



**DISCUSSION DRAFT ON THE ATTRIBUTION OF
PROFITS TO PERMANENT ESTABLISHMENT – PART I (GENERAL
CONSIDERATIONS)**

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PREFACE

1. 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 Member and non-member countries.

2. 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 broad consensus regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a broad consensus, a Working Hypothesis (WH) was developed as to the preferred approach for attributing profits to a PE under Article 7. This approach built upon developments since the last revision of the Model Commentary on Article 7 in March 1994¹, 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 was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could 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 development of the WH was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention was to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

4. To meet the policy goals described above, the WH was tested by considering how it could be applied 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. A Discussion Draft containing the interim results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II) was released for public comment in February 2001. Twenty five responses were received from the business community, banking associations and advisory firms, reflecting a diversity of views and interests. Because of the variety of positions expressed and the complexity of the issues, a consultation was held in Paris in April 2002 with the commentators on the Discussion Draft. The consultation was very valuable as it allowed the identification of common ground in terms of principles, of areas that needed further clarification and of areas where further work was needed.

5. A revised Part II and a Part III (Global Trading) were released for public comment on 4 March 2003. Nineteen responses were received from the business community, banking associations and advisory

¹ This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments".

firms. Again because of the complexity of the issues, a second consultation was held in Geneva in March 2004. This Revision of Part I takes account of the comments received and the discussions during both consultations.

Comments are invited on the revised Part I particularly in areas

- **Where the meaning or practical impact is not clear.**

6. The intention is now to finalise Parts I-III in early 2005. Once finalised, the conclusions of these Reports will be implemented through amendments to the Commentary on Article 7. Further practical guidance will be produced in the form of background Reports and/or Chapter(s) of the OECD Transfer Pricing Guidelines. The testing of the WH is reaching its conclusion and sufficient progress has been made in the development of the WH to mean that the WH has now become the authorised OECD approach.

Comments from the public are invited on

- **Any transitional issues that might arise from the implementation of the current conclusions of Part I through changes to the Commentary on Article 7, including suggestions as to how best to deal with them. An example of a potential transitional issue is how to attribute economic ownership of existing intangibles which were created at a time when taxpayers had no requirement to document the decision making process which led to the creation of the intangible (see Section C-2(b) for a description of how to attribute economic ownership of intangibles). Commentators should note that such transitional issues will not be dealt with in the Reports themselves but will be the subject of further work once the Reports have been finalised. Comments received will be taken into account at that stage.**

REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

PART I: GENERAL CONSIDERATIONS

A. Introduction

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the Draft Double Taxation Convention on Income and on Capital in 1963 and its successor in 1977 the Model Double Taxation Convention on Income and on Capital. 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 (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

1. The importance of the PE concept can be seen from the following extract from paragraph 1 of the Commentary on Article 7 of the OECD Model Tax Convention:

“When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention) is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9 of the OECD Model Tax Convention”.

2. There is considerable variation in the domestic laws of the Member countries regarding the taxation of PEs. Currently, there is also not a consensus amongst the Member countries as to the correct interpretation of Article 7. Indeed, the divergent interpretations as regards the meaning and application of Article 7 in some situations are reflected in the Commentary on the OECD Model Tax Convention (“Commentary”). As pointed out by the business community, the lack of a common interpretation of

Article 7 can lead to double taxation. The lack of consensus may also lead to less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the current unsatisfactory situation.

3. Accordingly, Working Party No 6, which has primary responsibility for this issue, decided that the establishment of a broad consensus regarding the interpretation and practical application of Article 7 (especially for the purposes of conducting mutual agreement proceedings and interpreting tax treaties based upon the OECD Model Tax Convention) is essential to achieve the goal of eliminating the risk of double, or less than single, taxation. To assist in this objective, the Working Party formulated a Working Hypothesis (WH) as to the preferred approach for attributing profit to a PE under Article 7 in terms of simplicity, administerability, and sound tax policy. The WH has been tested by considering its practical application, in general situations, and with regard to special issues involving PEs in the financial sector, i.e. banks, global trading and insurance. The testing of the WH is reaching its conclusion and sufficient progress has been made in the development of the WH to mean that the WH has now become the authorised OECD approach.

4. The development of the authorised OECD approach has not been constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade. Once finalised, the conclusions of Parts I –III will be implemented through the Commentary on Article 7. This will require consideration as to whether a particular conclusion is adequately authorised under the existing language of the Commentary on Article 7. It may be that clarifying changes to the Commentary will be necessary or desirable in order to validate the proposed conclusion. In that case, further work would be needed to consider how best to make the changes, and depending on the nature of the changes their possible implications for both future and existing treaties. This further work would be carried out in conjunction with Working Party No. 1. As the project approaches completion it is also appropriate to consider transitional issues arising from any changes to the Commentary on Article 7.

5. The Commentary to Article 7 has itself been regularly updated, including a substantial revision in March 1994 following the publication of “Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments” (hereafter referred to as the 1994 Report). However, the 1994 Report was completed before the Committee of Fiscal Affairs (CFA) had completed its fundamental review of the arm’s length principle, the results of which were reflected in the publication in 1995 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the Guidelines). The Guidelines address the application of the arm’s length principle to transactions between associated enterprises under Article 9 of the OECD Model Tax Convention. The basis for the development of the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken. The testing and development of the WH has examined how the guidance in the Guidelines can be applied to attribute profits to a PE of a banking or global trading enterprise in accordance with the arm’s length principle of Article 7. In particular, the examination has focussed on the extent to which modifications, if any, would be needed in order to take into account differences between a PE and a legally distinct and separate enterprise. It should be noted that under the authorised OECD approach, the same principles should be applied to attribute losses as to attribute profits. References to attributing “profits” should therefore be taken as applying equally to attributing losses.

6. This Report focuses on determining the preferred interpretation and application of Article 7. The question of whether the current interpretation of other relevant Articles of the OECD Model Tax Convention (such as Articles 5, 13 and 23) produces a desirable result is beyond the scope of this Report. For example, the Report does not address the question whether a PE exists in respect of any particular

business activity. The definition of a PE is described by Article 5 of the OECD Model Tax Convention and readers are referred to its Commentary for further information (including the changes made in the January 2003 update).

7. This revision of Part I (General) of the Report takes account of the comments made in the public consultations in April 2002 and March 2004. Part I was not scheduled for discussion in the March 2004 consultation, but in the event a lot of the debate on revised Part II and Part III proved highly relevant to issues covered in Part I. The project on the attribution of profits to PEs will not be finished until the publication of Part IV which deals with insurance. Given that this is a sufficiently self contained topic the intention is to finalise the other Parts of the Report even if Part IV is not complete. Accordingly the intention is to produce a final version of Parts I, II, and III in the first half of 2005.

8. The rest of Part I of this Report provides general background and further information about the authorised OECD approach in relation to the first five paragraphs of Article 7. Part B analyses Article 7, paragraph 1, which provides the central rule concerning the allocation of taxing rights over the business profits of an enterprise² between the country in which the PE is situated (the “host country”) and the country of residence of the enterprise (the “home country”). Part C analyses Article 7, paragraph 2, which provides the central rule concerning the attribution of the business profits of an enterprise to a PE and the statement of the arm’s length principle in the context of PEs. Part D addresses the meaning of Article 7, paragraph 3, regarding expenses, and its relationship to Article 7, paragraph 2. Part E examines Article 7, paragraph 4, which permits in certain circumstances the use of an apportionment method for attributing profits to a PE, based on the total profits of the enterprise. Part F examines Article 7, paragraph 5, which provides a special rule for PEs, engaged in the “mere purchase” of goods or merchandise. The authorised OECD approach is applicable to all types of PEs, but there is a separate Section examining the special considerations applicable to dependent agent PEs (Section C-3 (v)).

B. Interpretation of paragraph 1 of Article 7: Determining the profits of an enterprise

B-1. Approaches to determining profits

9. Article 7 (1) permits the host country to tax the “profits of an enterprise”, but only so much of them as is “attributable to” a PE of the enterprise in the host country. Much historical attention has been given to the question of how to determine the attribution under Article 7(2), but in fact another question must first be addressed: what are the “profits of an enterprise” for the purposes of Article 7(1).

10. Unfortunately, the Commentary on Article 7 provides little in the way of guidance on how to interpret the term “profits of an enterprise”, beyond confirming that, “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.” This language limits the scope of the taxing rights of the host country so that there is no “force of attraction” resulting from the existence of a PE (see paragraphs 5-10 of the Commentary on Article 7). However, the question arises as to whether the term “profits of an enterprise” requires a further limitation on the taxing rights of the host country. Historical practice has developed such that two broad interpretations of the term are most common by the Member countries. Additionally, there are further variations, which may have to be taken into account, the most important of which relates to the meaning of the term “profits”. This part of the Report analyses the two broad interpretations in more detail and discusses briefly possible variations in the interpretation of the term “profits”.

2. For the purposes of this Report, references to the “enterprise” or to the “enterprise as a whole” should be interpreted as describing the juridical entity.

(i) *The “relevant business activity” approach*

11. The first broad interpretation, referred to as the “relevant business activity approach”, defines the “profits of an enterprise” as referring only to the profits of the business activity in which the PE has some participation (the “relevant business activity”).

12. Under the “relevant business activity” approach, Article 7(1) imposes a limit on the profits that could be attributed, under Article 7(2) to a PE: the attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity. The profits of the whole enterprise would be those earned from transactions with third parties and those earned from transactions with associated enterprises, the latter of which would need to be adjusted under transfer pricing rules if they did not reflect the application of the arm’s length principle.

13. The profits of the enterprise as a whole would be considered as comprising the aggregate of profit and losses derived from all its business activities. Any limitation on the profits attributable to a PE under paragraph 1 of Article 7 would be determined relative only to the profits of the relevant business activity. More specifically, if the “relevant business activity” includes operations by other parts of the enterprise, and those operations incur a loss, the “loss” created by the other parts of the enterprise would effectively reduce the profit that could be attributed to the PE, because the “loss” would reduce the overall profits of the enterprise from the relevant business activity. By contrast, losses from a business activity not considered to be part of the same “relevant business activity” as that carried on by the PE would not reduce the PE’s attributable profit.

14. There are different views among countries as to how the “relevant business activity” approach would be applied in practice. For instance, the breadth or narrowness with which the “relevant business activity” is defined has a significant impact on whether the theoretical profit limitation described above will have any practical effect. There is a greater likelihood that the performance of other parts of the enterprise will limit the attribution of profit to the PE, the more broadly the term “relevant business activity” is defined. For example, consider an enterprise, which manufactures a new type of product at the head office and has a PE, which only carries out a distribution activity. Considerable research expenditure is incurred in developing the product, which results in an overall loss for the product line. The product is not well received in the market and is eventually discontinued. If the “relevant business activity” is considered to encompass all the business activities of the product line, i.e. research and development, manufacturing and distributing, it would not be possible to attribute a profit to the PE for performing only the distribution activity, even if a comparability analysis with uncontrolled transactions undertaken by independent distributors would support such an attribution.

15. On the other hand, if the “relevant business activity” is defined more narrowly by reference to function, rather than product line, there may be less participation by other parts of the enterprise in that function, so that there would be fewer instances in which the profit limitation would be operative. In the example above, it would be possible to attribute profit to the distributor PE based on a functional definition of the relevant business activity, i.e. only by reference to the performance of the distribution function. However, the determination of the “relevant business activity” becomes more difficult where both the PE and other parts of the enterprise participate in similar activities. Suppose that the enterprise has distributor PEs in two jurisdictions (A and B) and that by following a comparability analysis with uncontrolled transactions undertaken by independent distributors in each jurisdiction, profits could be attributed to A of 10 but B would be attributed a loss of 15, so that the overall distribution business activity for the enterprise as a whole produces a loss of 5. Should Country A limit the definition of “relevant business activity” to the distribution function in its jurisdiction and ignore the distribution function carried on in jurisdiction B? Historically, host countries have proved reluctant to consider limiting their attribution of profit by reference to activities performed by other PEs.

16. The taxing rights of the host country may also be restricted if the “relevant business activity” is interpreted to mean that profits cannot be attributed to the PE unless the activity is carried on only in the jurisdiction of the host country. Such an interpretation may give rise to problems in some cases, for example where the global trading of financial instruments is carried on in such a way that a number of jurisdictions, rather than just one, would be considered as participating in the “relevant business activity”.

17. There have also been variations between countries in the period over which the “relevant business activity” is evaluated. Some may not evaluate the situation solely by reference to one year. Consequently, if the business activity produced a loss in one year that would not prevent profit being attributed to the PE for that year, if the “relevant business activity” is profitable when looked at over a number of years. A further variation would be for the host country to base its taxing rights on the presumption (always rebuttable by reference to actual experience) that the relevant business activity would make sufficient profits over a period of years so that no restriction to the taxing rights of the host country would arise. In the circumstances described above, some countries would conclude that there are “profits of the enterprise” to attribute, even though they may have been realised at different times in different parts of the enterprise, perhaps because of differences in economic and business cycles. However, the actual attribution of profits would be made separately for each year by reference to the facts and circumstances pertaining in that year. The guidance on using multiple year data in paragraphs 1.49-1.51 of the Guidelines should be applied.

18. Further, some countries apply the limitation under the “relevant business activity” approach by reference to gross profits. Others apply the limitation separately to income and expenses. Some countries apply the profit limitation based on business activity by reference to the combined net profit of the various parts of the enterprise. The first two approaches are likely to produce fewer instances in which the profit limitation would be operative, since the calculation of the limitation would take less account of expenses incurred by other parts of the enterprise.

(ii) *The “functionally separate entity” approach*

19. The second broad interpretation of the phrase “profits of an enterprise” is referred to as the “functionally separate entity” approach. This approach does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated and properly applied the approach should reduce the incidence of double taxation. Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that, “the right to tax [of the host country] does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment”, i.e. there is no “force of attraction” resulting from the existence of a PE (see paragraph 13 above). The profits to be attributed to the PE are the profits that the PE would have earned at arm’s length as if it were a “distinct and separate” enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). This is discussed in detail in Section C below.

20. One key issue in understanding the above approaches relates to the time when profits can be attributed to the PE by the host country. As stated in paragraph 15 of the Commentary on Article 7, “Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State”. The “functionally separate entity” approach permits profits to be attributed to the PE, even though no profit has yet been realised by the enterprise as a whole, for example when the PE finishes manufacturing goods and transfers them to another part of the enterprise for distribution or assembly. On

the other hand, the “relevant business activity” approach has generally not regarded profits as being attributable to the PE until profits have been realised by the enterprise as a whole from transactions with other enterprises. A transfer of an asset may result in double or less than single, taxation where the host and home country take different approaches to the question of whether profit can be attributed in respect of that transfer.

21. Another key issue to understanding the above approaches, and which potentially gives rise to double taxation, relates to how the profits to be attributed to the PE are computed. The ways of computing profits may differ because the “functionally separate entity” approach is likely to take as its starting point the dealings of the PE (including those with other parts of the enterprise of which it is a part), whilst the “relevant business activity” approach is likely to take as its starting point the dealings of the enterprise as a whole in respect of that business activity. In situations where, under the “relevant business activity” approach, there are “profits of the enterprise” to attribute that are at least equal to the quantum of profits computed under the “functionally separate entity” approach, there should, in theory, be no difference to the profits attributed to the PE under either approach. This is because under Article 7(2), the arm’s length principle should be applied in the same rigorous manner to both approaches. However, where the home and host country use different ways of computing profits there may be an increased risk of double, or less than single, taxation in practice, if not in theory.

(iii) Conclusion

22. In summary, two broad interpretations of Article 7, paragraph 1, are currently used by Member countries³. Despite the fact that the different approaches may produce a similar result in a number of cases, the current lack of consensus is unsatisfactory as it results in a real risk of double, or less than single, taxation, especially in cases where one jurisdiction uses the “functionally separate entity” approach and the other jurisdiction uses the “relevant business activity” approach. Modern business practice and the development of global trading and electronic commerce may make such cases likely to occur with increasing frequency.

