies to the carrying on of any business. These definitions suggest that “enterprise” refers to a business rather than the entity carrying on the business. Both definitions are, however, subject to the caveat that the context otherwise requires. Moreover, the term “enterprise” in the phrase “the enterprise carries on business” used in both the first and second sentences in Article 7(1) appears to be a reference to the entity rather than the business. The Discussion Draft itself indicates that “references to the ‘enterprise’ or to ‘the enterprise as a whole’ should be interpreted as describing the judicial entity,” although it is unclear whether the Draft is referring just to the usage in the Draft or to the meaning for purposes of Article 7.

11. Second, and more important, some participants argued that the wording of the second sentence of Article 7(1) (and in particular, the words “but only so much of them”) limited the profits attributable to a PE to the total profits of a business or entity (depending on the resolution of the “relevant business activity” issue discussed in the preceding paragraph). Thus, if an entity has an overall loss, no profits could be attributed to a PE. The Discussion Draft rejects this interpretation summarily. The group agreed that, even if this interpretation was possible based on the wording of Article 7(1), it was inconsistent with the treatment of a PE as a separate entity and that it should be possible for a PE to make profits while the entity as a whole had a loss. Some participants thought that, because Article 7(2) is more specific than Article 7(1), Article 7(2) overrode, or at least clarified, Article 7(1) in this respect.

12. Third, even the precise meaning of the term “profits” generated debate. The Discussion Draft suggests that, because the term is not defined in the OECD Model Convention, the country in which the PE is located can apply its domestic law to determine the profits of a PE. However, in putting forth this interpretation, the Discussion Draft does not mention the caveat in Article 3(2) of the Model Convention that undefined terms do not have their meaning under domestic law if the context requires otherwise. Moreover, according to the Discussion Draft, the residence country computes the profits of the PE for purposes of the elimination of double tax in accordance with its domestic law, which “may well differ from the amount of profits attributed by the host country.” The Draft declines to address this issue. However, one of the primary purposes of the Discussion Draft is to formulate a common interpretation of Article 7 in order to minimise double taxation. Also, Article 7(2) mandates expressly that the profits attributable to a PE shall apply “in each Contracting State.” These words are virtually meaningless if the host and residence countries determine the profits of a PE under their respective domestic laws since the amounts so calculated will inevitably differ. One solution put forward to deal with this problem involved an interpretation of Article 3(2) that requires the residence country in applying Article 23 to adopt the source country’s determination of the profits of the PE as long as it is in accordance with Article 7 of the Model Convention.

---

3 Discussion Draft, paragraphs 14-21.
4 The ambiguity in the meaning of the term “enterprise” is not unique to Article 7; it also occurs in Articles 5(1), (5) and (6), 9(1), and 24.
5 Discussion Draft, paragraph 10, footnote 3.
6 Discussion Draft, paragraphs 35-36.
7 Discussion Draft, paragraph 37.
13. The relationship between Article 7(1) and 7(2) also stimulated a lively debate. Article 7(2) establishes both the assumption that a PE is a separate entity and the principle that the PE deals at arm’s length with the enterprise of which it is a part. Some participants thought that many of the difficulties in the interpretation of Article 7(1) could be resolved by reference to Article 7(2). They argued that Article 7(2) was not inconsistent with Article 7(1), but a clearer statement of the principles of Article 7(1). Some argued that if the two provisions were considered to be inconsistent, Article 7(2) should prevail because it is more specific. Others thought that article 7(1), as the primary rule concerning the attribution of profits to a PE, could not be relegated to a secondary role so easily.

14. Most participants accepted that Article 7(3) did not preclude the use of arm’s length prices for dealings between a PE and the head office in accordance with Article 7(2). Some participants thought that Article 7(3) and the words “subject to the provisions of paragraph 3” in Article 7(2) could support an argument that only an allocation of actual expenses was allowed in computing the profits of a PE. Everyone agreed that Article 7(3) should not restrict the application of the arm’s length principle to PEs and that this issue should be clarified possibly by deleting the opening phrase in Article 7(2).

