International

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Discussion Draft on a New Art. 7 of the OECD Model Convention

This article provides an overview of the discussion draft on a new Art. 7 of the OECD Model Tax Convention (OECD Model), which was released in July 2008. It describes the background to the discussion draft, the new Art. 7 and its Commentary, and the proposed consequential changes to other parts of the OECD Model. It is expected that, once finalized, the proposed changes will be included in the next update of the OECD Model.

1. Introduction

This article will provide an overview of the discussion draft on a new Art. 7 of the OECD Model Tax Convention (OECD Model), which was released in July 2008.[1] It describes the background to the discussion draft, the new Art. 7 and its Commentary, and the proposed consequential changes to other parts of the OECD Model. It is expected that, once finalized, the proposed changes will be included in the next update of the OECD Model.

The proposed text for a new Article 7 is as follows:

> **Article 7**
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> **Business Profits**
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> 1. 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.
>
> [*Existing paragraph 1*: 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.]
>
> 2. 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 it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, 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.
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> [*Existing paragraph* 2: 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 the profits which it might be expected to make if it were a distinct and separate 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.]
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> [*The existing paragraphs 3, 4, 5 and 6 are deleted:*
>
> ~~3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.~~
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> ~~4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.~~
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> ~~5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.~~
>
> ~~6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.~~
>
> 3. Where
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> a) in one Contracting State, the amount of "free" capital that is used for determining the interest that is deducted in computing the profits that are attributable to a permanent establishment situated in that State of an enterprise of the other Contracting State is determined using a method of attributing capital to the permanent establishment that is provided by the domestic law of the first-mentioned State and both States agree that the application of that method produces an arm's length result in conformity with paragraph 2 in that case; and
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> b) that method is different from the method provided by the domestic law of the other State and used by that State to attribute capital to the permanent establishment and, as a result of this difference, part of the profits of the enterprise are charged to tax in both Contracting States and, in the absence of this paragraph, Article 23 would not apply to eliminate the double taxation of these profits,
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> the other State shall, in determining the profits attributable to the permanent establishment for the purposes of Article 23, use the amount of "free" capital derived from the application of the capital attribution approach used by the first-mentioned State. For the purposes of this paragraph, "free" capital means capital

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1. Discussion Draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention. See www.oecd.org/dataoecd/37/8/40974117.pdf.

that does not give rise to a return in the nature of interest that is deductible in the first-mentioned State.

[*New.*]

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.

[*Identical to paragraph 7 of the existing Article.*][2]

2. Background

The attribution of profits to permanent establishments (PEs) has always been a subject of discussion. In order to achieve greater consensus in this area, and considering that the OECD Transfer Pricing Guidelines (the OECD Guidelines) were approved in 1995, after the latest relevant revision of the OECD Commentary on Art. 7, the OECD decided to address the issue. In 2001, it released Part I of a discussion draft on the attribution of profits to PEs. In 2003, discussion drafts of Part II (Banks) and Part III (Global Trading) were also published for comment. A revised draft version of Parts I-III was issued in 2004, while Part IV, which deals with PEs of insurance enterprises, was released for the first time in draft form in June 2005. In December 2006, the OECD Committee on Fiscal Affairs (CFA) released an advance copy of the proposed final versions of Parts I, II and III, along with a cover note containing an update on the status of the project. A revised draft of Part IV of the report, dealing with the insurance industry, was published for comment in August 2007. The CFA approved the final, four-part Report on the Attribution of Profits to Permanent Establishments (the Report) on 24 June 2008. This final Report replaces all previous drafts, including the interim version of Parts I-III published in December 2006 and the discussion draft of Part IV published in August 2007.

In considering how to implement the Authorized OECD Approach to attribute profits to PEs (AOA) under the OECD Model, the CFA recognized by 2006 that there were differences between some of the conclusions of the Report and the interpretation of Art. 7 given in the then-existing Commentary. The CFA therefore decided that it would be best to adopt a two-track implementation strategy. In order to provide improved certainty for the interpretation of existing treaties based on the current text of Art. 7, the CFA decided that a revised Commentary on the current version of Art. 7 should be prepared, to take into account only those conclusions of the Report that did not conflict with the existing Commentary.[3] The CFA also decided that the second track of the implementation package should consist in a new version of Art. 7 and its Commentary which would implement in full the conclusions of the Report and which would serve as the basis for the negotiation of new treaties.

