

Comments on the new Article 7, Paragraph 3 and some paragraphs of the new Commentary

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I. Proposed solutions to the issue on free capital and interest deductions

A. Introduction

Although practitioners are likely to understand by intuition what paragraph 3 is aiming at (in brief: every permanent establishment is required to have an appropriate amount of capital for which no interest deduction is allowed and the interest deduction attributed to the rest of the funding requirements, i.e. the “Liabilities”, must comply with the arm’s length principle), it is our persisting feeling that the initial wording of this paragraph as well as the examples given in the respective Commentary (paragraphs 44-46 and 57) are rather confusing. In fact, we hesitate between a desire for clarification and a proposal to replace the new Par. 3 with a more general provision, i.e. which would not be limited to the attribution of free capital and interest deductions.

In any case, even if it might be regarded as self-evident, the Commentary should clearly explain that Par. 3 of Art. 7 has no relevance as long as none of the two countries involved in the taxation of a given permanent establishment (host and home country) has adjusted the taxpayer’s interest deductions it has (symmetrically) reported in its tax returns.

B. Our understanding of the issue

« Free capital » as such is not a figure that directly tells you how much interest may be deducted by a permanent establishment. We are afraid that the present wording of Par. 3(a) gives this impression. On the right hand side of a balance sheet, besides a few equity accounts (free capital), the taxpayer reports many but not exclusively interest-bearing “Liabilities” which refer to third parties’ funding. However, its balance sheet will also show various kinds of provisions and other accounts payable for which normally no interest is due. If for analytical purposes the balance sheets of the taxpayer and its permanent establishments were “cleaned” so as to exclusively report free capital and interest-bearing funding, one would still not be automatically able to determine how much interest costs are attributable to the permanent establishments. Much will depend on the question whether treasury functions are performed within the entity to which they belong, which should be self-evident in the financial sector, and – in the absence of such functions - whether the actual overall interest costs are allocated proportionally to the various parts of the entity (as a consequence of the fungibility approach) or directly attributed to the permanent establishments to the extent that third parties’ funding was incurred for their specific business purposes (taking into consideration the thin-capitalisation approach).

While one might believe that on the basis of the fungibility approach the amount of free capital and the interest costs allocable to a given permanent establishment would invariably be clear-cut figures (no ranges) and - at the opposite - on the basis of the thin capitalisation approach the outcome would be a range of free capital and consequently a range of interest deductions, even if two countries were to apply the fungibility approach their results with respect to the same permanent establishment would in practice hardly converge. The fungibility approach requires a world-wide key to allocate the overall equity. However, while the risks or the assets will generally be the appropriate allocation key, there is no guaranty that the two countries will apply the same yardsticks with respect

to the same permanent establishment. Diverging results between the source and the home countries will logically be even more frequent where the two countries - despite their apparently common thin capitalisation approach – have recourse to different techniques to attribute interest costs (tracing, averaging of actual interest costs or a combination of both). Moreover, in the case of the thin capitalisation approach, there will invariably be a range of appropriate minimum amounts of free capital but no clear-cut answer as regards the upper limit of the range (threshold of over-capitalisation).

It is our understanding that the prerequisite for internal interest dealings is the performance of treasury functions. In such cases, the amount of free capital that derives either from the fungibility or from the thin capitalisation approach just determines to what extent no internal interest dealings would be accepted, but it does not disallow a higher amount of free capital and consequently a lower volume on internal interest dealings. We are surprised that the proposed new Commentary does not make explicit reference to Part II of the Report “Attribution of profits to Permanent Establishments”, e.g. to paragraphs 162 – 170 (Treasury functions and internal movement of funds/“interest” dealings) nor to paragraphs 194 – 196 of Part I (Determining the arm’s length price of treasury dealings). In any case, it should be said without ambiguity that all “treasury functions” performed by one part of the same entity for the business purposes of another part of that entity give rise to internal interest dealings to be examined as if they had occurred in the financial sector. Finally, it is not clear why the Commentary on Art. 7, Par. 3 does not make full reference to the paragraphs 184 – 193 of Part I of the Report on the “Attribution of profits to Permanent Establishments” (Determining the funding costs of the PE).

It is uncontroversial that the CFA has accepted two capital attribution approaches and both of them may claim the arm’s length “label”. Where necessary, priority has to be given to the method applied

by the host country but not automatically also to its determination of the interest-bearing liabilities, let alone of the deductible interest costs. The home country has still the freedom to disagree with the host country's interest deduction if it thinks that the permanent establishment is not taxed on an arm's length profit. Therefore, there is no guaranty that the tricky issues can be solved otherwise than through a MAP. We wonder whether it would not have been more efficient to say in Par. 3 (a) that the capitalisation approach applied by the host country and the amount of potentially interest-bearing liabilities indirectly deriving from the determination of free capital shall also be relevant for the taxation in the home country. This step will by itself significantly narrow the likely gap between the two countries. Not saying more than that would however leave to the home country the freedom to calculate the interest deduction in accordance with its own rules without going beyond the limits of the p.e.'s free capital and potentially interest-bearing liabilities as determined by the host country. Therefore, with respect to the interest deduction, the home country should be allowed to apply a tracing approach even though the host country has calculated the free capital by reference to the fungibility approach or it may prefer the deduction of average interest costs even though the host country has applied a thin capitalisation approach. Minor differences in the interest deduction should however, for the sake of practicability, be ignored and the result as determined by the host country should prevail; some guidance on what should be considered as a minor difference would be helpful. Should however adjustments become unavoidable in one of the two countries and supposing that – for whatever reason - Art. 23 does not automatically apply, the taxpayer will have no alternative but to request a MAP.