15. There was no agreement on the necessity for amendments to Article 7 to accommodate the Working Hypothesis. Most participants thought that amendments were either necessary or desirable. Some participants thought that some amendments, such as the deletion of the opening words of Article 7(3), were desirable but they were unrelated to the Working Hypothesis. Serious concern was expressed about the difficulty of amending the Model Convention as compared to amending the Commentary and the implications of the amendments for existing tax treaties with the current wording of Article 7. As a result, some participants thought that it was preferable to amend the Commentary to Article 7 to incorporate the contents of the Discussion Draft as a first step and then to amend Article 7 itself as a longer-term measure. Another concern expressed was whether a complete reversal of the position in the Commentary (for example, a change from the current Commentary that payments for the use of intangibles are not deductible to the new position under the Working Hypothesis that they are deductible) would be followed by the courts without an appropriate change in the wording of Article 7 itself. Finally, it was pointed out that the existing wording of Article 7 could not support the deduction of notional interest expenses for PEs of financial institutions but not for other PEs.

Identifying the PE as a separate entity

16. With respect to the first step in the application of the Working Hypothesis (a functional and factual analysis of the activities of a PE and the conditions under which such activities are carried on), the group generally agreed that such a functional and factual analysis could be successfully applied to a PE. Some participants thought that the functional and factual analysis required under Article 9 was different from the analysis required for a PE under Article 7. They raised concerns about the lack of any documentation to identify the activities of a PE as compared to a subsidiary. Others argued that documentation was often lacking, even with respect to transactions between a parent corporation and its subsidiaries, particularly in relation to management and administrative services, use of intellectual property, and so on. Some participants agreed that PEs could be required to create and identify relationships with other parts of the enterprise in the same way as a subsidiary. They pointed to branch accounts as reasonably equivalent to the financial statements prepared for subsidiaries, with the exception of the debt and equity components of the balance sheet. Others argued that a PE and a subsidiary were different and they pointed to the possible uncertainty concerning the existence of a PE and the absence of any independent capital structure for a PE as compared to a subsidiary. Branch accounts were not equivalent to financial statements for a subsidiary, it was argued, because the financial statements reflected legal contracts and relationships entered into by a subsidiary that had no counterpart with respect to a PE.
17. The question was raised about how to distinguish between a PE engaged in contract manufacturing for the head office and a PE engaged in manufacturing for its own account as a separate entity. Some participants thought that a functional and factual analysis of the PE would not provide any answer to this question. Others argued that the PE and head office could be required to document the nature of their intended relationship and pointed out that the same issue could arise in a parent/subsidiary context.

18. With respect to the determination of the risks assumed by a PE, the Discussion Draft suggests that this issue can be resolved by the functional and factual analysis of the PE’s activities. According to some participants, the assumption of risk was inherently a legal issue. In the absence of legal transactions between a PE and the other parts of the enterprise, any allocation of risks to the PE would be arbitrary and unreliable.

Identifying the dealings between the PE and other parts of the enterprise

19. As mentioned earlier, the key element of the Working Hypothesis is the identification of the dealings between a PE and other parts of an enterprise, and appropriately, most of the time was spent discussing this issue. The Discussion Draft indicates that a dealing should be recognised “where it relates to 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.).” Further, the branch accounts will provide the starting point for determining whether a dealing exists. Some participants pointed out that the branch accounts simply reflected the taxpayer’s position as to the characterisation of the dealings of the PE and that, because of the absence of any legal consequences, such characterisation might be made exclusively for tax reasons. They argued that there was nothing behind the characterisation of the dealing (such as a legally binding contract) against which to test the taxpayer’s characterisation. In other words, although typically documentation constitutes a record of transactions and arrangements that are not defined by the documentation process, with respect to PEs, documentation will in many respects define the basis for taxation. In contrast, other participants argued that the facts, in particular the conduct of the PE and head office, would operate as an effective constraint on the ability of taxpayers to create dealings just for tax purposes. The facts will usually demonstrate whether or not an asset is used by a PE, which is part of the first step in the application of the Working Hypothesis. However, the facts may not show how the asset is being used (e.g., sale, lease, or cost contribution arrangement) by the PE. In this respect, the documentation simply represents the taxpayer’s position as to the characterisation of the use of the asset by the PE and does not reflect any underlying reality. Some participants pointed out that related parties could choose the type of legal arrangement they entered into and amend such arrangement whenever they wished. As a result, legally binding contracts between related parties could not be considered to be as limiting as contracts between unrelated parties.