Through its Recommendation of 17 July 2008, the OECD Council proposed to the governments of Member countries that:

- their tax authorities follow, when applying the provisions of their bilateral income tax treaties that are drafted on the basis of Art. 7 of the OECD Model, the guidance in the 2008 Report to the extent that its conclusions do not conflict with the 2008 Commentary on Art. 7; and
- their tax authorities encourage taxpayers to follow the guidance in the 2008 Report when applying the provisions of income tax treaties that are drafted on the basis of Art. 7 of the OECD Model and, to that end, that they give the Report publicity in their country and have it translated, where necessary, into their national language(s).

In addition, the OECD Council instructed the CFA to continue its work on the implementation of the conclusions of the Report so as to be in a position to include in the next update of the OECD Model a new version of Art. 7 that will allow the application of the full conclusions of the Report. The discussion draft on such a new version of Art. 7 had been published for comments on 7 July 2008.

3. The Proposed New Art. 7

3.1. In general

The draft new Art. 7 is made up of four paragraphs which implement the AOA in full. Compared to the existing article, Para. 1 remains very similar; Para. 2 has been amended to avoid some problems of interpretation that may arise under the existing version; Paras. 3, 4, 5 and 6 of the existing article have been deleted while Para. 7 (renumbered as Para. 4) remains the same; and finally, a new paragraph (Para. 3 in the draft new article) has been included to minimize the risk of double taxation in certain areas.

3.2. Para. 1: The main rule

Para. 1 of the proposed new Art. 7 codifies the international tax principle under which business profits are be taxable only in the state of residence of the person carrying on the enterprise, unless that person maintains a PE in the other state. If this is the case, the other state may tax the profits which, in accordance with the rules contained in Para. 2 of the new Art. 7, are attributable to the PE.

The slight change in the wording compared to the existing Art. 7 is meant to avoid misinterpretations of the provision. For example, the words "only so much of them" in Para. 1 of the existing Art. 7 could be read as meaning that until the enterprise has realized profits, the PE state may not tax them; or that if the enterprise is in a loss position, no profits may be taxed in the PE state. By making reference to Para. 2 and by deleting the reference to the profits of the enterprise, the provision intends to make fully clear that it does not seek to allocate the overall profits of the enterprise to the PE and its other parts

2. Discussion draft on a new Art. 7, at 3-4.
3. This revised Commentary has been included in the 2008 update of the OECD Model. For an overview, see M. Bennett, "The Attribution of Profits to Permanent Establishments: the 2008 Commentary on Art. 7 of the OECD Model Convention", 48 *European Taxation* 9 (2008), at 467.

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but, instead, it requires that the profits attributable to the PE be determined as if it were a separate and independent enterprise. This means that profits may be attributed to a PE even when the enterprise of which it is a part has not realized any profits or is in a loss situation. Conversely, it may be the case that no profits are attributable to a PE even though the enterprise as a whole has made profits.

As under the Commentary to the existing article, the draft Commentary also clarifies that the provision prevents the application of the force of attraction principle applicable under the domestic law of some countries.[4] According to this principle, when a non-resident maintains a PE in a state, that state may also tax (certain) profits that are not attributable to the PE. In other words, some states consider that as soon as a PE exists in their territory, all the profits derived by the non-resident enterprise from sources in that territory are taxable therein, whether derived through the PE or not. The draft Commentary makes clear that only the profits which are attributable to the PE may be taxed in the PE state, therefore rejecting the force of attraction principle.