23. Of the Member countries that follow the “relevant business activity” approach, most believe that approach is required by Article 7, paragraph 1, given the precise language used in the OECD Model Tax Convention, but that the “functionally separate entity” approach would be preferred if there were more explicit support for it in the Commentary of Article 7. These countries believe that the “functionally separate entity” approach would be preferred because it is simpler, more administrable, and more consistent with the understanding of the arm’s length principle as applied in the context of Article 9.

3. It is noted for information that the Member countries of the Working Party have also considered two other possible interpretations of the phrase “profits of an enterprise”, even though these other interpretations have not been used in practice. The first interpretation is that the phrase “profits of the enterprise” refers to the total net profits of the enterprise as a whole. Under this approach, the PE could not have a profit attributed to it in excess of the total *net* profits of the enterprise of which it is a part. Such an interpretation has no regard to the possibility that the total net profits may have been reduced due to losses from activities completely unrelated to the activities of the PE.

The second interpretation would define “profits of the enterprise” as the enterprise’s total gross profit. Under this approach, the PE could not have a profit attributed to it in excess of the total *gross* profits of the enterprise of which it is a part. Such an approach suffers from the same problem identified in the preceding paragraph, although to a lesser extent because the limitation is applied at the level of gross, and not net, profit. In short, both approaches were rejected as not being supported by the language of Article 7, and not achieving a result consistent with sound tax policy.

24. From the perspective of simplicity, the “functionally separate entity” approach is preferred because (force of attraction considerations aside), it does not impose any profit limitation on the profits attributable to the PE that might affect the determination of the profits attributable to the PE in accordance with the arm’s length principle under Article 7(2).

25. From the perspective of administrability, the “functionally separate entity” approach is preferred because it does not require the host country to try and determine the enterprise’s world-wide profits from the relevant business activity (except where a profit split method is applied). Furthermore, the “functionally separate entity” approach avoids the need to revisit the assessment when the period of years has elapsed during which it is necessary to consider the performance or non-performance of the “relevant business activity”.

26. The “functionally separate entity” approach may not be more administrable in all cases. The amount of information required under the “relevant business activity” approach may not be too burdensome if a narrow definition of the “relative business activity” is adopted or the approach is applied in the context of an APA under the Mutual Agreement Procedure.

27. From the perspective of consistency, the “functionally separate entity” approach is preferred because it mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise. Further, it is more likely to produce a profit attribution in respect of a particular business activity, which is neutral as to whether the activity is carried on by a resident or a non-resident enterprise.

28. Paragraph 4 of this report identified the need to establish a consensus position as to “the preferred approach to attributing profit to a PE under Article 7”. To achieve this goal it is necessary to choose, for the purpose of testing the WH, one of the two approaches described above. After considering the expected merits of both approaches, the Working Party has decided, on balance, to adopt the “functionally separate entity” approach as the authorised OECD approach or the preferred interpretation of paragraph 1 of Article 7. In addition, there was wide support for the “functionally separate entity” approach from the public comments and the consultation.

29. Accordingly, the authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length as if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). The phrase “profits of an enterprise” in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment” (i.e. there should be no “force of attraction principle”).

B-2 Symmetrical application of the authorised OECD approach

30. The concept of symmetry has a number of meanings in the context of the attribution of profits to a PE in a manner which does not give rise to double taxation and it is important to be clear about which issues are addressed by the authorised OECD approach and which are not. A number of issues related to the interaction of Article 7 and Article 23, such as differences in host and home country computations of taxable profits, e.g. due to different rules on deductibility of expense, details in domestic rules for giving relief by way of credit or exemptions etc., predate the development of the authorised OECD approach and are unaffected by it.

31. The authorised OECD approach does, on the other hand, directly address the problems created by the current lack of consensus on the fundamental approach to applying the arm's length principle (i.e. whether to apply a "functionally separate entity" approach or a "relevant business activity" approach) by definitively deciding upon the "functionally separate entity" approach. One consequence of the authorised OECD approach is that "the functionally separate entity" approach is used irrespective of whether a country is the host country or the home country, or whether it gives relief from double taxation by exemption or credit methods. The development under the authorised OECD approach of a common interpretation of Article 7 should reduce the incidence of double taxation by reducing one common cause of double taxation, i.e. differences in the way countries compute the quantum of profit to be attributed to a PE under the arm's length principle. The development of the authorised OECD approach therefore represents a clear improvement over the existing situation, even if it does not address all issues.

(i) *Issues addressed by the authorised OECD approach- the symmetrical application of the arm's length principle under Article 7*

32. The existing Commentary on Article 7 describes symmetrical preparation of the PE accounts by the taxpayer as a necessary, but not sufficient, condition for the accounts to be accepted by tax administrations. Symmetrical preparation of accounts means that "the values of transactions or the *methods* (emphasis added) of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office" (paragraph 12.1).

33. Taxpayers who prepared symmetrical accounts in the way recommended by the Commentary were in the past exposed to the risk of double taxation in situations where the host country applied one method of attributing profits, say, the "relevant business activity approach" and the home country applied the "functionally separate entity" approach. Under the authorised OECD approach taxpayers who produce symmetrical accounts applying the functionally separate entity approach (along with the other steps of the authorised OECD approach, including the attribution of capital) should, in principle, be able to satisfy both tax administrations that an arm's length amount of profits have been attributed to the PE.

34. There are, however, a number of issues that need to be addressed in order to achieve the goal of a symmetrical application of the arm's length principle under Article 7. Article 7, and hence the authorised OECD approach, does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. In order to comply with Article 7(2), it is not necessary for the domestic law of the host country to expressly incorporate the arm's length principle – although this is the course taken by some countries' laws. Rather, the domestic law of a host jurisdiction may be phrased in different terms, and adopt different mechanical rules, so long as it is recognised that if these domestic rules result in an excessive attribution of profit, as compared to what may be justified under the arm's length principle of Article 7(2), then the Article 7(2) limit prevails. The exact way in which the Article 7(2) limitation applies depends on the interaction between domestic and treaty law in the host country. For example, in some countries the treaty position overrides the country's domestic rules through the Competent Authority mechanism. Other countries allow the taxpayer to file a treaty authorised approach in the tax return which differs from the domestic approach without reference to the Competent Authority process.

35. The interaction of the treaty and domestic rules is particularly important in addressing the fact that the authorised OECD approach permits more than one approach for attributing capital to a PE as consistent with the arm's length principle, whilst the domestic rules of many countries recognise only one method as discussed in Section C-2 (v)(c). Concern has been expressed that problems might arise where the host country's domestic rules prescribe one of the authorised approaches for attributing capital and the

domestic rules of the home country prescribe another approach. The main concern is that where the domestic rules of home and host countries require different authorised approaches for attributing an arm's length amount of capital to the PE, the home country may not give relief for tax on profits calculated under the host country approach. Taxpayers have also expressed concerns about the administrative burden of routinely re-computing the PE's capital under the home country rules.

36. However, a solution to the problem of two countries applying different approaches to capital attribution both of which are in accordance with the Convention can be found in the existing Commentary to Article 23 under the heading Conflicts of qualification (paragraphs 32.1-32.7). In cases where the home country and the host country treat the same item differently for the purposes of the convention, Article 23 obliges the home state to give relief (by credit or exemption as the case may be, and subject to domestic limitations) in relation to profit which has been attributed to the host state "in accordance with the provisions of the convention". This means that where the domestic rules of the host country are in accordance with the convention then the home state must give relief on that basis, notwithstanding the fact that its own domestic rules (even if in accordance with the provisions of the convention) treat the item differently.

37. In the context of the authorised OECD approach, which permits more than one approach to attributing capital to PEs, this means that any domestic host country rule that is consistent with one or more of these authorised approaches attributes profits to the permanent establishment in accordance with the provisions of the convention, provided the result in the particular case is consistent with the arm's length principle, i.e. that the approach attributes an amount of capital to the PE in a manner that is consistent with the discussion in section C-2 (v). It follows that in such circumstances the home country should give relief for tax on profits calculated under the host country basis. This is the case even where the home country has a domestic rule which attributes capital in accordance with another of the authorised approaches.

38. In short, when giving double taxation relief, the home country will accept that the tax imposed by the host country is in accordance with the convention if the host country has used an authorised approach, unless that approach does not give a result in accordance with the arm's length principle in the particular case. However, as in the case of any other tax that is imposed by a host country, the relief provided by the home country may be subject to domestic limitations.

39. The above principle is intended to provide taxpayers with certainty and to minimise the risk of double taxation in a cost efficient way by avoiding the need to routinely invoke the Mutual Agreement Procedure where host and home country have different authorised approaches to capital attribution. However, as in transfer pricing in general, tax administrations may disagree with taxpayers, and with each other, over whether a particular approach produces an arm's length result in particular circumstances. The attribution of capital to a PE gives rise to extremely complex issues and it is not reasonable or realistic to expect the authorised OECD approach to produce a solution which eliminates entirely the scope for dispute.

40. Where the result of the authorised host country approach to attributing capital does not appear to the home country to be consistent with the arm's length principle, the home country may adjust the results using the host country approach or may apply another of the authorised approaches in order to adjust the amount of capital attributed to the PE, and hence the profits qualifying for double taxation relief, to an arm's length amount. Where the tax administrations disagree over whether a particular authorised approach to the attribution of capital gives rise to an arm's length result in particular circumstances the Mutual Agreement Procedure is available to resolve those differences.

41. It is worth recalling at this point that the Mutual Agreement Procedure does not necessarily involve negotiations between two administrations. Article 25 (2) requires the Competent Authority to enter

into negotiations with the other Competent Authority “when it is *not itself* able to arrive at a satisfactory solution” (emphasis added). Different countries may have different preferences for authorised approaches to capital attribution, but there is consensus among tax administrations, notwithstanding any domestic rules on capital attribution, that there may be circumstances where their preferred domestic approach gives a result that is not consistent with the arm’s length principle. In such circumstances it is open to the Competent Authority of one of the Contracting States to resolve the case without reference to the other Competent Authority.

42. Similarly, as with transfer pricing in general, the authorised OECD approach cannot eliminate entirely the scope for tax administrations to disagree on other components in the attribution of profits to a PE, for example the price at which goods are transferred from one part of the enterprise to another. Symmetrical application of the authorised OECD approach does not mean, of course, that the home country must automatically give relief based on whatever price the host country chooses to assign to a transaction. There is still a requirement under the authorised OECD approach for host countries to attribute profits to the PE in accordance with the arm’s length principle.

43. Where the tax administrations of home and host countries disagree over the price of a dealing double taxation may occur, just as it would if the administrations disagreed over the price of transactions between associated enterprises. In such circumstances the Mutual Agreement Procedure would be available to resolve the dispute, just as it would be to resolve similar disputes arising from adjustments to transactions between associated enterprises. As with any Mutual Agreement Procedure the resolution may involve withdrawal of the host country administration’s adjustment if it proves not to be in accordance with the arm’s length principle. One test of the appropriateness of the host country’s method for determining the profits of the PE might be whether it gives a sensible result for the profits of the rest of the enterprise, taking into account the differences between the way in which the home and host countries measure tax profits.

44. Finally, it is worth noting that the symmetrical application of the authorised OECD approach should in *principle* mean that in any given year the aggregate profits attributed to the head office and its PEs should equal the profits of the enterprise in that year, assuming that the accounting and tax rules of the home country and any host countries are identical.. Where an enterprise with a single PE other than the head office makes a profit of, say 15, and the profits properly attributed to the PE by the host country under the authorised OECD approach are 30, it would follow in theory that the profit attributed to the head office would be a loss of 15 (so that the aggregate profits of PE and head office equal the enterprise profit of 15) However, in practice it is unlikely that there would be identical tax and accounting rules in the home and host countries so some measure of asymmetry within a single accounting period is inevitable. Where, asymmetry arises (other than for accounting or other differences which are not treaty issues) the Mutual Agreement Procedure, as previously noted, would be available to resolve any significant initial divergence that did arise, just as it is for resolving disputes that arise on applying Article 9 to transactions between associated enterprises.

(ii) *Issues not addressed by authorised OECD approach*

45. Symmetrical application of the authorised OECD approach means symmetrical application of the arm’s length principle to the attribution of profits to a PE for the purposes of both home and host country tax administrations. However, it is recognised that there are issues other than the symmetrical application of the arm’s length principle that may give rise to double taxation. Moreover, there are limitations on the ability of countries to eliminate double taxation in certain situations, even through the Mutual Agreement

Procedure. These limitations are not created by the authorised OECD approach, but predate its development and result from fundamental issues concerning the scope and interpretation of tax treaties⁴.

46. One limitation concerns how countries define the term “profits”. There is no definition of this term in Article 7 (7) (see paragraph 32 of the Commentary) and so the host country may apply the relevant definition found in its domestic law. For the purposes of eliminating double taxation under Article 23 of the OECD Model Tax Convention, the home country would compute profits according to the definition found in its domestic law. This may well differ from the amount of profits attributed by the host country (see paragraphs 39-41 and 62 of the Commentary on Article 23). The host and home countries may apply different rates of depreciation on assets. For example, if the host country applies a lower rate of depreciation to capital assets than the home country then the profits attributed to the PE may (because of the smaller depreciation) exceed the PE profits as recognised in the accounts of the enterprise as a whole. In that year the aggregate profits attributable in the PE and the home country will exceed the actual profits of the enterprise (as they would also in the case of transfers of inventory from a manufacturing part of the enterprise to another part of the enterprise that are not sold in the same year). Taking all years together these timing differences should in principle disappear with the result that in aggregate the profits attributable to the home country and the PE should equal the profits recognised in the enterprise as a whole.

47. However, there may also be more permanent differences between the way host and home country define profits, for example the host country may not give a deduction for entertaining expenses where the home country does. In these circumstances the difference will not of course disappear over time. However, such differences between countries’ rules for calculating taxable profits are outside the scope of tax treaties, and in particular are outside the scope of Articles 7 and 9. Accordingly the issue of taxation not in accordance with the treaty does not arise from such differences and there is no requirement for countries to resolve such differences.

48. In short, the problem for PEs is that the elimination of double taxation (by credit or exemption) depends not just on a common interpretation of the attribution of profit rules under the arm’s length principle of Article 7 but also on the interaction between the domestic laws of the home country for relieving double taxation and Article 23 of the OECD Model Tax Convention. Remedying this situation would require changes to countries’ domestic law on double taxation relief, and possibly changes to Article 23, and so is beyond the scope of this Report.

C. Interpretation of paragraph 2 of Article 7: Determining the profits attributable to the Permanent Establishment

49. Paragraph 2 of Article 7 provides that, “subject to the provisions of paragraph 3” of Article 7, the profits to be attributed to a PE are:

“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.”

4 . The Joint Working Group on Dispute Resolution is looking at the issues relating to the scope and purpose of the Mutual Agreement Procedure”

50. This language has its origins in the draft convention adopted by the League of Nations in 1932/33 and can be considered the statement of the arm's length principle in the context of PEs. Paragraph 11 of the Commentary on Article 7 indicates that this language "corresponds to the "arm's length principle" discussed in the Commentary on Article 9." The Guidelines issued in 1995, contain a detailed analysis of how to apply the arm's length principle under Article 9 in the context of an MNE group. This guidance is more recent than the latest changes made to the Commentary concerning the application of the arm's length principle under Article 7.

51. Accordingly, the Working Party formulated the authorised OECD approach on the premise that the guidance on the application of the arm's length principle of Article 9 given by the Guidelines should be applied to the attribution of profit to a PE using the arm's length principle under Article 7(2). The Working Party has tested the authorised OECD approach in a number of factual situations and business sectors to examine whether this premise should be adopted as the standard for attributing profit under Article 7(2).

52. However, apart from the issues already discussed in Part B in relation to paragraph 1 of Article 7, there are two further issues that warrant attention under Article 7 as distinguished from Article 9.

- (1) For the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is distinct and separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally distinct and separate; and
- (2) One of the two common interpretations of paragraph 3 of Article 7 would modify the arm's length principle as regards the quantum of expenses to be allowed as deductions when attributing profit to a PE, as discussed in Part D below.

53. To reflect the above issues, the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy. This Report discusses how and to what extent the guidance in the Guidelines can be applied, by analogy, to attribute profits to a PE and how to adapt and supplement that guidance to take into account factual differences between a PE and a legally distinct and separate enterprise.