20. The discussion then moved to a consideration of the statement in the Discussion Draft that the dealings of a PE identified by reference to the branch accounts and other internal documents must be respected by the tax authorities:

Except in the two circumstances outlined at paragraph 1.37 [of the Transfer Pricing Guidelines], tax administrations should apply the

---

8 Discussion Draft, paragraph 57.
9 Discussion Draft, paragraph 69.
guidance in paragraph 1.36 when attributing profit to a PE and so “should not disregard the actual dealings or substitute other dealings for them.”\(^\text{10}\)

The two circumstances referred to in paragraph 1.37 of the Transfer Pricing Guidelines are, first, where the substance of a transaction differs from its form, and second, where arm’s length parties would not have entered into the transaction entered into by the related parties.

21. Since a dealing between a PE and the head office is a notional construct, some participants had difficulty understanding how there could be “actual dealings” and why the tax authorities would be precluded, as a general principle, from challenging the taxpayer’s characterisation of the intended dealings. Further, it was unclear how the two exceptional circumstances could be applied in the case of a PE. It was suggested that paragraph 74 of the Discussion Draft should be clarified and might benefit from following the approach used in paragraphs 12 and 12.1 of the Commentary to Article 7. These paragraphs emphasise the importance of the branch accounts as the basis for computing the profits of a PE where they are based on internal agreements. The Commentary suggests that the tax authorities could accept the accounts “to the extent that the trading accounts of the head office and the permanent establishment 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.”\(^\text{11}\)

22. In general, the group thought that the explanation of the concept of dealings in the Discussion Draft was not sufficiently clear. Some participants thought that there should be a clear definition of the term “dealings.” Others argued that the Draft should distinguish clearly between the events that result in dealings and the characterisation of these events for purposes of computing the income of a PE. The tax authorities cannot disregard the former because they are essentially factual; however, they are not bound by the taxpayer’s characterisation of the events. For example, the use of a capital asset by a PE is determined on the basis of the facts. However, that use of the asset by the PE may be characterised as a sale, a lease, or a cost contribution arrangement. This characterisation is notional because there is no actual sale, lease, or cost contribution arrangement in law.

23. A question was raised about whether dealings between a PE and the head office could be changed. In the case of a subsidiary corporation any change in the transactions between the subsidiary and its parent corporation would ordinarily be reflected in legal contracts. By analogy, dealings could change if the change is documented properly and is in accordance with the facts. Some participants were not entirely comfortable with this analysis.

\(^{10}\) Discussion Draft, paragraph 74.

\(^{11}\) Commentary to Article 7, paragraph 12.1.
Dealings in capital assets

24. According to the Discussion Draft, where the use of a capital asset by one part of an enterprise shifts to another part of the enterprise, a dealing should be recognised. Whether this dealing should be treated as a sale, lease or cost contribution arrangement will depend on a factual analysis including the subsequent conduct of the parts of the enterprise and any relevant documentation. The Discussion Draft then sets out a non-exhaustive list of factors to be considered in determining the intent of the enterprise with respect to the change in use of the asset.