The draft Commentary reiterates the clarification (contained also in the Commentary to the existing article) according to which the provision does not prevent the application of domestic controlled foreign company (CFC) rules. Under these rules, generally a contracting state taxes its resident taxpayers on income derived by foreign entities controlled by them. In fact, the possibility of exercising control over the foreign entity allows the resident taxpayer to channel income to the foreign entity and to defer the distribution of the profits derived by the non-resident entity and thus to obtain a tax deferral that in certain cases can be indefinite. The draft Commentary clarifies that these rules are not in conflict with Art. 7 because the contracting state applying these CFC rules is taxing its own resident taxpayers, even though such tax may be computed by reference to the part of the profits of an enterprise carried on by a resident of the other contracting state.[5]

3.3. Para. 2: Application of the AOA in full

3.3.1. The functionally separate entity approach

Para. 2 of the draft new Art. 7 informs the application of the main rule contained in Para. 1 by specifying how to determine the profits that are attributable to a PE. The paragraph incorporates the so-called "functionally separate entity approach", under which the profits to be attributed to a PE are the profits it might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the PE and through the other parts of the enterprise. In addition, the paragraph contains an express reference to the dealings between the PE and the other parts of the enterprise.

The application of this approach is mandated to both the source state, for purposes of determining the profits that may be taxed in that state in accordance with Art. 7, and the residence state, for purposes of determining the profits on which relief must be granted under Art. 23 of the treaty. This is highlighted by the use of the term "in each Contracting State" and by the opening sentence of the paragraph, which makes reference to both Arts. 7 and 23.

3.3.2. A two-step approach

Para. 2 expressly incorporates the two-step approach contained in the AOA. Under this approach, first a functional and factual analysis must be performed in order to hypothesize the PE as a separate and independent enterprise, undertaking functions, owning assets, assuming risks and entering into dealings with the enterprise of which it is a part, and into transactions with other related and unrelated enterprises. Secondly, the profits of the hypothesized separate and independent enterprise must be determined by applying the OECD Guidelines, either directly or by analogy.

The functional and factual analysis under step one draws upon methodologies familiar to the comparability analysis of the OECD Guidelines in situations involving associated enterprises. However, different to the case of associated enterprises, in a PE context there is only one legal entity and there cannot be binding contracts within the same legal entity. The pragmatic solution chosen in the AOA is to look at the functions carried out by the people working for the enterprise, the so-called "people functions". People functions can range from support or ancillary functions to significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks.

Accordingly, the AOA attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE.[6] The AOA also sets forth approaches to attribute capital, including "free" capital (i.e. funding that does not give rise to a tax-deductible return in the nature of interest), to the PE to support the functions it performs, the risks assumed and assets attributed to it, as well as criteria for the recognition and characterization of dealings between the PE and other parts of the enterprise to which it belongs.

4. Para. 10 Commentary on the proposed new Art. 7.
5. Para. 12 Commentary on the proposed new Art. 7.
6. In the case of tangible assets, there was a broad consensus among the OECD member countries for applying use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. In other words, tangible assets are generally to be attributed based on where they are physically located and therefore used.

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Once a PE has been hypothesized as a separate and independent enterprise, the dealings that have been recognized and characterized for tax purposes should be priced on an arm's length basis. In order to do so, a comparison of dealings between the PE and the enterprise of which it is a part with transactions between independent enterprises must be made. The arm's length remuneration of dealings should then be determined by applying the traditional transaction methods (comparable uncontrolled price, resale price and cost-plus) or the transactional profit methods (profit split and transactional net margin method).

The arm's length principle applies also to transactions between the enterprise of which the PE is a part and other associated enterprises, when the transaction affects the profits attributable to the PE. This is now made fully clear by the use of the term "separate and independent" enterprise in the text of Para. 2, which indicates that the arm's length principle must be applied to both dealings and controlled transactions which affect the amount of profits attributable to a PE. This is the case when e.g. widgets are purchased from an associated enterprise in State *C* by a PE in State *A* of an enterprise of State *B*. In such a case, if the price agreed between the two enterprises is not at arm's length, Art. 7 Para. 2 of the treaty between State *A* and *B* requires that, for the purpose of computing the profits attributable to the PE, the price be adjusted to reflect the conditions of a similar transaction between independent enterprises.