54. The interpretation of Article 7(2) under the authorised OECD approach is that a two-step analysis is required. First, a functional and factual analysis in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks. Second, an analysis of the Guidelines relevant to applying the arm's length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. Section C-2 below discusses the factual and functional analysis and the attribution of functions, assets, risks and "free" capital to the PE. Section C-3 below discusses the attribution of profits to the PE in accordance with its functions, assets used and risks assumed by comparison to independent enterprises performing the same or similar functions, using the same or similar assets and assuming the same or similar risks. By way of introduction, an outline of the basic principles to be used is set out below.

C-1 Basic principles used to attribute profits to a PE

This Section provides an introduction to the basic principles of the authorised OECD approach. The basic principles described below are discussed in more detail in the rest of the Report.

Basic premise of the authorised OECD approach

55. The authorised OECD approach seeks to postulate the PE as a hypothesised distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and to attribute

profits to the PE under Article 7, using the guidance on the application of the arm's length principle of Article 9 given by the OECD Transfer Pricing Guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally distinct and separate enterprise. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a PE. Application of the authorised OECD approach should achieve equality of treatment between different types of PE, but will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. Thus, it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilisation, risk diversification, economies of scale etc.

Functional and factual Analysis

56. In the context of the authorised OECD approach the functional and factual analysis is used to delineate the PE as a hypothesised distinct and separate enterprise, and determines the functions (i.e. activities) of this hypothesised distinct and separate enterprise and the conditions (i.e. economically relevant characteristics) relating to the performance of those functions, based on the Guidance on comparability in the Guidelines applied by analogy. The functional analysis will also take into account the assets used and risks assumed as a result of performing those functions. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes one or more of those functions as this has consequences for the attribution of assets and risks as discussed below. The key entrepreneurial risk-taking functions will vary from business sector to business sector (e.g. the key entrepreneurial risk taking functions for an oil extraction company and a bank are unlikely to be the same) and from enterprise to enterprise within sectors (not all oil extraction companies or all banks are the same). Further, it should be stressed that a particular business may have one or more key entrepreneurial risk taking functions, each of which has to be taken into account. Clearly the determination should be on a case-by-case basis as the key entrepreneurial risk-taking functions and their relative importance will depend on the particular facts and circumstances. In addition to the key entrepreneurial risk taking functions, it will also be important to reward other functions in accordance with the arm's length principle. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of free capital and interest bearing debt to the PE.

57. The factual and functional analysis is of critical importance. In attributing profits to a PE it is not sufficient to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Book entries must be consistent with, and follow from, the factual and functional analysis. Where this is the case, the books provide the starting point for determining the profits attributable to the PE.

Attribution of assets

58. The functional and factual analysis will examine all the facts and circumstances to determine the extent to which the assets of the enterprise are used in the functions performed by the PE and the conditions under which the assets are used, including the factors to be taken into account to determine which part of the enterprise is regarded as the economic owner of the assets. This analysis will attribute assets to the PE and determine whether the assets are created by the activities of the enterprise itself or acquired from another enterprise. The attribution of assets and their classification will have consequences for both the attribution of profit and the attribution of capital and interest bearing debt to the PE. The

attribution of tangible and intangible assets is based upon economic ownership as determined by a functional and factual analysis of both parts of the enterprise involved in the dealing, focussing on the key entrepreneurial risk-taking functions in respect of those assets. The part of the enterprise attributed the asset will also be attributed any associated profit (taking into account any dealings at arm's length to reward other parts of the enterprise for functions performed in relation to that asset).

Attribution of risks

59. The functional and factual analysis will attribute to the PE any risks inherent in, or created by, the PEs' own functions, and take into account any subsequent dealings related to the subsequent transfer of risks or to the transfer of the management of those risks to different parts of the enterprise. The attribution and measurement of risk is an important part of the functional and factual analysis since the presence of risk impacts upon both the attribution of profits and the attribution of capital to the PE. Since capital follows risks, the economic owner would be attributed the capital necessary to support the associated risks. Depending on the nature of the enterprise's business, risk may either be intimately linked to assets attributed to the PE or it may not be so closely linked to the existence of assets. The attribution of risk is particularly important in the financial sector where it has a substantial impact on the attribution of both capital and income and expenses to the PE, but it can also be important in other businesses. The financial sector, because of the nature of its business, has very sophisticated risk measurement tools. Outside the financial sector it will often be more difficult to measure risk, but it will still be necessary to try and measure significant risks, for example those arising from the development of unique intangible property. The substance of the assumption of risks by each part of the enterprise depends on the actual performance of, or risk management of, the key functions associated with the activity.

Attribution of capital

60. The functional and factual analysis will attribute free capital (i.e. funding that does not give rise to a tax deductible return) to the PE for tax purposes, to ensure an arm's length attribution of profits to the PE. The factual 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 uses and the risks it assumes. In the financial sector regulations stipulate minimum levels of capital to provide a cushion in the event that risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors. The PE must have equity capital to act as a cushion, that is funds subordinated to the rights of all creditors (including loan creditors) and placed at the disposal of the business by investors who are prepared to accept higher levels of risk in respect of their investment in exchange for an economic return which is expected to be significantly higher than the risk-free rate.

61. A key distinction between a separate legal enterprise and a PE is that one legal enterprise can enter into a legally binding agreement to guarantee all the risks assumed as a result of the functions performed by another legal enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would reside in a different legal enterprise from that in which the transactions giving rise to the risks are booked. In contrast one of the key factual conditions of an enterprise trading through a PE is that the capital and risks are not segregated from each other within a single legal enterprise. To attempt to do so for tax purposes would contradict the factual situation and would not be consistent with the authorised OECD approach. Capital must be regarded as following risks. In other words, capital is to be attributed to a PE by reference to the risks arising from its activities and not the other way round.

62. This attribution of capital should be carried out in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the PE. The purpose of the attribution is to inform the attribution of profits to the PE under Article 7(2). The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of capital to a

PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the capital attributable to a PE, not a single figure. There is a common premise to the authorised approaches to attributing capital, that an internal condition of the PE is that the creditworthiness of the PE is generally the same as the enterprise of which it is a part.

63. The authorised OECD approach recognises a range of acceptable approaches for attributing capital that are capable of giving an arm's length result, each with their own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of capital attributable to a PE, which either put more emphasis on the actual structure of the enterprise of which the PE is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing capital is to recognise:

- The existence of strengths and weaknesses in any approach and when these are likely to be present (discussed in more detail in Section C-2 (v) (c)).
- That there is no single arm's length amount of capital, but a range of potential capital attributions within which it is possible to find an amount of capital that can meet the basic principle set out above.⁵

Funding costs:

64. The PE requires a certain amount of funding, made up of free capital and interest bearing debt. The objective is to attribute an arm's length amount of interest to the PE, commensurate with the functions, assets and risks attributed, using one of the authorised approaches to attributing capital. These issues are discussed in more detail in Section C-2 (v) (d).

Recognition of dealings

65. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- Save in exceptional circumstances, all parts of the enterprise have the same creditworthiness. This means that dealings between a PE and the rest of the enterprise of which it is a part should be priced on the basis that both share the same creditworthiness; and
- There is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

66. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions

⁵ Section B.2 on the symmetrical application of the authorised OECD approach discusses the interaction between the host and home country rules and describes how the incidence of double taxation can be reduced.

between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealing.

67. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). A functional and factual analysis will 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. 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, but would not be determinative where it was found to be inconsistent with the functional and factual analysis and therefore the economic reality of the dealing.

68. Dealings undertaken between the PE and another part of the enterprise (as structured by them) will be compared with transactions between independent enterprises, following, by analogy, the comparability analysis described in the Guidelines. Even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would not be recognised or would be restructured in accordance with economic and commercial reality).

69. Third, where dealings are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is a part to be independent of one another. This should be done by analogy, with the Guidelines, following a factual and functional analysis.

Attribution of profits

70. The attribution of profits to a PE of an enterprise on an arm's length basis will follow from:
- The attribution of functions, assets and risks between it and the rest of the enterprise of which it is a part based on a functional and factual analysis, taking account of the dealings that can appropriately be recognised.
 - The attribution of capital based on the assets and risks attributed to the PE.
 - The pricing on an arm's length basis of dealings that can appropriately be recognised, having passed the threshold test.
 - The recognition of transactions between the enterprise and independent third parties that are attributed to the PE (subject to, for example, any displacement of third party borrowings as a result of the attribution of capital to the PE's assets and risk).
 - The determination of comparability between dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, functional analysis, economic circumstances and business strategies) or by analogy (contractual terms) in light of the particular factual circumstances of the PE; and
 - The determination of an arm's length compensation for the functions that the PE performs, taking into account the assets and risks attributed to the PE, achieved by applying by analogy the Guidelines' traditional transactions methods, or, where such methods cannot be applied reliably, the transactional profit methods.

71. The authorised OECD approach, does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm's length as if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the Guidelines by analogy. This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises in respect of their activities (having regards to assets used and risks assumed) in the source jurisdiction. In addition, the authorised OECD approach is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the authorised OECD approach would not require the recognition of an analogous dealing in order to determine the profits of a PE.

C-2 First step: Determining the activities and conditions of the hypothesised distinct and separate enterprise

72. In accordance with Article 7(2), the first step of the authorised OECD approach is to hypothesise the PE as a distinct and separate enterprise “engaged in the same or similar activities under the same or similar conditions”. The approach of the Guidelines in linking the earning of profit to the performance of “functions” would appear to be capable of being applied in the PE context by equating “functions” to “activities”.

73. Further, the guidance on comparability at paragraph 1.15 of the Guidelines equates “conditions” with “economically relevant characteristics”. There is also an obvious similarity between the concept of “same or similar” and the concept of “comparability” discussed in Chapter I of the Guidelines. As noted by paragraph 1.17, “it is necessary to compare attributes of the *transactions or enterprises* (emphasis added) that would affect conditions in arm's length dealings.” In the PE context, some of the “conditions” of the PE as a hypothesised distinct and separate enterprise will be derived from a functional and factual analysis of the internal attributes of the enterprise itself (“internal conditions”), whilst other “conditions” will be derived from a functional and factual analysis of the external environment in which the functions of the PE are performed (“external conditions”). It is therefore necessary in the first step of the authorised OECD approach to analyse not only the functions of the hypothesised distinct and separate enterprise but also the “conditions” under which those functions are performed. Unless stated otherwise in the text, the term “conditions” refers to both “internal” and “external” conditions.

74. In short, the first step of the authorised OECD approach will apply a functional and factual analysis to the PE (based on the guidance in Chapter 1 of the Guidelines) in order to determine the functions of the hypothesised distinct and separate enterprise and the economically relevant characteristics (both “internal” and “external” conditions) relating to the performance of those functions.

(i) Functions (activities)

75. Chapter I of the Guidelines provides a considerable amount of detail about functional analysis and its application. The Guidelines at 1.20 state that a functional analysis “seeks to identify and compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises.” In the PE context, the functional analysis will be initially applied to the hypothesised distinct and separate enterprise and the rest of the enterprise of which it is a part in order to determine what economically significant activities and responsibilities are undertaken by the PE and how they relate to the activities and responsibilities of the enterprise as a whole. The functional

analysis must also determine which of the identified activities and responsibilities of the enterprise are associated with the PE, and to what extent. Where the PE is created through a fixed place of business within the meaning of Article 5(1), the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the “fixed place” that constitutes the PE and the functions performed at that “fixed place”. Where there is a PE by virtue of Article 5(5) of the OECD Model Tax Convention (a “dependent agent PE”), the functional analysis would have to take into account any functions undertaken by the agent on behalf of the enterprise. This issue is discussed in more detail in section C-3(v) below.

76. The guidance in the Guidelines on functional analysis seems capable of being applied fairly directly in the PE context in order to determine the “activities” of the hypothesised distinct and separate enterprise. The main difficulties are with determining how to take into account assets used and risks assumed. These are discussed later in this section. However, the guidance on comparability cannot be applied directly in the PE context and needs to be applied by analogy. This is because the guidance in the Guidelines is based on a comparison of the conditions of controlled and uncontrolled transactions. However, what is needed in the first step of the authorised OECD approach is a functional and factual analysis of all the economically relevant characteristics (“conditions”) relating to the PE so as to ensure that the “distinct and separate” enterprise is appropriately hypothesised to be engaged in “comparable” activities under “comparable” conditions to the PE.

77. The functional and factual analysis takes account of the functions performed by the personnel of the enterprise as a whole including the PE –“people functions” – and assesses what significance if any they have in generating the profits of the business. People functions can range from the routine to the key entrepreneurial risk-taking functions of the business. The latter are those which require active decision making with regard to the most important profit generators of the business and so it will be particularly important for these to be identified under the functional analysis. Part II of the Report deals with the significance of people functions in the financial sector, but whilst people functions may be less critical in generating profits in some types of non-financial sector businesses, they may be important in certain non-financial enterprises, where for example the creation of valuable intangibles is a key profit driver.

78. The guidance on comparability in Chapter I of the Guidelines identifies a number of factors in addition to a functional analysis which may have to be taken into account when undertaking a comparison of conditions:- characteristics of property or services, contractual terms, economic circumstances and business strategies. By analogy, such factors should also be considered when undertaking the factual and functional analysis to determine the “conditions” of the hypothesised distinct and separate enterprise and to ensure that they are “same or similar” to those of the PE. So under the authorised OECD approach, care needs to be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent those conditions are relevant to the performance of the PE’s functions.

79. In the distributor example at paragraph 15 above, a full functional and factual analysis of the distribution function would be undertaken under the first step of the authorised OECD approach. This would determine the economically relevant characteristics relevant to the performance of the distribution function by the PE, for example, the identification of a business strategy such as a market penetration scheme. It would be important to identify any business strategy in order to undertake properly the comparability analysis under the second step of the authorised OECD approach between the dealings between the PE and the rest of the enterprise of which it is part and transactions between independent enterprises. Such a “condition” might explain why in the example at paragraph 15 above, it may be appropriate to attribute a loss to B but not to A, for example because the enterprise as a new entrant to the market in B has been carrying out a market penetration scheme.

80. In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE's host country. For example, the PE may act as a distributor and carry on all the associated activities, including market research, in its jurisdiction. However, it is important that the functional analysis includes not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE and all activities performed by the PE on behalf of other parts of the enterprise. In another case, a functional analysis may show that some activities necessary to carry out the distribution function, say market research, are performed in a different jurisdiction. Such activities will have to be taken into account when attributing profit to the PE, although the exact manner of doing so will depend on an analysis of the facts and circumstances.

81. The functional and factual analysis needs to be carried out in a thorough and detailed manner in order to establish the exact nature of the function being performed. This is because where the functional analysis has determined that the PE has performed the key entrepreneurial risk-taking functions, the PE will be attributed the assets and risks associated with those functions. This in turn leads to the attribution to the PE of the income and expenses associated with those assets and risks.

82. An interesting issue can arise in an e-commerce operation in circumstances where it is accepted that the location of a server of itself constitutes a PE, as functions may be performed at that location without personnel. Nevertheless, the same principles apply and the functional analysis will determine what automated functions are performed by the server-PE and what assets are used and risks assumed in the performance of those functions. As noted in the draft from the Business Profits TAG released in 2001, the automated and routine nature of the functions means that the assets or risks attributed to the PE are only likely to be those directly associated with the server hardware. A server-PE will not be carrying out any key entrepreneurial risk-taking functions in the absence of personnel.

(ii) *Assets used and conditions of use*

83. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed but also the assets used and the risks assumed in performing those functions. The assets may be used in different capacities, e.g. as sole or joint owner, lessee or member of a Cost Contribution Agreement. They may be intangible assets or physical. They may be acquired or created internally by the enterprises own activities. The functional analysis needs to determine all these facts, because the attribution of profits to the PE will depend upon such characteristics.

84. In applying Article 7(2), the facts and circumstances must, in the first instance, be examined in order to determine the extent to which the assets (physical or intangible) of the enterprise are used in the functions performed by the PE. This is because income from third parties will include a return from assets used (whether or not owned) by enterprises to the extent that the assets are used to generate that income, though the profits of an enterprise which owns the asset will be different to the profits of an enterprise which uses an asset owned by someone else and so has to pay for that use. To the extent that assets are used in the functions performed by the PE, the use of those assets should be taken into account in attributing profit to the functions performed by the PE. Assets of the enterprise that are not used by the PE should not be taken into account for the purposes of attributing profits to the PE. The assets attributed may also need to be taken into account in the comparability analysis under the second step of the authorised OECD approach. For example, a business which needs to use expensive plant and machinery would, all things being equal, expect to generate greater profit than a business which did not require the use of such assets.