25. The seminar participants were agreed that characterising the change in use of a capital asset as a sale, lease or cost contribution arrangement would be difficult in many cases. The Cudd Pressure case was referred to as illustrative of the difficulty. Some of the participants were of the view that, because the snubbing unit in that case was used by the PE for a temporary period, it would have been more appropriate to characterise the dealing as a lease rather than a sale. They questioned the position in the Discussion Draft that there was no need to distinguish between temporary and more permanent changes in the use of assets. Others argued that because the taxpayer had never rented the snubbing unit to third parties, it would not have rented it to the PE on the assumption that the PE was a separate entity dealing independently with the head office. In response, it was pointed out that neither was the taxpayer in the business of selling snubbing units.

26. The group was uniformly of the view that increased emphasis should be placed on the need for contemporaneous documentation of any dealings between a PE and other parts of the entity involving capital assets. Such documentation would be extremely important in characterising the change in use of an asset as a sale, lease or other arrangement. It was suggested that, at the least, contemporaneous documentation should be added to the list of factors relevant to the determination of the intent of the enterprise, and highlighted as the most important of those factors.

27. Some participants questioned the position in the Discussion Draft that no dealing should be recognised where a PE uses an asset from the time of its acquisition by the enterprise. According to the Draft, the PE should be treated as the owner of the asset in this situation. Analogising the PE to a subsidiary, it was suggested that an enterprise has a choice: the asset could be acquired by or on behalf of the PE and used by it in which case the dealing between the PE and the head office would likely be treated as a sale or the asset could be acquired and leased to the PE. Which characterisation is more appropriate depends on all the circumstances but, in particular, on how the dealing is documented by the enterprise at the time.

Intangible property

28. The current Commentary to Article 7 takes the position that intangible property is owned by the enterprise as a whole and cannot be allocated among the parts of the enterprise. As a result, it is

---

12 Discussion Draft, paragraph 95.
13 Discussion Draft, paragraph 96.
14 Cudd Pressure Control v. The Queen [1999] 1 CTC 1, 98 DTC 6630 (FCA).
15 Discussion Draft, paragraph 108.
16 Discussion Draft, paragraph 96.
17 Discussion Draft, paragraph 91.
inappropriate for dealings with respect to intangibles to take place at fair market value; in other words, notional royalties cannot be deducted in computing the profits attributable to a PE.\textsuperscript{18} The Discussion Draft is critical of the current position in the Commentary and indicates that the Working Hypothesis requires that intangible property used by a PE should be treated the same as tangible capital property.

29. The participants agreed in principle with the suggested treatment of intangible property in the Discussion Draft. However, it was suggested that different approaches might be appropriate for different types of intangible property. For example, franchising was raised as a situation in which comparable transactions with arm’s length franchisees might be available. Also, several participants were critical of the non-exhaustive list of factors that the Discussion Draft indicates should be considered to determine whether a PE has participated in the creation of intangible property.\textsuperscript{19} They suggested that two factors were much more important than the others: if the PE directs the research and development activities resulting in the intangible property and if the research and development expenses are recorded in the branch accounts and are supported by contemporaneous documentation.

Services

30. Under the current Commentary to Article 7 services provided by the head office to a PE must be accounted for at cost rather than an arm’s length amount unless the enterprise provides similar services to third parties.\textsuperscript{20} According to the Discussion Draft, the current Commentary is inconsistent with the arm’s length principle in this regard.\textsuperscript{21} However, the Draft goes on to state that “there are times when the arm’s length principle would result in a transaction taking place without the realisation of a profit.”\textsuperscript{22} Participants found this aspect of the treatment of dealings involving services to be confusing and suggested it be clarified. It was also pointed out that dealings involving services would often arise in circumstances where it was unclear whether or not a PE existed.

Capital structure

31. The determination of the debt and equity of a PE and the deduction of notional interest are particularly troublesome aspects of the application of the Working Hypothesis to PEs. Time and again the discussion during the seminar returned to these issues.