3.3.3. Recognition of dealings

Para. 2 makes an express reference to dealings, and this is probably one of the most notable novelties of the article. In order for a dealing to be recognized for purposes of Art. 7, a threshold needs to be passed. According to the draft Commentary,[7] the functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits.

Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding the application of the AOA. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do, the structure as presented in the taxpayer's documentation does not practically impede the tax authorities from determining an appropriate transfer price; and
- the dealing presented in the taxpayer's documentation does not violate the principles of the AOA. If these conditions are met, a dealing will be recognized and characterized for purposes of attributing profits to the PE.

One point that the draft Commentary specifies is that the recognition and characterization of dealings applies only for purposes of Art. 7, and it does not create notional income for purposes of other articles of the treaty.[8] For example, if a dealing in the form of a loan from the head office to the PE is hypothesized and priced at arm's length under the AOA, a notional interest deduction will have to be allocated to the PE for purposes of determining the profits attributable to it. A question may therefore arise regarding whether the PE state may tax the notional interest in the hands of the non-resident enterprise. Where notional payments are not taxable under the domestic law of the PE state, no issue arises. In fact, it is a general principle that tax treaties only limit the taxing rights under domestic law and that they cannot create additional tax liabilities. Where, however, notional payments are taxable under the domestic law of the PE state, the question is whether the treaty would limit the exercise of such a taxing right. The draft Commentary states that this would be the case because (e.g. in the case of a notional loan) Art. 11 would not be applicable and therefore Art. 7 would prevent the PE state from taxing the notional payment. As a consequence, under treaties based on the OECD Model, and containing the new Art. 7, the PE state would have to allocate a notional interest charge to the PE without having the possibility of taxing it in the hands of the notional recipient.

The draft Commentary recognizes, however, the potential existence of a different position from a policy perspective. In the case of actual payments between separate enterprises, deductions are allowed by the source state, but the source state may also retain certain rights to tax the payment in the hands of the actual recipient. Reasoning from a theory that would treat PEs, as far as possible, the same as subsidiaries, some states consider that notional payments from a PE to another part of the enterprise should be treated, also for purposes of other articles of the Convention, in the same manner as payments that would be made by e.g. a subsidiary resident in one contracting state to its parent company resident in the other. The draft Commentary therefore suggests that states wishing to preserve any ability they may have under their domestic law to achieve this result should include in their tax treaties alternative provisions according to which charges for internal dealings should also be recognized for purposes of other relevant articles of the treaty and not only for purposes of Art. 7.[9] It goes

7. Para. 23 Commentary on the proposed new Art. 7.
8. Para. 25 Commentary on the proposed new Art. 7.
9. Para. 26 Commentary on the proposed new Art. 7.

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without saying that if the treaty does not contain such a deeming provision for purposes of other articles of the treaty, the PE state will not be allowed to tax the notional income.

3.3.4. Treatment of expenses

Para. 3 of the existing Art. 7 has been deleted from the new proposed article for a number of reasons. First, it could be interpreted as an exception to the arm's length principle contained in Para. 2, i.e. as limiting the deductibility of certain charges. In addition, it is not considered to be needed because the obligation to allocate expenses to a PE stems from the application of the separate entity approach and is therefore already mandated by Para. 2 of the article. In other words, it was felt that a provision such as that contained in Para. 3 of the existing article did not add much to the principles of Para. 2, and it could therefore be deleted. For these reasons, Para. 3 of the current Art. 7 has not been reproduced in the proposed new article and the treatment of expenses is covered by Para. 2 of the proposed new article.

This entails that, if a dealing is recognized between the PE and another part of the enterprise (e.g. in the form of a sale, lease, service or cost-sharing agreement) which would give rise to an expense if occurring between independent entities, an arm's length charge must be allocated to the PE. In cases where no dealing is recognized, expenses incurred by the enterprise of which the PE is a part which are nevertheless related to the activities of the PE must in any case be taken into account for purposes of determining the profits attributable to it. In this respect, the Commentary contains the example of a construction worker hired and paid locally to work exclusively on a construction site that constitutes a PE of a foreign enterprise.[10] In this case, the employee's salary would constitute an expense to be allocated to the PE for purposes of Art. 7. Basically, under Art. 7, Para. 2, all relevant expenses must be allocated to the PE, this being done either through the deduction of all or part of the expense actually incurred to a third party (where no intra-entity dealing is recognized) or through the deduction of an arm's length charge for an intra-entity notional expense (where a dealing is recognized).