85. Determining the use of an asset is not however, the end of the matter. Regard has also to be given in the functional analysis as to the conditions under which the asset is used; e.g. as owner, lessee or

member of Cost Contribution Agreement. The capacity in which the PE uses the asset will impact on the amount of profits to be attributed to it. This is because income from third parties will include a return from the assets used by an enterprise to the extent that the assets are used to generate that income, and the amount of that return attributed to the PE varies depending on whether the PE is the owner, lessee or member of a CCA. The part of the enterprise that is the “economic” owner of the asset may or may not be the PE making use of the asset.

86. Determining ownership of the assets used by a PE can present problems not found in separate enterprises where legal agreements can be relied upon to determine ownership. In a PE context, however, the assets owned by the enterprise belong, legally, to the enterprise of which the PE is part. It is therefore necessary to introduce the notion of “economic ownership” in order to appropriately allocate the return from third parties in respect of the asset. In determining the characteristics of the PE for taxation purposes, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity. Economic ownership of an asset, whether physical or intangible, is determined by a functional and factual analysis, and in particular rests upon performance of the key entrepreneurial risk-taking functions in relation to the asset. A discussion of the factors to be taken into account in the determination of the economic ownership of both tangible and intangible assets in a PE context is contained in section C-3 (iv) (a) and (b).

(iii) *Risks assumed*

87. As regards risk, in the context of a PE and its head office, as contrasted with a parent company and its subsidiary, it is the enterprise as a whole, which legally bears the risk. However, following the analysis of assets, the Working Party likewise concludes that it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk. Indeed, the PE should be considered as assuming any risks inherent in, or created by, the PE’s own functions (i.e. for the purpose of the PE), and any risks that relate directly to those activities. For example, the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by the PE. The determination of the risks assumed by the PE has consequences for determining the attribution of capital and the capital adequacy of the PE. This is because an enterprise assuming material additional risks would need to correspondingly increase its capital in order to maintain the same creditworthiness. The capital issue is discussed in general in section C-2. This issue is extremely significant for banks and is discussed in detail in Part II.

88. In the absence of contractual terms between the PE and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the PE will have to be highly fact specific. Following, by analogy, paragraph 1.28 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be, “deduced from their [the parties] conduct and the economic principles that govern relationships between independent enterprises.” This deduction may be aided by examining internal practices of the enterprise (e.g. compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made. The extent to which such documentation is determinative is discussed in more detail in Sections C-3 (ii) and C-3 (iv)(d).

89. In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE performing that function. If risks are found not to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should not be taken into account for the purposes of attributing profits to the PE. It should be noted that this discussion of risk only relates to the assumption of risks, inherent in, or created by, the performance of a function. It will be a

separate question (to be dealt with in Section C-3 below) how to take into account any subsequent dealings related to the subsequent transfer of risks (e.g. when an asset and the associated risks are transferred from a PE to another part of the enterprise) or to the transfer of the management of those risks to different parts of the enterprise.

90. The amount and nature of the risks assumed by the PE also impacts upon the amount of capital that needs to be attributed to the PE. This is most clearly seen in the financial sector where regulators may oblige banks to have minimum levels of capital to support the risks to which they are exposed. But the link between risk and capital is also present in non financial sectors. All business activity involves some element of risk, though some are more risky than others. The activities of an enterprise engaged, for example, in cutting-edge biotechnology research will assume risks that will generally require a greater level of “free” capital support, than an enterprise engaged, say, in property investment with blue chip tenancy agreements. Risks associated with the former activity are more likely to result in a differential between income generated and the costs (funding and non-funding) of carrying out the activity. It is the role of free capital to provide a cushion against the crystallisation of risks into actual losses.

(iv) *Attributing Credit worthiness to the PE*

91. It is an observable condition that permanent establishments generally enjoy the same creditworthiness as the enterprise of which they are a part. Accordingly, under the authorised OECD approach, the “distinct and separate enterprise” hypothesis requires that an appropriate portion of the enterprise’s “free” capital be attributed to its PEs for tax purposes and that the PE be attributed the creditworthiness of the enterprise as a whole. It is worth re-emphasising that an attribution of “free” capital in excess of the amounts recorded in or allotted to the PE by the home country may have to be made for tax purposes, even though there may be no need to formally allot “free” capital to the PE for any other purpose.

92. Generally, under the authorised OECD approach, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole; an exception being where for regulatory reasons the capital attributed to the PE of one jurisdiction is not available to meet liabilities incurred elsewhere in the enterprise. In addition, it was also determined that there is no scope for the rest of the enterprise guaranteeing the PE’s creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

93. It has been suggested that in hypothesising the same creditworthiness throughout the enterprise and not recognising intra-enterprise guarantee payments the authorised OECD approach fails to recognise the fact that the creditworthiness of an enterprise is greater than the sum of its parts; i.e. that the very act of hypothesising the PE as a distinct and separate entity has the effect of degrading the creditworthiness of all parts of the enterprise below that of the enterprise as a whole. Whilst not denying this effect it is not clear why one part of the enterprise, such as the Head Office, would have the higher creditworthiness necessary to enable it to guarantee the transactions undertaken by the PE. The authorised OECD approach is based on the factual situation of the enterprise, which is that the capital, risks etc are fungible, so it would be inconsistent to grant all the benefits of synergy to the Head Office.

94. Secondly, there are factors other than capital such as reputation, profitability, management quality, risk diversification that also affect creditworthiness. Again it is hard to understand why all these factors should be treated as belonging to one part of the enterprise.

95. The authorised OECD approach does not recognise dealings in respect of guarantee fees between the PE and its head office or between the PE and another PE. Guarantee payments between associated

enterprises are recognised in certain circumstances.⁶ This has led some commentators to conclude that the authorised OECD approach discriminates between subsidiaries and PEs by applying transfer pricing principles in different ways. However, it is not the authorised OECD approach that discriminates between the two legal forms. Rather the legal forms have different economic consequences: a PE, except in the circumstances referred to in paragraph 31 of Part II, generally has the same creditworthiness as the enterprise of which it is a part. The same is not necessarily true of a subsidiary and its parent company.

96. Moreover, a key distinction between a separate legal enterprise and a PE is that an enterprise can enter into a legally binding agreement to guarantee the debts of a second enterprise, and third party lenders may take that guarantee into account when assessing the creditworthiness of the second enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would reside in a separate enterprise from that in which the risk of default occurs. In contrast, one of the key factual conditions of a PE is that capital and risks are not segregated from each other within a single legal enterprise. And if capital is not segregated then there is no basis for guarantee fees. Discrimination arises when taxpayers in the same or similar circumstances are treated differently. For the reasons given above, PEs in their dealings with other parts of the same enterprise in the context of guarantee fees may not be in similar circumstances to a subsidiary.

(v) *Capital attribution and funding the operations of the PE*

a) Introduction – the importance of “free” capital

97. Enterprises require capital to fund day to day business activities, the cost of creating or acquiring assets (tangible and intangible), and as explained in the previous section to assume the risks associated with an ongoing business (e.g. credit or market risk). Broadly, capital comes from three sources: (1) contributions of equity by shareholders; (2) retained profits (including sometimes reserves, though practices among member countries may vary); and (3) borrowings. Sources (1) and (2) are referred to collectively in this Report as equity capital and source (3) is debt capital. Under tax law, deductions are generally not given for payments made to equity holders, whereas deductions are generally available (subject to thin capitalisation rules etc) for payments of interest or interest equivalents to the holders of debt capital. There may be differences between accounting, regulatory and tax definitions of debt and equity. For example, in the financial sector, certain types of subordinated debt may be treated as debt for accounting purposes, equity for regulatory purposes, and either debt or equity for tax purposes, and the tax classification may vary with jurisdiction. Accordingly within this Report the term “free capital” is defined as an investment which does not give rise to an investment return that is deductible for tax purposes under the rules of the host country of the PE.

98. Because interest expense is generally deductible for tax purposes, it will be necessary to ensure an appropriate attribution of the enterprise’s “free” capital to a PE in order to ensure an arm’s length attribution of profits to the PE. The impact on non-financial PEs may be significant, since the ratio of free capital to interest bearing debt is generally much higher outside the financial sector. Historically, the attribution of capital has been made difficult by a lack of consensus on a number of key issues related to the capital attribution and funding of a PE. This section analyses the current interpretation of Article 7 in respect of the key issues before going on to describe how the authorised OECD approach applies to attribute capital and funding costs to a PE.

6 . see the 1995 Transfer Pricing Guidelines at paragraph 7.13.

b) Current Interpretation of Article 7

99. There are a number of key issues identified in the Commentary on Article 7 that require resolution under the authorised OECD approach. One key issue in attributing capital and funding costs to a PE relates to the treatment of internal movement of funds. The conclusion at paragraph 18.3 of the Commentary is that the “ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below.” Paragraph 19 goes on to recognise that “special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises.” The current interpretation of this issue is revisited below in Section C-2 (v) (d) dealing with determining the funding costs of the PE.

100. Another key issue to address is how to take the capital of the whole enterprise into account when attributing profit. Paragraph 20 of the 1994 report considers that some internal interest adjustment should be allowed where there is a bilateral agreement that the PE is either over or under capitalised and indicates that:

“The answer to the question as to whether a permanent establishment is under- or over-capitalised will, in principle, depend on the rules and practice of the host country, unless there is a divergent mutual agreement under Article 25 of the Model Tax Convention”.

101. However, a mutual agreement may be difficult to achieve because of the different approaches member countries currently take to attributing the capital of the enterprise as a whole to its constituent parts. This is because the Commentary to Article 7 offers no clear principle or practical guidance as to how to determine whether a PE is appropriately capitalised, thereby making it difficult for the Competent Authorities to form a common view. The rest of this section attempts to remedy this deficiency by setting forth a clear principle and providing practical guidance on how to apply that principle in practice.

c) Principles of the authorised OECD approach

102. Under the authorised OECD approach, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. Under the authorised OECD approach, assets are attributed to a PE based on where the economic ownership of the assets lies and where the risks associated with those assets, or the attempted creation of assets, are assumed. Once the factual and functional analysis has attributed the appropriate assets and risks of the enterprise to the PE based on economic ownership, the next stage in attributing an arm’s length amount of profits to the PE is to determine how much of the enterprise’s “free” capital is needed to cover those assets and to support the risks assumed. This process involves 2 stages. The first is to measure the risks and value the assets attributed to the PE. The second is to determine the “free” capital needed to support the risks and assets attributed to the PE.

Stage 1 – Measuring the risk and valuing the assets attributed to the PE

103. As noted above, in attributing profits to a PE the authorised OECD approach uses a functional and factual analysis to attribute assets and risks to the PE and it also works on the premise that capital and risk cannot be segregated. It follows that under the authorised OECD approach it is necessary to attribute “free” capital to the PE in accordance with the risks and assets so attributed. Certain financial enterprises are obliged by regulators to measure risks and attribute capital (see Part II sections B-4 (iii) and (iv) for more detail). Enterprises that are not banks or non-bank financial institutions (“non-financial institutions”)

are less likely to measure risks and value assets for business purposes on a day to day basis and will not be subject to regulatory requirements requiring them to do so.

104. Where enterprises which are non-financial institutions do not measure risks, one possible approach would be to attribute capital to a PE by reference only to the assets attributed to the PE. This is because, for non- financial enterprises, more so than for financial enterprises where the role of capital is to support risk, the capital would primarily be serving a funding purpose and it is the assets that are being funded. There are a number of possible valuation options. One option would be to use the book value of the asset as shown in the accounts for the relevant period. Another option would be to use the market value of assets, either as a matter of course or in cases where there is a significant difference between book and market value.

105. Another option would be to use the original purchase price or cost of the asset. This approach would appear to offer a number of advantages. Firstly, the borrowed amounts would bear a close relation to the historical value of assets funded by the borrowings. Secondly, the approach facilitates a consistent measurement of assets across jurisdictions (in particular where different accounting rules exist to determine the book value of assets) and thirdly it would be simpler to comply with than an approach requiring the periodical determination of the market value of assets. However, the cost approach can produce inappropriate results where, for example, different parts of the enterprise have assets of similar value, but very different costs (because one part of the enterprise bought the asset at a different time when the cost was different). There is no prescribed method for valuing assets but any method used must be used consistently from year to year. Ideally, similar asset classes would be valued in a consistent manner across different parts of the enterprise, whilst recognising that there are practical difficulties in doing so given different domestic laws and/or accounting rules.

106. However, further consideration shows that for non-financial enterprises risks are not necessarily directly correlated to particular assets. It may be the activity putting the assets to use that creates the risk rather than the assets themselves. An approach that just used assets to attribute capital would therefore seem unlikely to lead to an arm's length result in situations where significant risks are assumed by the PE; for example where the PE takes on all the risks of developing a marketing intangible but is unsuccessful so no intangible asset is ever produced. Such developmental or entrepreneurial risks were effectively not taken into account when attributing capital to financial enterprises except to the extent that they were recognised by the regulator, on the basis that anything not recognised by the regulator was, in context of financial enterprises relatively insignificant compared to the other types of risk assumed by financial institutions. However such risks may be more significant in some non financial businesses, and where this is the case it would be appropriate to recognise that more "free" capital would need to be attributed to support this entrepreneurial risk.

107. Significant risk in the context of a non financial business means risks which would be regarded as requiring capital by the market in which the PE operates. For example, whilst the risk of, say, a fast food vendor being sued in a particular location for contributions to obesity in the population is a theoretical risk, if independent fast food vendors in that location would not provide capital to support that risk, then it is not a "significant risk" for the purposes of attributing capital. In other jurisdictions the risk might be more than theoretical and independent fast food vendors might reserve against such litigation risks. In such jurisdictions this would be a significant risk for the purposes of attributing capital. Equally, some business activities are subject to more volatile economic cycles than others, and additional capital may be needed to support the business against the cyclical downturns. Again, outside the financial sector, there is little regulatory constraint on capital adequacy for different business sectors. The amount of free capital being determined rather by market perceptions of what is appropriate for given sectors, business strategies etc, and by the shareholders' and loan creditors' appetite for risk.

108. Quantifying the amount of additional capital in such circumstances will be difficult given the lack of a regulatory environment. However, one might expect that businesses are likely to try and evaluate significant risks at least to some extent and it might be possible to use an enterprise's own measurement tools, where they exist, as a starting point. Even if it is accepted that significant risks may not be capable of being measured exactly, where the PE assumes significant risks, an attempt should be made to take account of these risks. Where on the other hand the risk is not significant it may not be necessary to try to measure such risk and simply valuing the assets is enough.

109. The rest of this section discusses how to apply the authorised OECD approach to non-financial PEs in the context of capital allocation and funding issues. Three main issues arise and are discussed below. The first is how to determine the funding costs of the PE, especially how to allocate "free" capital to a PE. The second is whether a movement of funds within an enterprise could be treated as a dealing giving rise to interest. The third is how to determine the amount of interest expense that should be attributable to a PE and how to make any necessary adjustments to the interest expense recorded in the books of the PE.

Stage 2 Determining the "Free" capital needed to fund the assets and support the risks attributed to the PE

110. Tax considerations aside, and in the absence of regulatory requirements, there is ordinarily no need for any "free" capital to be formally allotted to a PE. Consequently, the PE's funding needs could legally be entirely debt funded. Nevertheless, while the PE may not need to have "free" capital allotted to it, under the authorised OECD approach the PE is treated as having an appropriate amount of "free" capital in order to support the functions it performs and the assets and risks attributed to it. Moreover, if the same operations were carried on through a subsidiary in the host country, the subsidiary may be required by thin capitalisation rules to have some equity or "free" capital.

111. Under the authorised OECD approach, the PE needs for tax purposes to have attributed to it an arm's length amount of "free" capital, irrespective of whether any such capital is formally allotted to the PE. To do otherwise would be unacceptable on tax policy grounds. The result would not follow the arm's length principle, would not reflect the profits earned in the PE, and it would provide considerable scope for tax avoidance. Accordingly, a management decision in the home office to allot a certain amount of capital to the PE, or to record capital on the books, is not determinative of the risks assumed by the PE and the amount of capital that is attributed under the functional and factual analysis.

