



THE
CHARTERED
INSTITUTE OF
TAXATION

Article 7 (Business Profits) of the OECD Model Tax Convention

**Discussion Draft published by Organisation for Economic Co-Operation and
Development (OECD) on 7 July 2008
Response by The Chartered Institute of Taxation**

1. Introduction

- 1.1 The Chartered Institute of Taxation (CIOT) welcomes the opportunity to comment on the new draft of Article 7 (Business Profits) of the OECD Model Tax Convention published in July 2008.
- 1.2 We would broadly welcome the changes proposed.

2. General principles

- 2.1 The report discusses the two general principles regarding taxing permanent establishments (PEs): first, that profits of an enterprise in one state shall not be taxable in that other state unless it carries on a business via a PE, and secondly that the right to tax does not extend to profit not attributable to the PE.
- 2.2 The clarification at paragraph 11, that the other state cannot tax profit not attributable to the PE, will be welcome to international companies, as divisions often make sales via independent agents, and this clarification is helpful to ensure that those sales will not be included in a profit calculation for the PE.
- 2.3 The Commentary also makes it clear that the companies need to have clear documentation of what the PE does to avoid any misunderstanding as to what constitutes profits of the PE. This seems to us to be a reasonable requirement on businesses.
- 2.4 However, we would query the level of detail to which the Commentary now extends. It appears to us that it may be intended that the Commentary should be viewed as an extension of the Article itself, rather than merely offering a view or interpretation. In our view, whilst a Commentary can be helpful to provide further explanation on the reasons behind a certain choice of wording, or the principles driving the changes in the Article itself, it should not attempt to quasi-legislate.

3. Calculating the profit

- 3.1 Paragraphs 13, 19 and 20 indicate that general transfer pricing principles should be applied to determine how much profit is attributable to the PE which should be treated as a notional stand alone enterprise. We welcome this to the extent that it provides a transparent mechanism for attributing profit to PEs.
- 3.2 However, there is also a requirement that all dealings between the PE and other parts of the business be treated on an arm's length basis, and that adjustments be made to the terms of the transaction to make it arm's length. It should be recognised that it will be potentially very onerous to a business to ensure that every time sales are made through the PE there is documentation in place to demonstrate that it is at arm's length.
- 3.3 Paragraph 15 also indicates that, as the PE is to be treated as a separate enterprise, it may make a profit while the rest of the business does not. This seems reasonable, as a third party would not act without earning a reward for what it does, although this may not be a popular outcome with business.

4. Free capital

The concept of Free Capital is controversially addressed in the document. We do not think that there is clear agreement in this area and, accordingly, it would be best omitted.

5. Drafting of the article

- 5.1 We suggest that in paragraph 1 the word 'instead' is inserted in the final sentence, so that this reads '... the provisions of paragraph 2 may *instead* be taxed in the other State.'
- 5.2 We are concerned that some of the drafting is very wide and gives a lot of room for subjective interpretation. Examples of this are the reference to profits that a company 'might be expected to make' (paragraph 2) and to 'returns in the nature of interest' (paragraph 3). We suggest that this will not lead to clarity or a consistent approach amongst the participating States.

The Chartered Institute of Taxation
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The Chartered Institute of Taxation

The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

The CIOT's comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members' experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT's 14,000 members have the practising title of 'Chartered Tax Adviser'.