Once the relevant expenses have been allocated to the PE, the question of whether they are deductible in computing the taxable income of the non-resident enterprise is then a question of the domestic law of the PE state. For example, where certain expenses (e.g. public relations expenses) have been properly allocated to the PE under the principles of Art. 7, but they are not deductible under the domestic law of the state where the PE is situated, nothing in Art. 7 obliges the PE state to allow such a deduction. However, this should not be interpreted as a blank check to the PE state to deny the deductibility of certain expenses that have been properly allocated to the PE. In fact, the PE state is bound to respect both Art. 7 and Art. 24, Para. 3. For example, a state's domestic law that would disallow the deductibility of expenses incurred abroad or not solely for the purposes of the PE located in its jurisdiction would contravene the treaty, and should therefore be overridden by it.

3.4. Para. 3: Minimizing the risk of double taxation

3.4.1. Relationship between Arts. 7 and 23

Para. 2 of Art. 7 makes clear that its directives apply to both the PE state and the residence state. This will in most cases ensure that double taxation is eliminated, in the sense that the amount of profits attributed to a PE by both the PE state and the residence state will be determined through the application of the same principles. This applies despite the likely existence of domestic law differences in the computation of the taxable income, which is not covered by the provisions of Art. 7. In other words, Art. 7 is concerned with the allocation of revenues and expenses to a PE. Whether and how these are taken into account for purposes of determining the taxable income of the non-resident taxpayer operating through a PE is then a question of domestic law.

Very importantly, the Commentary to proposed new Art. 7, Para. 3 also states that insofar as each state agrees that the taxpayer has determined the profits attributable to the PE in conformity with Para. 2 and with its domestic law, it should refrain from adjusting the profits on a different arm's length basis.[11] In other words, it states that if the taxpayer has chosen an arm's length point in the range, and that point complies with each state's domestic law rules for the computation of taxable income attributable to the PE, states should not make an adjustment claiming that a different point in the arm's length range is more appropriate. This is broadly consistent with what is stated in the OECD Guidelines,[12] and it should avoid controversies in a wide range of cases.

There may, however, still be cases where, despite the fact that both states are taxing in accordance with the provisions of the Convention, double taxation may arise. One such case relates to the determination of the free capital of the PE, as the AOA recognizes more than one authorized approach for making that determination. In order to overcome uncertainty and ensure that double taxation is effectively relieved, the proposed new article contains a provision regarding the determination of the free capital of the PE in Para. 3.

In addition, double taxation may also arise in cases where the contracting states price a dealing differently, but both are within an accepted arm's length range. Alternative provisions roughly based on Art. 9, Para. 2 are therefore inserted in the Commentary to the new article for states wishing to use them. The Commentary to the draft article notes that these provisions only provide additional protection against double taxation and that their insertion does not imply that double taxation will

10. Para. 30 Commentary on the proposed new Art. 7.
11. Para. 41 Commentary on the proposed new Art. 7.
12. Para. 1.48 OECD Guidelines.

be accepted when they are not included in the relevant treaty. Indeed, the interaction between Art. 7 and Art. 23 will in many cases ensure that double taxation is avoided. In addition, whenever the taxpayer considers that the actions of one or both contracting states result or will result in taxation not in accordance with the Convention, it may request the initiation of a mutual agreement procedure (and that the issue be referred to arbitration under Para. 5 of Art. 25 if no timely agreement is reached by the competent authorities).

3.4.2. Symmetry in the determination of free capital

Any enterprise requires a certain amount of funding, made up of free capital and interest-bearing debt. Under the AOA, a PE needs to have an arm's length amount of free capital for tax purposes, irrespective of whether any such capital is formally allotted to the PE. The starting point for the attribution of capital is that under the arm's length principle, a PE should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. Generally, under the AOA, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole – an exception being where for regulatory reasons a certain part of the enterprise's capital is not available to meet liabilities incurred elsewhere in the enterprise.