112. The next issue is how to attribute an appropriate amount of "free" capital and interest bearing debt to the various parts of the enterprise. The attribution would be made in accordance with where the assets and the associated risks have been attributed and should take into account, as far as practicable, the specific functions, assets and risks of the PE relative to the functions, assets and risks of the enterprise as a whole. This recognises that some business activities involve greater risks and require more capital than other activities; hence the business activities undertaken through a PE may require proportionately more or less capital than the enterprise as a whole.

113. A number of approaches to determining funding costs are considered below, but a few points of general application are made first. As indicated in Section B-2 which discusses the symmetrical application of the authorised OECD approach, where an authorised approach to attributing capital appears to produce results in a particular case that are not consistent with the arm's length principle, another authorised approach which does so may be substituted for it. For the purpose of the authorised OECD approach, the debt to equity characterisation rules used for tax purposes in the PE's host country would be applied to the enterprise's capital for the purpose of determining which items would be treated as "free" capital for tax purposes under the domestic laws of the host country.

114. It is noted that debt/equity characterisation rules for financial instruments may vary from country to country and that such variation may result in double, or less than single, taxation. While less variation in such rules between jurisdictions may be desirable, it is not appropriate to address this issue in the authorised OECD approach. This issue is of wider significance and is not confined to PEs.

115. A final point to bear in mind is that there are some important differences between a regulated banking enterprise and a non financial enterprise, which give rise to additional difficulties in resolving funding issues within non-financial enterprises. A combination of the regulatory environment and market forces will generally ensure banking enterprises have a narrower range of debt to free capital ratios than non-financial enterprises, a category of businesses which by definition covers a wider range of activities than banking.

The Capital Allocation Approach

116. The capital allocation approach seeks to allocate an enterprise's actual "free" capital to a PE in accordance with the attribution of assets owned and risks assumed. Under this approach, "free" capital is allocated on the basis of the proportion of assets and risks attributed to the PE by the functional analysis. So if the PE has 10% of the enterprise's assets and/or risks it will have attributed to it 10% of the enterprise's free capital.

117. Where enterprises have capital structures that are consistent with those observed in comparable independent enterprises, then allocating capital of any such enterprise to its PE can produce an arm's length result. Similarly where the enterprise of which the PE is a part is resident in a different jurisdiction to the group parent company, the thin capitalisation rules of the enterprise's country of residence may ensure that the enterprise is adequately capitalised and the capital of the enterprise may again provide an appropriate starting point for allocating capital to the PE.

118. Since the capital allocation approach seeks to attribute the actual capital of the enterprise the effect is that it distributes the benefits of synergy to the constituent parts of the enterprise in a way that, in theory, minimises the likelihood of double taxation. In practice however differences in definition of "capital" between home and host countries may result in the attribution of more or less than the total amount of capital of the enterprise.

119. A problem with the capital allocation approach is that there will be instances where the PE conducts a very different type of business to the enterprise as a whole (e.g. the PE is a distributor and the enterprise as a whole is also a manufacturer) or the market conditions in the host country of the PE are very different from those applying to the rest of the enterprise (for example the enterprise has a dominant market position in its home territory but is in a very competitive market in the host country). In general, the focus of the authorised OECD approach on attributing "free" capital by reference to the functional and factual analysis should mean that such differences are adequately taken into account. However, in cases where the differences, for example in market conditions, are not appropriately reflected in the measurement of risk, the results of the capital allocation approach might be outside the arm's length range unless reasonably accurate adjustments could be made to account for the differences in the way the PE operates or the conditions under which it operates

120. Another potential problem with the capital allocation approach is that where the enterprise of which the PE is a part is itself thinly capitalised, a simple allocation of the actual "free" capital of the enterprise is unlikely to produce an arm's length result without adjustment. This issue is discussed later in this section.

121. In situations where the capital allocation approach may be applied straightforwardly (i.e. where the enterprise is adequately capitalised) there are still a number of issues to be resolved. It has been suggested, for example, that whilst in principle the total “free” capital should be allocated, there are circumstances in which this should not be the case. For example, a company might have designated capital to acquire a business (a “war chest”) or might have a temporary cash surplus from selling a business. How these situations would be treated would be determined on a case-by-case basis. If the company has a general intention to acquire a business in a jurisdiction, but no commitment, so that the capital still could be used for other purposes, that capital should be allocated along with other capital. In those cases, the company frequently will have cash or other short term investments that need to be actively managed to maximise the investment return. Where this is the case the authorised OECD approach would be to attribute economic ownership of those financial assets to the part of the enterprise performing the key entrepreneurial risk taking functions associated with managing the surplus cash or other short term investments. If, however, the company has a commitment to purchase a particular business (such as legally binding purchase contract), then the capital may be segregated. Segregation might also be appropriate if the enterprise has earmarked the proceeds for timely distribution to shareholders or otherwise committed itself to using the funds in a particular manner within a reasonable period of time.

122. The discussion in this sub-section attempts to provide an agreed framework for the OECD member countries that favour a capital allocation approach. The framework does not cover all the issues, including what deductions to allow when computing capital, over what period to compute the capital ratios (perhaps using some kind of weighted or moving average) or how to deal with foreign exchange gains and losses issues. There may also be problems for the host country in obtaining the information necessary to apply the approach. It should also be stressed that in the case of non financial enterprises, because of the absence of a regulatory framework which requires measurement of risk, there are practical difficulties in producing a meaningfully narrow range of acceptable outcomes, even after determining the creditworthiness.

Economic Capital Allocation approach

123. In the banking context another approach to allocating “free” capital has been suggested based not on regulatory measures of capital but by reference to economic capital. This approach has the potential to conform to the authorised OECD approach as it is explicitly based on measuring risks. The rationale for this approach is that regulators only look at the types of risk that cause concern for regulators and are not concerned with other types of risk that may well have a greater impact on bank profitability. Such an approach could in theory be useful in non-financial sectors; in seeking to measure for example, the economic risk inherent in developing patented technology. However, such measures do not appear to be very well developed even in banking institutions that have very sophisticated risk measurement systems. It is likely to be rare therefore for non-financial institutions to have risk measurement systems in place. Nevertheless such measures might provide a useful starting point where the PE has significant developmental risks. Moreover, developments in the area might mean that economic measures of capital usage may become more accurate and an increasingly acceptable proxy to arrive at a result within the arm’s length range.

Thin capitalisation approach

124. Another approach would be to require that the PE has the same amount of “free” capital as would an independent enterprise carrying on the same or similar activities under same or similar conditions in the host country of the PE by undertaking a comparability analysis of such independent enterprises. The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding per se (i.e. without distinguishing between debt and “free” capital) that

would be required by the PE. The next stage would be to determine the allocation of the funding into interest bearing debt and “free” capital.

125. There are a number of factors relevant to the determination of an arm’s length amount of debt and “free” capital for PEs. These include:

- The capital structure of the enterprise as a whole
- The range of actual capital structures of independent host country enterprises carrying on the same or similar activities as the PE under the same or similar conditions (including the condition discussed in Section C-2(iv) that generally the PE has the same creditworthiness as the enterprise as a whole)

126. Issues arise in seeking to apply a thin capitalisation approach to non-financial enterprises. For non-financial enterprises it will probably be necessary to focus on capital structure, such as debt to equity ratios rather than on free capital in isolation and it would be desirable to use the same method as is used to limit the interest expense for associated enterprises. This would require a determination first of all the arm’s length amount of funding that should be attributed to the PE to support its functions, assets and risks. Then comparable debt/equity ratios in the host country could be used to determine which part of the arm’s length funding should be made up of free capital.

127. One concern with such an approach is what appears to be the wide range of debt to equity ratios observable at arm’s length (i.e. between MNE Groups and their third party lenders) and whether, given the diverse range, it is possible to apply a thin capitalisation approach outside the financial sector. However, the debt to equity ratio of a particular enterprise within the wide range is unlikely to be the result of random chance, but is rather likely to be the outcome of a number of factors. A critical issue is whether it is possible to take into account all the factors that underlie such different debt to equity ratios. Further consideration perhaps needs to be given as to why certain MNE Groups are highly geared and some are not. Differences in shareholders appetite for risk has already been identified as one contributing factor, but in the context of an adequately capitalised enterprise the authorised OECD approach significantly decreases the importance of that variable by making the creditworthiness/ capital structure of the enterprise one of the internal conditions of the PE.

128. Other key variables, the “external” conditions – location of the borrowing PE, quality and nature of assets, cash flows, business sector, business strategies, capital acquisitions and disposals, market conditions in the host jurisdiction etc., could be identified and an effort made to quantify the effect of those variables on gearing; where possible by examination of the accounts of comparable independents or by researching the criteria used by independent bankers when lending to particular categories of borrowers. A functional and factual analysis of the assets, risks and activities of the PE would reveal the extent to which the key variables were present in its business, and it could be possible to attribute to the PE an appropriate amount of “free” capital for a business with these features. Further work on these issues is currently being undertaken by the Working Party No. 6 in a separate project dealing with associated enterprises and thin capitalisation.

129. The thin capitalisation approach has the advantage of avoiding some of the issues that arise in determining the amount of free capital to be attributed in situations where the enterprise as a whole is entirely debt funded. However, a weakness of a thin capitalisation approach is that the aggregate amount of “free capital” it attributes to individual PEs may be greater than the amount of “free capital” in the enterprise as a whole

Safe harbour approach - Quasi thin capitalisation / regulatory minimum capital approach

130. Another possibility discussed in Part II for banks would be to require the PE to have at least the same amount of “free” capital required for regulatory purposes as would an independent banking enterprise operating in the host country (quasi thin capitalisation/regulatory minimum capital approach). This approach is not an authorised OECD approach as it ignores important internal conditions of the authorised OECD approach, e.g. that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a safe harbour as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised OECD approach.

131. In practice there are likely to be significant problems in finding sufficiently objective benchmarks outside the regulated financial sector to apply the quasi thin capitalisation/regulatory minimum capital approach. More generally, there may be limited scope for having fixed ratios based on sector benchmarks for particular industries outside the financial sector, but only as part of a safe harbour regime.

132. However, the main disadvantage of the *quasi thin capitalisation / regulatory minimum capital* approach is that it is unlikely to provide a solution for all taxpayers in all sectors, it relies on sector benchmarks which may not meet comparability standards; and the more refined and wide ranging the approach becomes the more it resembles the thin capitalisation approach (and therefore loses the advantages of administrative simplicity).

133. The quasi thin capitalisation/regulatory minimum capital and the thin capitalisation approaches may be used in conjunction with safe harbours. The Guidelines contain much discussion of the pros and cons of safe harbours in general before concluding in paragraph 4.123 that “the use of safe harbours is not recommended”. However, as noted in paragraph 4.96 the discussion in the Guidelines “does not extend to tax provisions designed to prevent excessive debt in a foreign subsidiary (“thin capitalisation” rules) which will be the subject of subsequent work”. That subsequent work is currently being undertaken by the Working Party No. 6 in a separate project dealing with associated enterprises and thin capitalisation. Whatever views are expressed as a result of that work as to whether domestic thin capitalisation rules that adopt a safe harbour approach may be considered to accord with the arm’s length principle should apply in a PE context.

Other Methods

134. In the context of the insurance sector, other potential approaches to attributing capital are being analysed. The results of this analysis will be included in Part IV.

Attribution of capital to the PE of a thinly capitalised enterprise

135. Outside the regulated financial sector a difficulty arises that there is often no requirement for individual enterprises within the Group to have an arm’s length amount of free capital. The enterprise of which the PE is a part may for example be almost entirely debt funded (so called \$2 companies, with 2\$ equity and \$1m debt)) so that even attributing all such an entity’s free capital to the PE is likely to leave the PE thinly capitalised. Accordingly a separate discussion of the problems connected with thinly capitalised enterprises now follows the main discussion of capital attribution approaches.

136. In circumstances where the capital structure of the enterprise to which the PE is a part does not provide an arm’s length result it is necessary to look outside the enterprise itself for suitable data. There are two possible solutions to arrive at a result consistent with Article 7.

- A thin capitalisation approach

- An approach which adjusts the capital of the enterprise to an arm's length amount before allocating that capital to the PE.

137. The thin capitalisation approach looks at the capital structures of comparable independent enterprises in comparable circumstances etc. The objective under this approach is to determine an arm's length amount of free capital. Consistent with the conclusion for PEs of non-thinly capitalised enterprises, the creditworthiness implied by that amount of free capital would be assumed to belong to the enterprise as a whole, with the consequence that internal dealings in respect of guarantee fees and creditworthiness differentials impacting on intra-enterprise interest rates would not be recognised.

138. A second approach would be to first adjust the capital of the enterprise of which the PE is a part to an arm's length amount. The PE would subsequently be attributed an arm's length amount of the adjusted capital under Article 7 through a capital allocation approach.

139. As discussed in Section B-2, since both approaches are capable of giving an arm's length result, the approach used by the host country should be accepted by the home country, except in situations where the host country method does not give an answer that is consistent with the arm's length principle. In determining whether a particular capital attribution approach gives an arm's length result for a PE of a thinly capitalised enterprise it may be necessary to consider why the enterprise as a whole is thinly capitalised.

140. In applying a thin capitalisation approach, if any commercial reasons for the enterprise being thinly capitalised had nothing to do with the business operations of the PE, then the attribution to the PE of more than the enterprise's capital may well be consistent with the arm's length principle. If such commercial reasons *did* relate to the business operations of the PE, then this must be accounted for in seeking to benchmark the PE's capitalisation against whatever uncontrolled comparables are selected. This would be either by selecting comparables that are similarly impacted by such factors, by adjusting the comparables to account for any differences in such factors, or if the available comparables data cannot reliably be used because of such factors, using a different authorised OECD approach that would be more consistent with the arm's length principle.

Conclusion on attributing capital to the PE

141. The attribution of "free capital" among the parts of an enterprise is a pivotal step in the process of attributing profits to the PE. The general principle is that the PE should have sufficient "free capital" to support the functions, assets and risks attributed to the PE. For this reason, the method by which capital is attributed is an important step in avoiding or minimising double taxation or less than single taxation.

142. The consultation process has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient capital to support the functions, assets and risks it assumes. However, the consultation process has also shown that it is not possible to develop a single internationally accepted approach for attributing the necessary free capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all circumstances.

143. Rather the focus of the Report is on articulating the principles under which such an attribution should be made and on providing guidance on applying those principles in practice in a flexible and pragmatic manner. As such, whilst any of the authorised approaches described in this section are capable of producing an arm's length result, there may be particular situations where the approach does not produce an arm's length result and so flexibility may be required but in a manner that should reduce the incidence of double taxation.

144. The fact that countries may incorporate different authorised approaches to attributing capital in their domestic regimes has raised concerns that double taxation may arise. However, Article 23 requires home countries to accept host country domestic rules consistent with one or more of the authorised approaches, provided the result is consistent with the arm's length principle in a particular case. It follows that in such circumstances the home country should give relief for tax on profits calculated under the host country basis. This is the case even where the home country has a domestic rule which attributes capital in accordance with another of the authorised approaches.

145. Nevertheless, there will inevitably be some cases where tax administrations disagree over whether the results produced by the host country method are consistent with the arm's length principle. The Mutual Agreement Procedure is available to resolve such differences. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of capital to a PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weakness of different approaches and therefore provides a framework for resolving difficult cases.

d) Determining the Funding Costs of the PE

Introduction

146. The authorised OECD approach acknowledges that the PE requires a certain amount of funding (made up of both free capital and interest bearing debt). Once that amount has been determined, one of the authorised capital attribution approaches as described in the preceding section is used to determine the amount of the funding that is made up of free capital. The balance of the funding requirement is therefore the amount by reference to which the interest deduction is calculated and is the focus of this section. For simplicity sake the discussion is couched in terms of "debt" and "interest" but the comments below are applicable to any financial instrument and any funding costs, whether strictly classified as interest for tax purposes or not.