32. Currently, the Commentary to Article 7 does not authorise the deduction of notional interest in computing the profits of a PE, except in the case of a PE of a financial enterprise because the ordinary business of a financial enterprise involves loaning funds to third parties. Although the Discussion Draft rejects the position in the current Commentary to Article 7, it proposes to continue the ban on the deduction of notional interest “for administrative simplicity.”\textsuperscript{23} Accordingly, in computing the profits attributable to PEs, other than PEs of financial institutions, only part of the actual interest expense incurred by an entity would be allocated to the PEs based on either factual tracing or formula apportionment.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{18} Commentary to Article 7, paragraph 17.4.
\item \textsuperscript{19} Discussion Draft, paragraph 114.
\item \textsuperscript{20} Commentary to Article 7, paragraphs 17.5 – 17.7.
\item \textsuperscript{21} Discussion Draft, paragraph 123.
\item \textsuperscript{22} \textit{Ibid.}
\item \textsuperscript{23} Discussion Draft, paragraph 157.
\end{itemize}
\end{footnotesize}
Some participants expressed the view that the prohibition on the deduction of notional interest by taxpayers other than financial institutions could not be justified under the Working Hypothesis and the application of the arm’s length principle to PEs. Others suggested that it did not make sense to treat debt financing in one way but other types of financing, such as leasing, in another way. As mentioned earlier, concern was expressed about how a functional and factual analysis of the activities of a PE would assist in determining the amount of debt and equity to be allocated to a PE. Considerable discretion is available concerning the establishment of the capital structure of a subsidiary corporation subject to domestic thin capitalisation rules and possibly the arm’s length standard in Article 9 of the Model Convention. By analogy, the same flexibility should be available in the case of PEs. However, the application of the Working Hypothesis would arguably require the establishment of precise amounts of debt and equity for PEs based on the capital structure of comparable independent enterprises. Therefore, the results under Article 7 for a PE and the results under Article 9 for a subsidiary would be different unless domestic law provides some flexibility by way of an independent enterprise test in determining both thin and fat capitalisation for PEs. Issues were also raised concerning the realisation of foreign currency gains and losses on notional debt. The group did not have any solutions for these problems. It was suggested that Articles 11 and perhaps 24 of the OECD Model Convention might be revised to distinguish between interest on related party and third party debt and that any deduction of notional interest by a PE should be accompanied by a symmetrical deemed income receipt by another part of the enterprise. Many participants were concerned about the practical problems of attributing notional amounts of debt and equity to PEs especially since it would often be difficult to identify dealings between the head office and the PE in this regard and even a requirement for contemporaneous documentation was not thought to be sufficient to allay these concerns.

Treaty issues other than Article 7

34. The Discussion Draft is limited to issues arising from the application of the Working Hypothesis to PEs under Article 7 of the OECD Model Convention. Related issues concerning other aspects of the Convention were considered to be beyond the scope of the Discussion Draft. Despite this disclaimer, the seminar participants agreed that several other issues involving the Model Convention are inextricably linked to the application of the Working Hypothesis to PEs. First, it was noted that the continuing Appropriateness of the concept of permanent establishment, defined in Article 5 of the Convention as the threshold for source country taxation of business profits, was threatened by changing models of commercial practice, in particular electronic commerce. Obviously, any significant change in the threshold for source country taxation might affect the determination of the amount of business profits subject to tax by the source country. However, this was not considered to be a serious shortcoming in the Discussion Draft.

35. Second, the Discussion Draft and the OECD Model Convention do not deal with the imposition of withholding tax on notional expenses that are deductible in computing the profits attributable to a PE under the Working Hypothesis. This issue is extremely important because of the potential erosion of the source country’s tax base by the deduction of notional expenses such as interest and royalties. Under the Working Hypothesis, if a PE uses tangible or intangible capital property owned by the entity and the dealing between the PE and the head office is considered to be a lease or a license, a notional arm’s length rental or royalty will be deductible in computing the profits of the PE. However, no actual payment is made because the PE and the head office are just parts of a single legal entity. If the entity is resident in a country that does not tax the profits of the PE or taxes those profits at a significantly lower tax rate than the tax rate applicable in the source country, there would be a significant incentive for taxpayers to claim notional expenses for PEs. Applying the underlying assumption of the Discussion Draft that PEs and

---

24 Discussion Draft, paragraph 10.
subsidiaries should be treated alike, if a subsidiary were involved, it would make actual rental or royalty payments to its non-resident parent that would be subject to source country withholding tax, at least potentially, and probably residence country tax with a credit for the source country withholding tax.