The AOA describes a number of different possible approaches to attributing free capital to a PE, recognizing that the particular facts and circumstances of each case are likely to generate a range of arm's length results for the free capital attributable to a PE. Different methods adopt different starting points for determining the amount of free capital attributable to a PE. In general terms, these methods either put more emphasis on the actual structure of the enterprise of which the PE is a part (so-called capital allocation approach), or alternatively, on the capital structures of comparable independent enterprises (so-called thin capitalization approach). The AOA also mentions a regulatory minimum capital requirement approach, but rejects it as an authorized approach and accepts it only as a domestic law safe harbour.

Given the existence of more than one accepted methods to attribute free capital to a PE, an issue arises when the residence state and the PE state apply different methods, as this may lead to double taxation. Concerns were expressed that this risk could apply even where there is agreement between the two states that the PE state's method has produced an arm's length result. In order to overcome this problem, Art. 7, Para. 3 codifies a commitment to avoid double taxation in such cases. The solution given is that the residence state of the enterprise will accept, in computing the income attributable to the PE for double taxation relief purposes, the quantum of free capital derived from the application of the approach used by the PE state. This ensures that both contracting states will take into account the same amount of free capital for purposes of determining the profits attributable to the PE.

However, the residence state is obliged to accept the quantum of free capital as determined by the PE state only if two conditions are cumulatively met. First, the difference in capital attribution between the PE state and the residence state must result from the application of different domestic law capital attribution methods. Second, there must be agreement that the PE state has used an authorized approach to attribute capital and that approach produces a result consistent with the arm's length principle in that specific case. If these conditions are met, Para. 3 requires deference by the residence state to the method used by the PE state to determine the free capital of the PE.

The text of Para. 3 makes clear that it applies only when part of the profits of the enterprise are charged to tax in both contracting states and Art. 23 does not eliminate that double taxation. This means that if double taxation is already avoided, because of e.g. a difference in the tax rates between the two contracting states or because of the way in which double taxation relief is granted under the domestic law of the residence state, the taxpayer may not claim the benefits of the provision. Assume, for example, that the residence state levies tax at a rate of 40% and relieves double taxation through the credit method, while the PE state levies tax at a rate of 10%. It may be possible that even if the free capital of the PE is determined differently by the two contracting states, the PE state tax levied on the profits attributable to the PE will still be creditable against the residence state tax on the same income, due to the rate differential. In such a case, Para. 3 of the proposed new Art. 7 would not apply, as double taxation would already have been eliminated.

3.4.3. Alternative provisions on corresponding adjustments

The Commentary to the proposed new Art. 7 also contains two alternative provisions which provide for a corresponding adjustment mechanism to avoid potential risks of double taxation in certain cases. These provisions aim at giving certainty to taxpayers that double taxation will be avoided, even if both contracting states are arguably taxing in accordance with the provisions of the Convention. This may be the case when an adjustment is made by one state to a non-arm's length position reported by the taxpayer, and the other state, although it agrees that the adjustment is within an arm's length range, considers it more appropriate to make the adjustment to a different point in the range. In addition, the alternative provisions could also be relevant to the case where the domestic laws of the contracting states require the taxpayer to report different prices for a dealing, both of which are arm's length.

The first alternative operates in a manner very similar to Art. 9, Para. 2.[13] In the case of an adjustment made (or deemed to be made) by one of the contracting states to the profits attributable to the PE, it obliges the other con-

13. Para. 53 Commentary on the proposed new Art. 7.

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tracting state to make a corresponding adjustment, provided that the latter state considers that the adjusted profits correctly reflect what the profits would have been if the PE's dealings had been transactions at arm's length and thus that the primary adjustment is justified both in principle and as regards the amount. This obligation is imposed on both states if the domestic law of one or both states requires the taxpayer to use different arm's length prices or methods in each state. The existence of this obligation even where there is no adjustment to the taxpayer's reporting position therefore entitles the taxpayer to request, if necessary, that the issue be resolved through the mutual agreement procedure and also through arbitration if the competent authorities are not able to reach a timely mutual agreement. Similarly, if there is a dispute between the contracting states over the amount and character of the adjustment, the taxpayer will be able to request, if necessary, the initiation of a mutual agreement procedure under Para. 1 of Art. 25, and request that the issue on which there is no agreement be remitted to arbitration under Para. 5 of Art. 25, if necessary.