147. Just as there is more than one authorised approach to attributing free capital to a PE so too there is more than one authorised approach to attributing interest bearing debt and to determining the rate of interest to be applied to that debt. Under the authorised OECD approach the attribution can include, in appropriate circumstances, the recognition of internal "interest" dealings. The various approaches are discussed in the first sub-section below. The recognition of internal dealings represents a departure from the existing Commentary on Article 7(3), which only recognises internal dealings in financial enterprises. This recognition creates the potential for tax avoidance as discussed in the second sub-section below. The third subsection discusses the extent to which it is appropriate to recognise a mark up on any internal "interest" dealings.

Authorised approaches to attributing funding costs to PEs

148. A key feature of the authorised OECD approach as it applies to funding costs is that it moves the focus away from the recognition of dealings as such to a wider consideration of determining an allowable interest deduction for the PE. The objective of the authorised OECD approach is to establish using one of the authorised approaches described below an arm's length amount of interest in the PE, commensurate with the functions, assets and risks attributed.

149. The current approach of the Commentary makes a distinction between financial and non-financial enterprises based on the fact that the making and receiving of advances is closely related to their ordinary business (the "direct or indirect approach"). On this basis it is said to be permissible to recognise internal interest dealings for financial enterprises but not for non-financial enterprises (para 18.3 of Commentary on

Article 7). The authorised OECD approach rejects the “direct” and “indirect” approach in favour of applying the functional approach of the Guidelines. The question then becomes how to account for the movement of funds within the enterprise. Whilst movements of funds between parts of the enterprise do not necessarily give rise to dealings, there would be circumstances where they could be recognised as internal interest dealings within non financial enterprises, for the purposes of rewarding a treasury function (“treasury dealing”). Treasury functions are described in Part II of this Report, sub-section D-2 (iii) (b).

150. Where such an approach is used, the question of whether any movement of funds would be recognised as a “treasury dealing” would depend on a functional and factual analysis of the “dealing” and the conditions under which it was performed. In particular, it would be necessary in order to recognise a dealing as a “treasury dealing” to identify one part of the enterprise as undertaking in substance the key entrepreneurial risk-taking functions in relation to the cash or financial asset in order to be treated as the “owner” of the cash or financial asset and therefore entitled to an arm’s length return from the cash or asset under an internal “treasury dealing”. In the absence of such entrepreneurial risk-taking functions, it would not be possible to recognise any internal “treasury dealings” at arm’s length prices.

151. The existing Commentary mentions two other approaches for attributing the external interest expense of the enterprise to its PE (neither of which is fully endorsed): (1) a tracing approach, and (2) a fungibility approach. A number of countries currently use some variation of these approaches. Under a "pure" tracing approach, any internal movements of funds provided to a PE are traced back to the original provision of funds by third parties. The interest rate on the funds provided to the PE are determined to be the same as the actual rate incurred by the enterprise to the third party provider of funds. A tracing approach could, in certain circumstances be evidenced by internal dealings that allocate the actual interest expense of the enterprise to the PE. Under a "pure" fungibility approach, money borrowed by a PE of an enterprise is regarded as contributing to the whole enterprise's funding needs, and not simply to that particular PE's funding needs. This approach ignores the actual movements of funds within the enterprise and any payments of inter branch or head office/branch interest. Each PE is allocated a portion of the whole enterprise's actual interest expense paid to third parties on some pre-determined basis. Hence, there would be no need under a fungibility approach for any recognition of internal interest dealings.

152. Both a tracing approach and a fungibility approach, at least in their pure form, have problems. The Commentary on Article 7 also remains equivocal on this issue. Paragraph 18.2 states:

"The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality."

153. Just as for capital attribution, it does not seem possible to develop a single approach that could be applicable in all circumstances. Some countries favour a fungibility approach, whilst others want to retain tracing of funds for non-financial institutions. Others want a more flexible approach, perhaps by using tracing for “big-ticket” items and a fungibility approach for the rest of the assets. Other countries want to determine the amount of interest by reference to the amount of interest of comparable independent enterprises in comparable circumstances. Other countries may want to use appropriately recognised “treasury dealings” to reward a treasury function. The important point to stress is that the goal of all the approaches described above is the same, i.e. that the amount of interest expense claimed by the PE does not exceed an arm’s length amount and that any treasury functions are appropriately rewarded. Accordingly,

all these approaches should be treated as authorised under the authorised OECD approach and the home country should accept the results of any of the authorised approaches in a particular case, provided that the result is consistent with the arm's length principle.

154. One of the reasons given in the current Commentary on Article 7 (3) for not recognising internal dealings is the scope for avoidance. In particular the scope for giving an interest expense to the PE in cases where the enterprise as a whole is solely or predominantly equity funded (see paragraph 18 of Commentary to Article 7(3)). However, it should be noted that the recognition of "treasury dealings" only rewards the performance of any key entrepreneurial risk-taking functions performed in respect of the cash and financial assets of the enterprise. If there are no key entrepreneurial risk-taking functions then only the actual external interest expense of the enterprise will be allocated amongst the various parts of the enterprise. For example, in the absence of any external debt it is unlikely that there will be key entrepreneurial risk-taking functions performed by one part of the enterprise such that one part of the enterprise would be treated as the economic owner of all the cash and financial assets of the enterprise.

155. Under the authorised OECD approach, therefore, the concern for avoidance identified at paragraph 18 in the current Commentary for non-financial enterprises disappears because internal interest dealings are recognized only for the purpose of rewarding treasury functions and therefore do not affect the attribution of free capital and, by way of consequence, the quantum of debt attributed to the PE determined under the basic principles set out in Section C-2 (v) (c) above.

Determining the arm's length price of treasury dealings

156. Finally, it remains to consider how to reward the "treasury dealings". The answer will be to do so under the arm's length principle and by reference to a comparability analysis applying by analogy the methods of the OECD Transfer Pricing Guidelines. For example, where the "treasury dealing" relates to external debt, one method of arriving at an arm's length price might be to add a margin to the external debt by reference to comparable margins earned by independent enterprises performing comparable functions. One feature of the WH is that it generally attributes the creditworthiness of the enterprise to its constituent PEs. It follows from this that no margin should be added in respect of credit differentials between one part of the enterprise and another. The addition of a margin would therefore only be appropriate where there is clear evidence that one part of the enterprise is providing a real treasury function to the other parts of the same enterprise. Where the "treasury" PE is doing little more than acting as a conduit (borrowing funds and immediately on-lending) the functional analysis is unlikely to show that the "treasury" PE has been performing the key entrepreneurial risk-taking functions and so should be treated as the economic owner of those funds and so entitled to the associated return. Instead, it may be appropriate to reward the "treasury" PE not as the owner but instead as a service provider, for example with a reimbursement of any administrative costs incurred or on a cost plus basis, depending on what precisely was involved (i.e. the costs do not include interest cost).

157. Where the PE of a non-financial enterprise, is performing a fully fledged treasury function, the functional analysis may well determine that the treasury centre is the economic owner of the internal financial assets as it has been performing the key entrepreneurial risk-taking functions in respect of those assets and so is entitled to the return on those assets. The pricing of that return can be determined in accordance with the discussion of treasury centres in the revised Part II (Section D-2 (iii) (b)). As noted in Part II, the addition of a margin to an internal interest dealing is only one of a number of possible methods to reward the performance of a treasury function. Where these other methods are used, the treasury function would be rewarded separately through an arm's length remuneration.

158. There are other financial dealings which may occur in non-financial enterprises, for example hedging transactions, but such purported transfers of risk would need to meet the threshold hurdle, i.e. they

would not be recognised unless, for example, the part of the enterprise the risk was transferred to had the expertise to manage the risk and so was performing the key entrepreneurial risk-taking functions in respect of those risks.

e) The authorised OECD approach for adjusting interest expense

159. Where the amount of “free” capital allotted by the enterprise is less than the arm’s length amount as determined by one of the authorised approaches, an appropriate adjustment would need to be made to reduce the amount of interest expense claimed by the PE in order to reflect the amount of the enterprise’s “free” capital that is actually needed to support the activities of the PE. The adjustment will be made following the rules of the PE’s host country, subject to Article 7.

160. It should be noted that the host country PE may be taxing less than an arm’s length amount if no adjustment is made to increase the allotted amount of “free” capital. The focus of Article 7 is on determining the appropriate taxing rights of the PE host country in that it cannot tax in excess of the arm’s length amount of profit. No adjustment is mandated under Article 7 in this case. However host countries may wish to exercise their full taxing rights by adjusting upwards the amount of “free” capital. Article 7 permits this adjustment provided that the host country does not make an upwards adjustment in excess of the arm’s length amount.

161. Where interest bearing debt attributed to the PE (including recognised “treasury dealings” in respect of internal movements of funds) covers some part of the arm's length amount of "free" capital properly attributable to the PE, any interest on the amount so covered would not be deductible in arriving at the PE's taxable profits. In some cases, the PE's accounts may specifically identify the interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. In these cases, it may be a fairly simple matter to determine the amount of non-deductible interest. In other cases, the PE's accounts may not readily identify any specific interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. This raises the question of how to determine the amount of non-deductible interest.

162. A variety of methods are possible. One method for determining the amount of non-deductible interest might simply be to apportion the actual interest expense claimed by the PE (after any adjustment to reflect arm's length amounts) by using a ratio based on the average debt level that the PE had during the year, and the average debt level that the PE would have had during the year after adjustment to reflect the additional "free" capital that should have been attributed to the PE. Another method might be to use a weighted average of rates actually charged on the interest bearing debt attributed to the PE. It is also desirable to allow the use of other methods where the results produced are more acceptable to the taxpayer and to the tax administration of the host jurisdiction.

163. Another issue that can arise is where the PE has allotted capital in excess of the arm’s length range of “free” capital. This might be because the host jurisdiction has a domestic tax law requirement on allotted capital. In that case the host jurisdiction is taxing more than is permitted under Article 7. Any such domestic tax law requirement that provided for an amount of free capital in excess of the arm’s length range would be restricted by Article 7 to an amount that was within the limit set by the arm’s length range. Alternatively, an enterprise may allot an excessive amount of “free” capital to a PE, for example where the PE is subject to a low rate of taxation and the enterprise wishes to maximise interest deductions in its home jurisdiction subject to higher taxation. In such situations the authorised OECD approach would enable the home country to adjust the amount of capital attributed to the PE to an amount within the limits set by the arm’s length range – this issue is discussed in more detail in Section B-2 above.

164. Another issue relates to the situation where all the operations of the PE are funded by borrowings from third parties. Is it still necessary to disallow part of the interest expense by reference to an amount of “free” capital? The answer is that it would be consistent with Article 7 to make such an adjustment, given that the PE when hypothesised as a distinct and separate enterprise would have “free” capital as discussed earlier in the Report. However as noted earlier in this section Article 7 does not mandate such an adjustment when the host country imposes tax on an amount of business profits that reflects the recognition of an amount of “free” capital in the PE that is below the limits set by the arm’s length range of “free” capital.

165. Some practical issues arise as to how to make any such adjustment. Where the PE borrows funds from the treasury centre a “free” capital adjustment can potentially be made in respect of the internal “treasury” dealing. However, this solution is not possible where the PE’s borrowings are wholly with third parties. One way of making the adjustment for “free” capital would be to impute a “loan” from the PE to the treasury location of the enterprise which would have the effect of decreasing the interest deduction of the PE by reference to the amount of “free” capital.

f) Conclusion

166. The first step of the authorised OECD approach determines the activities and conditions of the hypothesised distinct and separate enterprise. A functional and factual analysis attributes functions, assets and risks to the PE, and sufficient “free” capital is attributed to support those functions, assets and risks. The attribution of capital and funding to PEs of non-financial enterprises presents certain difficulties not encountered in the financial sector, however the approach is practical and effective.

167. As with the attribution of free capital to the PEs of financial enterprises, the testing in the general situation has demonstrated the need for flexibility over such issues as the attribution of free capital and the determination of funding costs. To some extent, this flexibility also reflects the real practical difficulties of translating the authorised OECD approach in precise guidance in this area. On the other hand, the attribution of capital is now governed by a clear principle the observance of which will help minimise instances of double taxation. The application of the authorised OECD approach represents a significant departure from the existing Commentary by authorising an approach to attributing interest expense based on the recognition of internal interest dealings in non-financial enterprises in appropriate circumstances. The authorised OECD approach is able to do this because it is rooted in a detailed factual and functional analysis which attributes functions, assets and risks to the PE, then attributes a sufficient amount of “free” capital to support the assets used and the risks assumed.

168. Given the importance of the attribution of assets and risks to the determination of both the profits of the PE and an appropriate funding structure, it will be necessary to require PEs to document how they have attributed assets, measured risks, (or why they do not consider it necessary to measure risks) and attributed “free” capital and interest expense. Documentation requirements are discussed in more detail below in section C-3 (iv) (d).

C-3. *Second step: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis*

(i) *Introduction*

169. The authorised OECD approach provides for the choice and application of methods described in the Guidelines for purposes of determining the profits to be attributed to a PE, based upon its functions performed and the assets and risks attributed in the manner described in the foregoing section. The PE

should obtain an arm's length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise.

170. A functional and factual analysis of the PE will already have been accomplished in the process of constructing the hypothetical "distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions". However, the language of Article 7(2) goes on to require that the profits to be attributed to the PE must also be based on the hypothetical distinct and separate enterprise, "dealing wholly independently with the enterprise of which it is a permanent establishment". In some cases, it may therefore be necessary to carry out a functional and factual analysis of another part of the enterprise (of which the PE is a part) if the other part contributes to the functions being performed by the PE or undertakes activities in relation to the assets and risks attributed to the PE, or vice versa.

171. Continuing to follow, by analogy, the approach of the Guidelines, profits should be attributed to a PE by applying the traditional transaction methods (CUP, resale price and cost plus), or, where such methods cannot be applied reliably, the transactional profit methods (profit split and TNMM).

172. The question arises as to how to adapt the guidance of the Guidelines on transfer pricing methods to the PE context. In an Article 9 situation, there are "controlled transactions" between associated enterprises, and the transfer pricing methods apply by comparing those transactions with comparable uncontrolled transactions between independent enterprises. In the PE situation there are "dealings" rather than actual "controlled transactions" that govern the economic and financial relationships between the PE and another part of the enterprise.

173. The authorised OECD approach is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the PE context means either that there are no differences materially affecting the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences. Principles similar to the aggregation rules of Chapter I of the Guidelines should also apply, to permit the PE's dealings to be aggregated, where appropriate, in determining the PE's attributable profit. The rest of this section looks at some of the issues identified above in a little more detail.

(ii) *Recognition of dealings*

174. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for a greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealings.

175. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independents at arm's length, and should therefore be reflected in the attribution of profits under Article 7(2). In the associated enterprise situation it will usually be self-evident that a transaction has occurred, e.g. the transaction will have legal

consequences other than for tax. Even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would not be recognised or would be restructured in accordance with economic and commercial reality). A dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of determining an arm's length attribution of profit. Consequently, intra-entity dealings are perhaps more susceptible to being disregarded or restructured than transactions between associated enterprises.

176. The starting point for the evaluation of a potential "dealing" will normally be the accounting records of the PE showing the purported existence of such a "dealing". Under the authorised OECD approach, that "dealing" as documented by the enterprise will be recognised for the purposes of attributing profit, provided 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). A functional analysis should be used to determine whether such an event has occurred and should be taken into account as an internal dealing of economic significance. And ultimately it is the factual and functional analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise.

177. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the "dealing". In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction. This analysis would follow the guidance on contractual terms found in paragraphs 1.28 and 1.29 of the Guidelines.

178. A dealing takes place within a single legal entity and so there are no "contractual terms" to analyse. However, the authorised OECD approach treats "dealings" as analogous to transactions between associated enterprises and so the guidance in paragraphs 1.28 and 1.29 can be applied in the PE context by analogy. In particular, as noted in paragraph 1.28, "The terms of a transaction may also be found in correspondence/communications between parties other than a written contract." So, by analogy, the "contractual terms" are the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part. Further, paragraph 1.26 of the Guidelines notes that "in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties conduct should generally be taken as the best evidence concerning the true allocation of risk." Paragraph 1.27 goes on to note that "{a}n additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control".