36. The group agreed that in principle notional expenses deductible in computing the income attributable to a PE should be subject to withholding tax if an actual payment of the same character paid by a subsidiary to its parent in similar circumstances would be subject to withholding tax. This would require changes to most countries’ domestic laws to allow the imposition of withholding tax on notional amounts. It would also be necessary to amend the OECD Model Convention to permit source countries to levy withholding tax on notional payments, although it is not clear what amendments would be required. It was noted that it would be appropriate for countries to decide for sound tax policy reasons not to subject certain notional payments to withholding tax just as certain actual payments are exempt from withholding tax.

37. Third, the crucial issue of relief from double taxation is not dealt with in the Discussion Draft. However, the basic purpose of the Draft is to establish a common interpretation of Article 7 in order to minimise the possibility of double taxation or non-taxation. The Draft indicates that the Working Hypothesis “should ideally be applied by countries symmetrically, i.e., in the same manner regardless of whether they are the host or the home country.”25 However, the Draft goes on to suggest that because of Article 23 of the Model Convention and the domestic laws of the residence country, symmetrical treatment may not be achieved in all situations. However, as mentioned earlier, the Draft does not discuss the meaning of the words in Article 7(2) requiring that the profits attributable to a PE be the same “in each Contracting State.” The group was unanimous in the view that the issues involving Article 23 and the elimination of double taxation should be addressed as part of the consideration of the application of the Working Hypothesis to Article 7. However, there was no detailed discussion of the Article 23 issues.

Tax administration and compliance

38. Issues of tax administration and compliance surfaced frequently during the seminar discussions. There was general agreement that PEs should be required to document their intended dealings contemporaneously. This contemporaneous documentation requirement would put PEs in a similar position to subsidiaries, which are already subject to such a requirement. Also, it was thought that such a requirement would restrict the ability of taxpayers to artificially create dealings giving rise to notional deductions. The Discussion Draft did not deal extensively with documentation requirements and suggested that the approach used in the Transfer Pricing Guidelines could be applied to PEs without difficulty.26 The participants were agreed that the documentation requirements were essential to the successful application of the Working Hypothesis to PEs, although there was no agreement about the precise nature of such requirements. There was agreement that the Discussion Draft did not emphasise the importance of documentation requirements sufficiently and did not examine the issues concerning documentation of intended dealings adequately.27

39. There was some discussion of the possible consequences if a taxpayer did not document the dealings of a PE contemporaneously. By analogy to a subsidiary corporation, substantial penalties could be

25  Discussion Draft, paragraph 33.
26  Discussion Draft, paragraph 166.
27  In paragraph 8 of the Discussion Draft it is indicated that documentation will be addressed after the testing of the Working Hypothesis has been completed. According to the participants, documentation is a necessary condition for the proper application of the Working Hypothesis, which should be addressed as part of the Working Hypothesis itself.
imposed under domestic law. Alternatively, the deduction of notional expenses could be disallowed unless the dealings giving rise to the expenses are properly documented. Concern was expressed that these types of penalties should not be too draconian. In many situations, it might be unclear whether or not a PE existed. It might be too burdensome to require taxpayers to file tax returns with a computation of the income of a PE supported by contemporaneous documentation of any dealings engaged in by the PE if the taxpayer was reasonably taking the position that no PE existed. There was agreement that the OECD should consider these issues further.

