

OECD RESPONDS TO PUBLIC COMMENTS ON DISCUSSION DRAFT ON ATTRIBUTING PROFITS TO A PERMANENT ESTABLISHMENT

By John Neighbour,

*Head of Tax Treaty, Transfer Pricing and Financial Transaction (TTP) Division,
OECD Centre for Tax Policy and Administration¹*

On 8 February the OECD published on its website (www.oecd.org/daf/ctpa/tp) a discussion draft on attributing profits to a permanent establishment under Article 7 of the OECD Model Tax Convention. The purpose of releasing this discussion draft was to solicit comments from the public on the detailed and fundamental review of Article 7 in the discussion draft. Comments were requested by 1 July, although the deadline was extended to 4 September following requests for more time from a number of potential commentators.

To date 25 comments have been received, the last in early October. We are in the process of obtaining the permission of the authors of the public comments to display the comments on our website. This process is expected to be completed by 30 November. This article is divided into two parts. The first part gives some brief background on the discussion draft. The second part outlines the proposed process for handling the public comments and taking forward work in this important and complex area.

Background

The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD and non-OECD countries.

¹ The views in this Article are those of the author and should not be represented as the positions of the OECD or any of its Member governments.

There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a consensus position regarding the interpretation and practical application of Article 7. As a first step in establishing a consensus position, a working hypothesis (WH) has been developed as to the preferred approach for attributing profits to a PE under Article 7. This approach builds upon developments since the last revision of the Model Commentary on Article 7 in March 1994², especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9.

The basis for the development of the WH is to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise can be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention is to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

To meet the policy goals described above, the WH has been tested by considering how it applies in practice to attribute profits both to PEs in general and, in particular, to PEs of businesses operating in the financial sector, where trading through a PE is widespread. The discussion draft contains the results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II). Testing is still underway for PEs of insurance companies and enterprises undertaking global trading of financial products. For more information on how to apply the working hypothesis to a PE involved in e-commerce transactions, readers are referred to the discussion paper (www.oecd.org/daf/ctpa/ec) from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (BP TAG)

The process of testing the WH is not finished and there is not yet a consensus on how the WH would be applied in practice in certain situations. The WH would also be revised in the light of any particular problems that emerge from the testing and consultation process. In short, it is hoped that the process of public consultation will assist in developing a consensus position regarding the interpretation and practical application of Article 7.

Responding to the public comments and taking the work forward

² This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments".

The discussion draft has more than fulfilled its objective of attracting public comments. Indeed, the 25 comments received were of exceptional quality and amount to several hundred pages of thought provoking analysis and comment. I would like to put on record our appreciation of the considerable effort that the contributors obviously devoted to their responses. The Chair of Working Party No. 6, David Grecian, has already written to thank the contributors personally for their input.

In terms of Part I of the Discussion Draft (attributing profits to a PE in general), the comments were generally positive about the goals of the project, the need for a consensus to take into account changes in ways of doing business and the idea of greater conformity between the taxation of branches and subsidiaries. There also was general support for using, by analogy, guidance from the OECD Transfer Pricing Guidelines to apply the arm's length principle of Article 7. Some commentators did however disagree with the premise on which the Working Hypothesis (WH) was based. Concerns were also raised as to the practicality of applying the WH in specific situations.

Concerns as to the practicality of the WH were expressed particularly in relation to the comments on Part II of the Discussion Draft (attributing profits to a PE of a bank). Most attention was naturally focused on the approach to attributing capital to a bank PE. Most commentators expressed reservations about the ability to apply in practice the regulatory approach to allocating capital that was advocated by the majority of countries in the discussion draft, especially in the light of recent developments from the Basel Committee on Bank Supervision designed to improve the internationally accepted regulatory standards for capital adequacy. Clearly, more work is needed on this important and difficult area. Some comments also demonstrated a reluctance to have to apply the disciplines of the OECD Transfer Pricing Guidelines to branches of financial sector businesses.

The dialogue with both the business community and non-OECD governments has already commenced. There have already been a number of informal contacts between the OECD and business and the OECD and non-OECD governments through conferences, workshops etc. This informal dialogue has not been confined to the issues covered by the discussion drafts but has also helped to inform the testing of the WH also underway for PEs of global trading and insurance enterprises. On a more formal basis the attribution of profit to a PE was one of the topics for the consultation between Working Party No. 6 and the BIAC held in London in April this year. Business supported the general approach taken by these papers and welcomed the opportunity to comment constructively on the drafts and the desire of OECD countries to reach a consensus on these difficult issues.

This topic was also the subject of the opening plenary session of the 2001 Global Forum on Taxation Meeting on the Practical Application of Tax Treaties and Transfer Pricing. This proved to be a truly global policy forum for dialogue on key international tax issues, with a wide attendance of about 200 participants representing 84 economies (OECD and non-OECD) and 9

international organisations. The OECD work was generally well received by participants from non-OECD economies and they very much appreciated the opportunity to influence the ongoing work in this area before it is finalised. Non-OECD economies were exhorted to provide comments on the draft by 30 November.

Due to the number and diversity of the comments received from different organisations, the OECD has decided that the most effective way of continuing the dialogue is to organise a public consultation with representatives from the organisations that commented on the discussion draft. We intend to discuss comments on both Part I and II of the report but owing to the greater number of comments received we will spend most time discussing the comments on Part II of the report (Special Considerations For The Application Of The Working Hypothesis To Permanent Establishments Of Banks).

In order to give the OECD government representatives time to adequately review and consider the extremely detailed public comments, the consultation is scheduled for mid-April 2002. This meeting will bring together representatives of governments and representatives of the business sector – mainly banking associations and other representative bodies who have shown an interest in the report. The aim of this public consultation is to help establish an open and interactive discussion between business and tax administrations so that a clearer understanding of the objectives and concerns of each can be obtained. It is expected that further opportunities for ongoing dialogue will arise after the April consultation, although it is too early at this stage to predict what form such dialogue would take.

Conclusion

Attributing profits to a PE is one of the most conceptually difficult and practically complex issues in international business taxation. The OECD very much welcomes the input from the business community provided to date and looks forward to continuing the dialogue. Such dialogue is an essential element of the process needed in order to reach the common goal of both governments and business, i.e. the establishment of a consensus position amongst governments regarding the interpretation and practical application of Article 7 that takes into account modern-day multinational operations and trade.