C. Proposal

Should paragraph 3 be kept up more or less with its present wording, then we would prefer a more realistic drafting. Paragraph 3 (a) might be amended as follows: "Where in one Contracting State, the amount of "free" capital which is used for determining the maximum amount of potentially interest-

bearing liabilities and, depending on whether treasury functions are performed or not, the amount of notional or actual interest that is deducted in computing the profits that are attributable to a permanent establishment situated in that State

..... (unchanged till the end of paragraph 3 (b).”

Paragraphs 44 and 45 should clearly explain that double taxation may have two causes: If one State allocates the total interest on a proportional basis (based on the fungibility approach) and the other State (based on the thin-capitalisation approach) attributes to the permanent establishment its interest charges borne by the permanent establishment or borne by the enterprise for the specific business purposes of that permanent establishment, the two results will nearly invariably diverge from each other. Which result and under what conditions has priority over the other result is clearly said in Art. 7 Par. 3 and in its Commentary, although in practice – for the reasons given above – even if the two countries apply the same capitalisation method conflicting opinions on what should be an arm’s length amount of free capital and/or an arm’s length interest deduction will be unavoidable. Where the two countries do not apply the same capitalisation method, the priority given to the host country’s capitalisation approach does not guarantee either that the home country will accept the interest deduction as determined by the host country on account that it does not produce an arm’s length result. In other words, either a home country applies Art. 23 and implicitly accepts the interest deduction allowed by the host country or a MAP becomes necessary. Under such circumstances our doubts on the necessity to have the proposed Art. 7 Par. 3 are growing more and more.

Paragraph 46 as such consistently reflects the principles of the new Art. 7 Par. 3. Since the first State applies a fungibility approach, it seems logical to say that its interest deduction equals a certain percentage of the overall interest paid by the enterprise, in this case 9 %. However, it is not self-evident why the deduction determined by the other State should also be measured as a percentage

of the overall interest paid by the enterprise. We think that a statement saying that the interest deduction in State R would be higher or lower (and the taxable profit lower or higher) than in State S would be more in line with the spirit of the thin capitalisation approach which - as we have been repeatedly told - does not guarantee the full deduction of the actual interest paid by the enterprise. We think that in practice the facts would normally be the other way round, i.e. the host country has often no alternative but to apply a thin capitalisation approach and the home country is more comfortable with the fungibility approach.

As to paragraph 57 we think that it would help a lot the reader if the example gave some additional information: The domestic law of State S requires a thin capitalisation approach, which explains its tracing approach. State R, it is said, has a fungibility approach. This example clearly shows that the determination of free capital is not so important; what counts is the determination of the interest deduction, which ought to be consistent with the domestic capitalisation rule. Unless State R has good arguments to sustain that the tracing approach applied by State S does not reflect an arm's length interest deduction, Art. 7 Par. 3 should apply and priority should be given to the host country's determination of deductible interest. As already expressed, we do not think that a (host) country applying a thin capitalisation approach has to bother about the percentage of the overall interest it deducts. While we disagree with the conclusion of this paragraph and prefer the application of Art. 7 Par. 3, we can only reiterate our doubts on the necessity of this provision.

II. Conflicts between the State of source and the State of residence

Art. 7(3) of the draft aims at resolving double taxation stemming from the **domestic law of both contracting States**. Specifically, if, as a result of a diverging domestic law rule, the State of source uses a method to attribute free capital to the permanent establishment which is different from the one applied by the State of residence, that latter should, for the purpose of applying Art. 23 A or B, rely on the method used by the State of source. As mentioned by Art. 7(3): *“the other State [State of residence] shall, in determining the profits attributable to the permanent establishment for the purposes of Art. 23, use the amount of “free” capital derived from the application of the capital attribution approach used by the first-mentioned State [State of source]”*.

In our opinion, the endorsement by the State of residence of the view of the State of source for the purpose of applying art 23 is **fully consistent with the principles governing the interpretation of double taxation conventions**.

This being said, it may be argued that following the view of the State of source for the purpose of applying Art. 23 A or B already flows from a proper interpretation of these provisions. Indeed, if the domestic law method used by the State of source complies with the arm’s length principle, it may be argued that the State of source has determined the profits attributable to the permanent establishment *“in accordance with the provisions of this Convention”* (Art. 23 A and B) and, therefore, that double taxation relief should be granted by the State of residence.

In this respect, it is interesting to observe that the interpretation of the term “*in accordance with the provisions of the conventions*” has also been dealt with by the OECD in the context of **conflicts of qualification of income between the State of source and the State of residence**. The OECD recommends that these conflicts, which are equally exclusively rooted in diverging domestic law rules, **be resolved by having the State of residence follow the characterization adopted by the State of source** (see OECD Commentary para. 32.1 et seq ad Art. 23). Yet, no express provision has been included in the OECD MC reach this conclusion. Rather, this recommendation, which is to be approved and which was included in the 2000 update of the OECD Commentary, is merely based on the correct interpretation of Art. 23 A and B (see thereupon inter alia Danon, R/Salome, H: *Conflicts of Qualification*”, in : International Tax Review (Kluwer), 2003, vol. 31, pp. 190 to 196)

Therefore, it can be questioned whether an express provision is really needed to solve the conflict addressed by Art. 7(3).