179. An analysis of the contractual terms of the transaction is part of the factual and functional analysis and can be used to examine whether the actual conduct of the parties conforms to the terms of the contract and is consistent with the economic principles that govern relationships between independent enterprises. Such an examination is considered necessary even where there are contractual terms between legally distinct, albeit associated, enterprises. Paragraph 1.29 of the Guidelines states that it will be necessary to, "examine whether the conduct of the parties conforms to the terms of the *dealing* or whether the parties' conduct indicates that the *terms of the dealing* have not been followed or are a sham." The paragraph goes on to note that in such cases, "further analysis is required to determine the true terms of the transaction." Such an analysis will be even more important in the PE context where any terms between the various parts of the enterprise are not contractually binding.

180. In summary, an accounting record and contemporaneous documentation showing a “dealing” that transfers economically significant risks, responsibilities and benefits would therefore be a useful starting point for the purposes of attributing profits, but would not be determinative where it was found to be inconsistent with the functional and factual analysis and therefore the economic reality of the dealing. Ultimately the authorised OECD approach relies on a factual and functional analysis to determine the economic reality behind any documented dealing relating to the attribution of risk.

181. Once the above threshold has been passed and a dealing recognised as existing, the authorised OECD approach applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and the other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the 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.”

(iii) *Applying transfer pricing methods to attribute profit*

182. Consider a PE that distributes a product manufactured by its head office. The PE’s dealings that are at issue are the obtaining of the product from the head office, and the sale of the product to a third party customer. It is assumed that the third party sales price is at arm’s length and so the transfer pricing examination would be focused on the dealings with head office. To determine the PE’s attributable profit from these dealings, the transfer pricing methods would be applied in light of the PE’s business activities and functions as a distributor. If, for example, the head office also sells the product to third party distributors, the CUP method might be used to determine the profit that the PE would have obtained had it been a “distinct and separate enterprise” within the meaning of paragraph 2 of Article 7. The amount of gross profit attributed to the PE would be determined as the difference between revenues received by the PE from third party customer sales and the price charged by the head office, adjusted, if necessary, to the arm’s length price by reference to comparable transactions between third party distributors and manufacturers.

183. Where a CUP is unavailable, the PE’s gross profit might be determined based upon a comparable resale price margin percentage applied to the third party customer sales revenues. Net profit would then be computed by deducting expenses incurred by the enterprise for the purposes of the PE, including appropriate reflection of compensation for any functions performed by other parts of the enterprise for the purposes of the PE. See Part D, below. This result is consistent with paragraph 17.3 of the Model Commentary on paragraph 3 of Article 7, which states:

“Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm’s length principles.”

The same approach would be used in applying the other methods described in the Guidelines. This approach determines the profit of the PE in the host country. It should be noted that the timing of profit recognition for the purposes of relieving double taxation in the home country will depend on the interaction between Article 23 and domestic law and may be different.

184. An issue arises where there is a dealing between the PE and another part of the same enterprise and there are costs related to that dealing that have been incurred by the other part of that enterprise. To the extent that the costs that have been incurred by the other part of the enterprise have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE. Moreover, care is needed with regard to the internal accounting for the costs attributed to different dealings, e.g., to ensure that costs covered in a dealing are not also claimed again under another dealing. For example, product testing costs relating to an arm's length CUP for a product "sold" to the PE may not also be claimed a second time as part of "services" charged to the PE under a cost-plus method. The issue is akin to the issue addressed by paragraph 7.26 of the Guidelines and the guidance in that paragraph will be relevant by analogy for the situation where there is a dealing between the PE and another part of the same enterprise.

185. When attributing profit to the PE, it may also be necessary, as mandated by Article 7(3) of the Model Tax Convention, to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length. Whether expenses incurred outside the PE need to be taken into account would be revealed by a functional and factual analysis of the relevant parts of the enterprise. Subject to the preceding paragraph, the method by which this is achieved may vary. Some countries prefer to take such compensation for functions performed by other parts of the enterprise into account, by adjusting the gross profit margin to reflect the performance of those functions. The actual amount of expenses incurred by other parts of the enterprise in performing those functions should not be deducted to arrive at the PE's arm's length net profit. Other countries prefer a two step analysis. First, the gross margin for the PE based on comparables would be determined, without taking into account compensation for the functions performed by other parts of the enterprise. Second, an appropriate compensation for the functions performed by other parts of the enterprise would be determined based on comparables and this amount would be deducted to arrive at the PE's arm's length net profit. Both methods should produce the same result. Section D discusses in more details the issue of the interpretation of Article 7 (3) in relation to Article 7 (2) of the Model Tax Convention.

186. The transfer pricing methods are intended to determine the arm's length compensation for the functions that the PE performs, taking into account the assets and risks attributed to the PE. As discussed in Section C-2(i) above, the functional analysis undertaken to construct the hypothesised distinct and separate enterprise would have already determined the characteristics and functions of the PE, including a determination of the assets used and risks assumed.

187. The risks assumed by the enterprise as a whole, which are not directly attributable to activities carried on by particular parts of the enterprise, may still need to be taken into account in some manner when attributing profit to the PE using the arm's length principle. Such risks might enter into the analysis of whether the conditions of the dealings between the PE and another part of the same enterprise are comparable with conditions of the transactions between independent enterprises.

188. Where the PE has dealings with other parts of the enterprise, those dealings (provided they pass the threshold test above) will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other parts of the enterprise, taking into account assets used and risks assumed. For example, the PE may begin to use assets (tangible or intangible) belonging to the enterprise that were developed by the head office or purchased for the business of the head office or vice versa. The PE may use services rendered by the head office or vice versa. The PE may use cash earned by the head office or vice versa. Under the authorised OECD approach, internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises. However, the authorised OECD approach is based on the premise that the internal dealings are postulated solely for the purposes of attributing the appropriate amount of profit to the PE.

(iv) *Comparability analysis*

189. The Guidelines identify 5 factors determining comparability between controlled and uncontrolled transactions; characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies. The authorised OECD approach seeks to apply the same factors to ensure comparability between dealings and uncontrolled transactions. It is considered that all the factors, with the exception of contractual terms, can be applied directly to evaluate dealings as they are essentially based on fact. The concept of contractual terms is rooted in relationships between legally distinct, albeit associated, enterprises and so needs to be applied by analogy to dealings within a single legal entity (see discussion in Section C-3 (iii) as to how to apply, by analogy, the guidance on contractual terms at paragraphs 1.28 and 1.29 of the Guidelines). Once the “contractual terms” of the internal dealings have been determined, a comparison can be made with the contractual terms of potentially comparable transactions between independent enterprises.

190. The comparability analysis might determine that there has been a provision of goods, services or assets etc. between one part of the enterprise and another that is comparable to a provision of goods, services or assets etc. between independent enterprises. Accordingly, the part of the enterprise making such a “provision” should receive the return which an independent enterprise would have received for making a comparable “provision” in a transaction at arm’s length. In an arm’s length transaction an independent enterprise normally would seek to charge for making a provision in such a way as to generate profit, rather than providing it merely at cost, although there can be circumstances in which a provision made at an arm’s length price will not result in a profit (e.g. see paragraph 7.33 of the Guidelines in connection with the provision of services).

191. Another outcome of the comparability analysis might be that the PE and the other part of the enterprise dealing with the PE have structured their dealings in a comparable manner to economic co-participants in an activity corresponding to a cost contribution arrangement (CCA). If the PE and the rest of the enterprise are found to be economic co-participants in such an activity, the dealings would be treated in a manner similar to transactions between associated enterprises in a CCA.

192. The guidance in Chapter VIII on determining whether a CCA between associated enterprises satisfies the arm’s length principle can be applied, by analogy, in the PE context. A CCA is, like any other transaction between associated enterprises, an arrangement containing rights and obligations designed to achieve a given economic goal for its members. Notwithstanding the fact that the PE is not a distinct and separate legal entity from the rest of the enterprise, the same economic goals can nonetheless be replicated as between a PE and the rest of the enterprise as a notional construct to assist in the attribution of profits to a PE. Given the absence of contracts between parts of the same enterprise, however, the enterprise presenting certain activities as being the object of a notional CCA will need to meet a significant threshold in order to provide reliable evidence in support of its position. Therefore, the onus will be on the taxpayer to prepare and produce, where required, the type of contemporaneous documentation that would have been created to document an actual CCA structured in accordance with the Guidance of Chapter VIII of the Guidelines. Beyond the documentation of the notional CCA meant to reveal the intentions of the participants, a functional and factual analysis will be required that will determine the conduct of the participants and, thus, establish the true nature of the economic relationships between different parts of the enterprise.

193. For example, where a PE is claimed to be a participant in a CCA type activity within a single legal enterprise, there should be sufficient evidence available to enable the tax authority in the PE’s host country to evaluate whether the PE’s contribution to the “CCA” type activity is, as stated at paragraph 8.8 of the Guidelines, “consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to receive from the arrangement.”

Documentary evidence will be critical in making this evaluation, provided it reflects the real situation and any documented intentions are put into effect and followed during the life of the CCA activity.

194. Consistent with the earlier guidance on the recognition of dealings, an enterprise and its PE would not ordinarily be found to be acting in a manner consistent with a CCA where this was not the intent of the enterprise, as supported by relevant documentation. Likewise, given the extent of the documentation required to support the existence of a notional CCA, an enterprise could not claim after the fact the existence of the CCA where no contemporaneous documentation is available to support such a claim. In other words, the degree of sophistication of the notional construct that is required by an economic CCA between parts of a single legal enterprise precludes claims that are not backed by convincing contemporaneous documentation.

195. The comparability analysis may also result in other outcomes than those described in the previous paragraphs. Member countries are of the opinion that these other outcomes should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

196. The current approach found in the Model Commentary is based on the nature of the property involved, for example by presuming that the supply of goods for resale creates a provision, whilst a supply of intangible property would not. This approach creates problems where different types of property are supplied as part of a package. One analytical tool currently used by Member countries to determine the effect of internal dealings on the attribution of profit is the “direct or indirect approach” outlined in paragraph 17.2 of the Commentary on Article 7. This approach is based on the premise that provisions should be postulated, and arm’s length prices charged, in cases where the relevant functions contribute directly to the realisation of profit from external entities. However, this view requires a determination of which functions contribute directly, as opposed to indirectly, to the earning of profit. It is also considered that it may be extremely difficult to find objective criteria for making the determinations described earlier in this paragraph. Accordingly, the Working Party agrees that the authorised OECD approach is to reject the current approach based largely on the nature of the property or services involved and use of the “direct and indirect approach” in favour of applying the comparability approach, by analogy, based on the guidance in the Guidelines.

197. To summarise, where internal dealings take place, the factual and comparability analysis will attribute profit in respect of the dealings by reference to comparable transactions between independent enterprises. The guidance in the Guidelines on undertaking such analyses will be applied, by analogy, in light of the particular factual circumstances of a PE and as a result of testing the authorised OECD approach. Three particular circumstances are considered in this regard: use of capital assets, use of intangible assets, and the provision of internal services.

(a) Capital assets

Determining ownership of capital assets at the time of acquisition

198. Physical assets may be either owned or rented and there are commercial pros and cons associated with either option. The starting point of the analysis is to determine the nature of the risks related to the asset used in the PE. The nature of these risks will vary according to whether the asset is legally owned or not by the enterprise. So, if the asset is leased or rented from a third party, the PE would usually be considered to use a leased or rented asset and neither the PE nor another part of the enterprise could be found to be the economic owner of the asset. However, where the enterprise is a licensee its contractual

rights to use the leased, rented or licensed asset may themselves constitute an asset⁷ owned by the enterprise. Where a physical asset is acquired by the enterprise as a whole and is located in, and used exclusively by, one PE, the question arises as to which part of the enterprise should be considered the economic owner of the asset.

199. Economic ownership of an asset belongs with the part or parts of the enterprise performing in particular the key entrepreneurial risk-taking functions in respect of that asset, as determined by the factual and functional analysis. This is why, in practice, the actual acquisition of an asset by one part of the enterprise is not determinative in assigning its economic ownership within the enterprise.

Change in use of a capital asset

200. The issue of determining which part of the enterprise should be considered the economic owner of an asset that is legally owned by the enterprise as a whole does not arise only at the time of acquisition by the enterprise. It can also become an issue when an asset is transferred from one part of the enterprise for use in another part of the enterprise. For example, the situation may arise in which the use of a capital asset by one part of an enterprise, e.g. the head office is changed to use by another part of the enterprise, e.g. the PE. For instance, if both the head office and the PE engage in a manufacturing function, and the head office no longer has need for a particular machine, that machine might be moved from the head office to the PE for use in the manufacturing business of the PE. After this removal, the factual and functional analysis of Article 7(2) would show the PE as using the asset, and accordingly the profits associated with the use of the asset would become attributable to the PE. The removal of the machine from the head office to the PE is a real and identifiable event, and so would constitute an internal dealing.

201. The question then becomes how to account for the acquisition and use by the PE of an asset, either acquired from a third party or transferred from another part of the enterprise, when computing the amount of profit that should be attributed to the PE. Should the PE be treated as having “bought” the capital asset from the head office? Should the PE be treated as leasing or renting the capital asset? Is it possible for the PE to be treated as a participant in a “CCA” type activity in respect of the capital asset? The answers to these questions raise issues owing to the special factual circumstances of a PE. If there had been a change of arrangement between two independent enterprises, the question as to whether the asset had been bought, leased or rented would have been determined by examining the contractual arrangements between the parties (provided their actual conduct followed the contractual arrangements, see paragraphs 1.28 and 1.29 of the Guidelines). A dealing takes place within a single legal enterprise, however, and so there are no “contractual terms”. However, as noted in Section C-3 (iii) the guidance in paragraphs 1.28 and 1.29 can be applied by analogy so that the “contractual terms” may be the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part.

202. Where a physical asset has been transferred from one part of the enterprise to another, such a transfer is clearly an economically significant event and will pass the threshold test for the recognition of an internal dealing. The question to be determined is the character of that dealing. An important factor in determining the character of the dealing is the documentation produced by the taxpayer at the time of the transfer. The dealing may be characterised in the documentation as a rental agreement, an outright sale or as the commencement of a “CCA” type of activity. As is always the case with intra-enterprise transfers, however, the documented characterisation of the dealing will only be respected for tax purposes if the documentation reflects the economic reality. Documentation which characterises the dealing as, for example, a rental arrangement, will only be recognised if, in fact, the original economic owner of the asset

7. A right to use can become a liability over time, if the licence payment or rent exceeds the economic benefit derived from the right to use the asset

continues to bear the economic risk and take the key entrepreneurial risk taking decision in respect of that asset.

203. As already noted, economic ownership of an asset belongs with the part of the enterprise performing the key entrepreneurial risk taking functions in respect of that asset. Depending on the asset and the circumstances of its transfer, the key entrepreneurial risk taking decisions in relation to a transferred asset might include responsibility for organising serial use for short periods by different parts of the enterprise. In such circumstances, ownership of the asset would not be transferred to the PE which was intended to use the asset for a short time (it would be “renting” the asset, and that characterisation would override any documentation to the contrary) and the economic owner would bear the risk that the asset might not be needed by other parts of the enterprise and so may not generate sufficient income to cover the expenses of ownership.

204. On the other hand, a transfer might be documented as a “rental”, but if in fact the PE is responsible for the regular maintenance of an asset for which maintenance is a significant cost or has to recruit personnel to perform unforeseen repairs, and if the PE has responsibility for deciding when to replace the asset rather than continue to maintain it, then it may be that the PE is assuming most of the risks associated with the ownership of the asset. In such circumstances economic ownership of the asset appears to have been transferred to the PE.

205. As indicated in paragraph 196, one must first establish whether the enterprise itself owns the assets, leases it or rents it from an independent enterprise. Where the enterprise itself rents the asset, it is hard to see how the factual and functional analysis could show that one part of the enterprise was performing key entrepreneurial risk-taking functions equivalent to being the owner of the asset, given that the enterprise itself had only assumed the risks of a licensee. Where the enterprise legally owns the asset, it may be relevant to know what independent parties making use of a similar asset under similar conditions would do. As noted in paragraphs 200-202 above, while the documentation of the arrangement will assist in the determination, if the conduct of the parties is inconsistent with this documentation, consideration must be given to the actual conduct of the PE and the rest of the enterprise in order to establish the true nature of the arrangement.