The second alternative provision included in the Commentary to the proposed new Art. 7 is similar to the first one, but contains some important differences.[14] Under the second alternative provision, a corresponding adjustment will always have to be made through the mutual agreement procedure, even where the state that did not make the primary adjustment considers it to be at arm's length. In other words, the provision would always give the possibility for a state to negotiate with the other state regarding what is the most appropriate arm's length price or method. Importantly, however, as this second alternative provisions creates an affirmative obligation to reach mutual agreement, then where no agreement is reached, both contracting states will be in violation of their treaty obligation and the taxpayer may request that the issue be remitted to arbitration under Para. 5 of Art. 25.

Importantly, as in the case of Para. 3 of the proposed new Art. 7 in relation to the determination of the PE's free capital, both alternative provisions apply only if the same profits have been charged to tax in both states, and only to the extent necessary to avoid double taxation. This means that if double taxation is already avoided (because of e.g. the application of Art. 23 or of Para. 3 of the proposed new Art. 7, or differences in domestic law), there is no obligation under these alternative provisions to make the corresponding adjustment.

3.5. Para. 4: Relationship with other articles

Para. 4 of the proposed new Art. 7 is identical to Para. 7 of the existing Art. 7. It sets a priority rule under which when an item of income is also covered by other articles of the treaty, these articles will have priority over Art. 7. This provision is needed because the term "profits" has a broad meaning and generally covers all income derived from the exercise of a business activity.

3.6. Deletion of other paragraphs

The proposed new Art. 7 does not contain Paras. 3, 4, 5 and 6 of the existing article. The reasons for the deletion of Para. 3 have been outlined in 3.3.4.

As regards Para. 4 of the existing article, this paragraph allows the calculation of the profits attributable to a PE on the basis of an apportionment method, provided that (1) its application is customary in a contracting state and (2) the result is in accordance with the principles of Art. 7. The Commentary to the proposed new Art. 7 clarifies that it was decided to delete the paragraph because its application had become very exceptional and because of concerns that it was very difficult to ensure that the result of its application would be in accordance with the arm's length principle.[15]

Para. 5 of the existing article provides that profits must be determined by the same method year by year unless there is good and sufficient reason to the contrary. The paragraph is no longer needed because there is now only one accepted method to attribute profits to PEs, namely the functionally separate entity approach.[16]

Finally, the discussion draft also proposes the deletion of Para. 6 of the current Art. 7.[17] This paragraph stated that no profits will be attributed to a PE by reason of the mere purchase of goods or merchandise for the enterprise. This rule is not consistent with the arm's length principle, as in similar circumstances an independent enterprise purchasing goods or merchandise for someone else would be remunerated at arm's length for its services. As a consequence, it was decided to delete Para. 6 from the proposed new Art. 7.

4. Consequential Changes to Other Articles of the OECD Model

The discussion draft contains a number of consequential changes to the Commentary on other articles of the OECD Model. For example, minor changes are proposed in relation to the Introduction to the OECD Model and to the Commentary on Arts. 5 and 26. Other changes are proposed in relation to Arts. 8, 10, 11, 12, 13, 15, 21, 22 and 24.