40. Some concern was expressed that many tax administrations would be unable to apply the Transfer Pricing Guidelines to PEs without substantial additional resources. The existing transfer pricing rules applicable to associated enterprises are already heavy consumers of the resources of tax administrations. Moreover, the necessity under the Working Hypothesis to postulate a PE as a notional separate entity and also notional dealings between the PE and other parts of the entity involves large areas of uncertainty with the resulting possibility of increased disputes between taxpayers and tax administrations. The functional and factual analyses that are necessary to resolve these issues are likely to be time-consuming and expensive. Some participants argued that these analyses were required under existing tax treaties and in the case of parent/subsidiary relationships and that, in any event, there was no alternative.

41. There was a brief discussion, but no consensus, about the extent and severity of the current problems with respect to the attribution of income of PEs under existing Article 7. The concern underlying this discussion was that the administrative burden resulting from the Working Hypothesis could not be justified if the problems of the current rules were not serious. Some practitioners expressed the view that problems concerning the computation of income attributable to PEs arose infrequently and were usually resolved satisfactorily through negotiations with the tax authorities. They pointed to the absence of cases, foreign or Canadian, dealing with the attribution of income to a PE — the Cudd Pressure case being exceptional in this regard — as evidence that the current rules (or lack of rules) work reasonably well in practice. It was also pointed out that in many situations any problems resulting from doing business through a PE could be avoided through the use of a subsidiary corporation. Other practitioners argued that there were significant problems under the current rules and that these problems would be exacerbated by the growth of electronic commerce, cross-border trade in services, and the development of free trade blocs such as the European Union and the North American Free Trade Agreement. This issue is an important one that deserves more attention by the OECD Steering Group. It is generally conceded, as discussed earlier, that there is no consensus among the member countries of the OECD concerning the interpretation of Article 7 of the Model Convention. The fundamental purpose of the Discussion Draft is to establish a common interpretation of Article 7 on which countries can agree. Perhaps it is appropriate for the OECD to consider whether the lack of a common interpretation of Article 7 is currently causing serious problems of double taxation or non-taxation or whether the problems are merely theoretical possibilities. If the deficiencies in Article 7 are more theoretical than real, then it is questionable whether it is necessary or desirable to make the Transfer Pricing Guidelines more thoroughly applicable, by analogy, to PEs.

PEs of financial institutions

42. Most of the seminar was devoted to discussing Part I of the Discussion Draft dealing with the application of the Working Hypothesis to PEs other than banks and other financial institutions. Little time was available to discuss Part II dealing with the application of the Working Hypothesis to PEs of banks. Gilbert Ménard of the Department of Finance gave a brief introduction to the work of the Steering Group and an explanation of some of the special difficulties with respect to bank PEs. It was suggested that the

---

28 See the penalties in Income Tax Act, subsections 247(3) and (4).
distinction between banks, other financial institutions, and other entities was not very clear in the Discussion Draft and that the distinction should be clear because of the significantly different treatment accorded to different types of PEs.

Summary of points on which agreement was reached

43. Virtually all of the seminar participants agreed with the following points:

1. The Working Hypothesis represents the correct approach in theory and principle for the attribution of income to PEs. The arm’s length principle in Article 9 of the OECD Model Convention should also apply to PEs under Article 7 to the maximum extent possible.

2. The concept of “dealings” between a PE and other parts of an enterprise, and in particular, the distinction between events and the characterisation of events, should be clarified.

3. Taxpayers should be required to document contemporaneously the intended dealings of a PE for purposes of computing its income. The Discussion Draft should deal with these documentation requirements (e.g., the nature of documentation required, the role of branch accounts, the consequences of the lack of contemporaneous documentation, etc.) in detail.

4. In principle, notional expenses that are deductible in computing the income of a PE should potentially be subject to source country withholding tax and to residence country tax (if the residence country does not otherwise tax the income derived in the source country) with a credit for the source country withholding tax.

5. The implications of the Working Hypothesis for the relief of international double taxation under Article 23 of the OECD Model Convention should be addressed as part of the consideration of the Working Hypothesis.