With regard to Art. 8, the draft changes clarify that where Art. 8 applies, only the state where the place of effective management of the enterprise is situated may tax the profits derived from the international transport activities, even if there is a PE in the other contracting state. This means that income and expenses related to these activities will not be taken into account for purposes of determining the profits attributable to the PE.[18] In addition, another change has been made to clarify that

14. Para. 67 Commentary on the proposed new Art. 7.
15. Para. 37 Commentary on the proposed new Art. 7.
16. Para. 38 Commentary on the proposed new Art. 7.
17. Para. 39 Commentary on the proposed new Art. 7.
18. Para. 20 Commentary on Art. 8.

accounts will be relied upon only when they reflect the functions performed through the PE.[19]

With regard to Arts. 10, 11, 12, 13, 21 and 22, changes have been proposed in order to clarify the relationship between the expressions "effectively connected" and "forming part of the business property of" on the one hand, and "attributable" on the other. The expressions "effectively connected" and "forming part of the business property of" make reference to the assets, while "attributable" refers to the income generated by these assets. The draft changes state that these expressions convey the same concept, which is that an asset is effectively connected with (or forms part of the business property of) a permanent establishment if the economic ownership of the asset is allocated to the PE under the AOA; this indicates that assets may not be allocated to a PE simply because they are recorded in the accounts of the PE.[20] In addition, a special clarification, which refers to Part IV of the Report, is inserted in relation to the allocation of assets within an insurance enterprise.[21]

With regard to Art. 15, the draft changes relate to the case where an employee of an enterprise of a contracting state renders services for the benefit of the enterprise's PE in the other contracting state. In such a case, one possibility is that a dealing in the form of a provision of services to the PE (e.g. by the home office) should be hypothesized, with the consequential allocation to the PE of an arm's length service charge. Another possibility is that no such dealing is hypothesized because of the specific facts and circumstances, in which case part of the salary paid to the employee will have to be directly allocated to the PE. The draft changes clarify that in both cases the remuneration of the employee must be considered as "borne by" the PE for purposes of Art. 15.[22] This is so even in the case of a notional service agreement because the fiction applies only for purposes of determining the profits attributable to the PE under Arts. 7 and 23, and not for purposes of the other articles of the treaty. As a result, Art. 15, Para. 2 will not protect the employee from taxation in the PE state on his or her employment income earned there.

With regard to Art. 24, the PE non-discrimination clause requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities. The draft changes clarify that rules which determine the profits attributable to a PE as if it were a separate and independent enterprise cannot be considered to violate Para. 3 of Art. 24, which is based on the same principle.[23] The clarification is particularly relevant with regard to the recognition and taxation of dealings between different parts of the same enterprise.

5. Conclusion

The discussion draft on a new Art. 7 is part of the last phase of the long-lasting OECD project on the attribution of profits to PEs. Once it is finalized and inserted in the OECD Model, it will have the effect of making some language in the Report (i.e. language that refers to deleted provisions of the former Art. 7) obsolete. There will therefore likely be a need to revise the Report to delete all the parts that are not relevant in relation to the new Art. 7, such as those suggesting the deletion of certain paragraphs of Art. 7. At that stage the policy work will be considered as completed, and it is anticipated that countries will begin to include the new Art. 7 in their treaties. Under both the existing and the new treaties, the big challenge will be the concrete application of the guidance by taxpayers and tax authorities. In a period of economic downturn, and particularly because of the extraordinary losses suffered in the financial industry, it will be vital for all the stakeholders to approach problems in a reasonable manner, on the basis of internationally agreed principles. Hopefully, the AOA and its implementation package will help to achieve that goal.

19. Para. 21 Commentary on Art. 8.
20. Paras. 32 and 32.1 Commentary on Art. 10; Paras. 25 and 25.1 Commentary on Art. 11; Paras. 21 and 21.1 Commentary on Art. 12; Para. 27.1 Commentary on Art. 13; Paras. 5.1 and 6 Commentary on Art. 21; Para. 3.1 Commentary on Art. 22.
21. Para. 32.2 Commentary on Art. 10; Para. 25.2 Commentary on Art. 11; Para. 21.2 Commentary on Art. 12; Para. 27.2 Commentary on Art. 13; Para. 5.2 Commentary on Art. 21; Para. 3.2 Commentary on Art. 22.
22. Para. 7.2 Commentary on Art. 15.
23. Para. 20 Commentary on Art. 24.

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