206. The determination of the nature of the dealing would be assisted by reference to the terms agreed between the parties (whether explicit or implicit), following, by analogy, the guidance given by paragraphs 1.28 and 1.29 of the Guidelines (see general discussion in Section C-3 (ii)). The compliance obligation of the taxpayer, then, is to document the transfer contemporaneously, and ensure that the documented characterisation is consistent with how the different parts of the enterprise subsequently behave.

207. If it is considered that the factual situation reflects the provision of a capital asset in a manner comparable to an outright sale between independent enterprises, the fair market value of the asset at the time of transfer would need to be established. Under the authorised OECD approach, where the asset is transferred from head office to the PE, the fair market value would provide the basis upon which an allowance for depreciation would be computed in the host country. The computation of the depreciation allowance would be made according to the domestic law of the host country for each year in which the asset is used by the PE.

208. Again, where the asset is transferred from the PE to another part of the enterprise, the fair market value of the asset at the time of transfer would generally be used as the basis upon which an allowance for depreciation would be computed in the country to which the asset had been transferred. The situation in the PE’s host country will depend on its domestic law and the interaction between domestic law and Article 7.

209. The domestic law of many countries will recognise for tax purposes the transfer of the asset from their jurisdiction, for example by computing a profit or loss by comparing the fair market value of the asset at the time of transfer with its book value or its depreciated cost base for tax purposes (see paragraph 15 of the Model Commentary on Article 7). However, the domestic law of some countries will not permit the unrealised profit from such a transfer to be taxed, although a loss may have to be allowed under the provisions of an applicable tax treaty. It should also be noted that the authorised OECD approach only determines the attribution of profits to a PE under Article 7. The authorised OECD approach does not override domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets.

210. As indicated in Section B-2(i) differences in domestic law treatment between home and host country may give rise to double taxation due to an asymmetric treatment of the transfer of the asset. For example, if the asset is transferred to head office in a jurisdiction, which would not recognise the unrealised profit from the notional transfer, the taxpayer will not get immediate relief for any tax paid in respect of that transfer in the jurisdiction of the PE.

211. For the authorised OECD approach to apply in a completely symmetrical manner in this situation, the home country of the head office would need to recognise that the transfer into its jurisdiction gives rise to a disposition of the asset by the enterprise and an immediate reacquisition at fair market value. This would produce a profit or gain that could be taxed in the head office's home country, thereby permitting that jurisdiction to provide relief against that profit or gain for the tax paid in the host country of the PE in respect of the transfer. However, the absence of a right to tax the profit or gain under the domestic law of the head office's home country would mean that it is not possible to tax the profit or gain on the transfer and so provide for immediate double taxation relief.

212. The above situation is one where the authorised OECD approach could not be applied in a symmetrical manner without a change in the domestic law of the country of the head office. As discussed at Section B-2 above, remedying such a situation is beyond the scope of this Report. However, if the asset is ultimately disposed of by the enterprise at a profit or gain, partial or complete relief from double taxation may be achieved at that time, if the head office jurisdiction is a credit country and allows for the carryover of unused credits from the time of the transfer of the asset from the PE.

213. If it is considered that the factual and functional analysis reflects the provision of a capital asset in a manner comparable to a lease or a licence between independent enterprises, no profit or loss at the time of the transfer of the capital asset would have to be recognised. Instead, profits would be attributed between the parties to the notional transfer, based, for example, on a comparable transaction between independent enterprises (a lease or a licence). Therefore, when computing its taxable profits, the PE would be entitled to deduct an amount equivalent to the arm's length charge for the use of the lease or licence that would have been agreed upon between independent enterprises had they entered into the same transaction. Whether the dealing representing the change of use of the asset was comparable to a lease as opposed to a licence would be determined described in paragraphs 198-202 above.

214. Another possibility might be that the PE and other parts of the enterprise have structured their dealings in a comparable manner to economic co-participants in a "CCA" type activity that contemplates serial use of a capital asset by different parts of the enterprise. Following, by analogy, the guidance given in Chapter VIII of the Guidelines there might not be a need in such cases to recognise any appreciation (or depreciation) at the time of the change in the use of the capital asset, if the asset were transferred between "participants" in a manner consistent with the contemplated serial use of the asset under the "CCA" type activity.

215. In other cases, there may still be a need to recognise any appreciation or depreciation in the value of a capital asset following a change of use, even where an asset is used pursuant to a CCA type activity. For example, the asset may no longer be used in the activity which is the subject of the “CCA” or because one part of the enterprise involved in the change of use has ceased to be a participant in the “CCA” type activity or because another part of the enterprise has started to use the asset and has become a new participant in the “CCA” type activity.

(b) Intangible property

Introduction

216. One of the most important commercial developments in recent decades has been the growth in the significance to an enterprise or an MNE group of its intangible property. The pace of technological change has meant that, more than ever before, the ability of an enterprise or MNE group to generate profits is linked to the specialised knowledge and processes at its disposal, while the revolution in communications has led to an ever-increasing emphasis on advertising and the value of brands and the creation of new ways of conducting business such as e-commerce in which reliance on physical capital may in certain cases be less significant.

217. These developments represent a major challenge for tax administrations and taxpayers who need to place a value on a company’s intangible property or estimate the revenue it generates. Intangible property in various forms, including the company’s name itself, can represent the main part of the substantial differences between the net asset value of many quoted companies and the market value of their shares. Therefore, it is vitally important that, in determining the profits attributable to a PE under the authorised OECD approach, due consideration is given to the treatment of intangible property. This is a complex area not least because unlike the situation involving other assets (considerations relating to CCAs aside), it is common for intangible property to be used simultaneously by more than one part of the enterprise. Significant issues may arise where there is some change of use in relation to intangible property.

Existing Guidance

218. There is little existing guidance on intangible property in the Commentary to Article 7. In the PE context, intangible property is mentioned in only two places; once in the Commentary on Article 5 in the context of establishing whether a PE exists; and once in paragraph 17.4 of the Commentary on Article 7, which represents the only discussion in the Commentary of the treatment of intangible property within a single enterprise operating through a PE. The general presumption in the 1994 Report was that notional payments are not recognised for the use of intangible property by one part of the enterprise, i.e. notional royalties, are not allowed. The position reached in the 1994 Report is reflected in the comments at paragraph 17.4 of the Commentary, which advise that:

“Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprises without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (e.g. the

responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate to a compensatory charge.”

219. The discussion in paragraph 17.4 is deficient in a number of respects. It focuses on whether an internal “royalty” could be paid and is silent on other important issues such as the impact of intangible property on the comparability analysis, the allocation of a return to intangible property from third parties, the rewarding of the parts of the enterprise that may have performed the functions leading to the creation of the intangible, etc. Further the paragraph flags up the issues of allocating costs of development of an intangible and the risks of adverse consequences related to an intangible but without providing much in the way of guidance as to how to perform such an allocation. The rest of this section aims to provide guidance to remedy the current deficiencies.

Guidance on applying the authorised OECD approach to intangible property

220. It would be overly prescriptive to allow only one approach for dealing with the variety of ways in which intangible property can be exploited. Indeed, although the language of paragraph 17.4 of the Commentary (reproduced above) favours the cost allocation model, there is a clear implication that arm’s length notional payments between different parts of the enterprise could be allowed if the costs of creation could actually be identified as having been, in practice, incurred by one part of the enterprise. Unfortunately, the paragraph does not explicitly distinguish between legal and economic ownership and this may have led to an overstatement of the difficulty in identifying which part of the enterprise has borne the costs and risks of creating and developing the intangible property in certain circumstances. Nor has it recognised that more than one part of the enterprise may have contributed to the development of the intangible property.

221. By contrast with the lack of guidance in a PE context, the Guidelines provide an entire chapter (Chapter VI) on the treatment of intangible property, which usefully distinguishes between marketing intangibles and other commercial intangibles (referred to as “trade” intangibles) and could be applied by analogy in the PE context. In particular, the concept of functional and factual analysis would be applied in order to determine which, if any, part of the enterprise could be identified as having performed the function of creating the intangible.

222. The possibility of using functional analysis to determine the economic “ownership” of assets has already been tested in one common situation where assets are created by the functions of the enterprise – namely the financial assets created by financial enterprises such as banks. As can be seen from paragraphs 10 and 11 of Part II, this determination was made on the basis of where the key entrepreneurial risk-taking functions were performed.

223. Clearly the determination of the economic ownership of intangible property created by an enterprise should also be based on similar principled grounds so as to rule out the possibility of the enterprise simply nominating one part of the enterprise as the owner (by booking the intangible assets there) irrespective of whether, for example, that part had the expertise and/or capacity to assume and manage the risks associated with the intangible property. The discussion below explores the extent to which it may be possible to attribute economic ownership of the intangible property to one part of the enterprise, in a way that is consistent with the general principles of Part I and the attribution of financial assets and risks described in Parts II and III.

224. The rest of this section provides guidance on three main issues. First, the determination of which part(s) of the enterprise is the economic owner of the intangible property. Second, the impact of intangible

property on the profits to be attributed to the PE. Third, any dealings between the part of the enterprise that is the owner of the intangible and another part(s) of the enterprise that uses the intangible.

1. Which part(s) of the enterprise is the economic owner of the intangible property

225. The discussion in this section focuses first on trade intangibles, then moves on to consider whether it is possible to apply the same approach to marketing intangibles. The following two situations are discussed:

- Where the intangible property is newly developed by the enterprise
- Where the intangible property has been acquired from another enterprise

The attribution of trade intangibles to a single part of the enterprise.

Internally Developed Trade Intangibles

226. The authorised OECD approach seeks to attribute profit to the PE by reference to a functional and factual analysis which determines the functions performed by, and the assets and risks, attributed to the PE. As noted under the first step of the authorised OECD approach it will be necessary to use a functional and factual analysis to determine what intangible property the PE uses and under what conditions, i.e. does it “own” the intangible either solely or jointly with another part of the enterprise. It may be that one part of the enterprise is a research centre for the enterprise and therefore has performed most or all of the functions by which a trade intangible, e.g. a complex software operation, has been created. However, that does not necessarily mean that one of the internal “conditions” of the research centre PE is that it is treated as the economic owner or joint economic owner of the intangible.

227. Between associated enterprises, one company may commission another to develop a particular piece of software in return for remuneration. The legal terms of the contract will determine their relationship, and in particular may define what risk, if any, is borne by the developer and what ownership rights the developer and the commissioning company will acquire in the finished software. In short, the performance of the development function(s) does not of itself determine the legal ownership. Rather the key issue is which enterprise acts as the entrepreneur in deciding both to initially assume and subsequently bear the risk associated with the development of the intangible property.

228. The decision to initially assume the development risk would appear to be similar to the concept of the key entrepreneurial risk-taking functions described in Parts II and III that are used to determine the economic ownership of financial assets. The economic ownership of newly developed intangible property would seem to be capable of determination under a similar factual and functional analysis. As noted in Section B-1 (iii) of Part II, “it will be important to identify not just what key entrepreneurial risk-taking functions are performed but also their relative importance. The key entrepreneurial risk-taking functions are those which require ***active decision-making*** with regard to the taking on and ***day-to-day management*** of individual risk and portfolios of risks” [*emphasis added*].

229. In financial enterprises, depending upon what business organisation model they use, the active decision-making and day-to-day management may often be devolved throughout the enterprise. An issue arises as to whether this is likely to be the same with regard to the development of intangible property or whether it is more likely that the key entrepreneurial risk-taking functions are undertaken at a high strategic level by senior management or whether by a combination of centralised and devolved risk taking functions.

230. Whether the degree of centralisation of the decision making process for the development of intangible assets is high will depend on the circumstances of the particular business, and so be dependent on the facts. However, it should be noted that there is no hard evidence that the decision making process for the development of intangible property is generally so centralised, especially as given the comments at paragraph 226 above, the focus for determining the key entrepreneurial risk-taker is on the active decision making and day to day management rather than on simply saying yes or no to a proposal. This suggests that, just as for financial assets, economic ownership may often be determined by functions performed below the strategic level of senior management. This is the level at which the day to day management of a program toward the development of an intangible would occur, where the ability to actively manage the risks inherent to such a programme lies. Further, as noted in paragraph 11 of Part II, such a determination must be made on a case-by-case basis as the key entrepreneurial risk-taking functions and especially their relative importance are likely to vary according to facts and circumstances.

231. The functional and factual analysis should therefore describe and evaluate the dynamics of the particular enterprise's research and development programme, and in particular the nature of the critical decision-making process and the level at which those decisions are taken. It is also suggested that the performance of such a rigorous functional analysis should protect against manipulation so that there should be no problem in accepting the case where genuinely all the decision-making process for the development of intangible property is centralised in one part of the enterprise such as the Head Office.

232. Parts II & III discuss at length the various types of risk associated with financial assets. With the development of intangible property the main risk is that the development is unsuccessful or is not successfully implemented for some other reason, thereby creating a financial loss (the researchers salaries and other costs not covered by income received from the successful development of the intangible). Depending on the type of intangible property there may also be other developmental risks, e.g. adverse side-effects caused in a trial of a new active ingredient for a drug. Under the authorised OECD approach the "developer" of the assets would have to bear such losses and would have sufficient capital attributed to it to support the risk assumed. With a financial asset the risks are assumed by the economic owners unless there is a recognised dealing which transfers risk (and economic ownership) to another part of the enterprise. Only the profits of the economic owner are affected by the crystallisation of risk assumed in the creation of financial assets.

233. The failure to develop an intangible asset on the other hand may affect not just the owner of the asset, but also the intended users of the intangible property. Financial assets are not generally used by other parts of the financial enterprise to the extent that intangible property is used by other parts of the enterprise. This raises a question as to whether use and intended use of an intangible should be a factor in determining economic ownership. The answer would seem to be that intended use per se does not determine the capacity in which the user subsequently uses the asset once developed, i.e. as sole or joint economic owner or licensee. Therefore it is not so much the intention to use the intangible per se that should be a factor in determining economic ownership of an intangible, but the extent to which the intended user performed the key entrepreneurial risk-taking functions, e.g. by taking (or taking part in) the initial decision to develop the intangible or undertaking the day to day management of the R&D programme. It may well turn out that the user of the developed intangible is, in fact, the party or one of the parties that has performed the key entrepreneurial risk taking decisions, precisely because the user stood to gain from it. And this can be as true for tangible assets as it is for intangible assets.

234. Again consistent with the position taken for created financial assets, an assertion that one part of the enterprise has the capital necessary to support the risks of development would not be a relevant factor. As already noted, capital follows risks and not the other way round so the part of the enterprise found to be the economic "owner" of the intangible property would be attributed the capital necessary to support the associated risks. In short, the key factor is whether the PE undertakes the active decision-making with

regard to the taking on and day-to-day management of the risks related to the creation of the new intangible.

Acquired Trade Intangibles

235. Although trade intangibles are commonly developed internally they are also acquired from other enterprises, either outright or through a licensing agreement as discussed in paragraph 196 above. The question arises as to how to attribute the ownership of such assets, once acquired. Again under the authorised OECD approach, the approach is to determining the key entrepreneurial risk-taking functions.

236. In some circumstances, this may be determined in exactly the same way as for internally created intangibles. For example, where an enterprise both acquires and develops similar trade intangibles the functional and factual analysis might show that ownership of both the acquired and internally created intangibles lies with the same part of the enterprise because the part(s) of the PE responsible for the key entrepreneurial risk taking decisions on developing intangibles are also responsible for the key entrepreneurial risk taking decisions on acquiring intangibles. This may not be that unusual given that two decisions are involved in making an acquisition of intangibles. The first is to determine whether that particular intangible is valuable to the enterprise's business. And secondly that it makes more sense to buy the intangible than to develop it in house. Such decisions may well be made by the same people who would decide whether it is better to develop the intangible internally.

237. In other circumstances, an important factor in determining the key entrepreneurial risk-taker might be intention to use the acquired asset. The reasoning behind this would be that when an existing intangible is acquired there is no risk that the development of the intangible will be unsuccessful (since it has already been successfully completed). Rather, the risks are that the acquired intangible will not be successfully used, say for example, there are practical difficulties in making the acquired software compatible with existing systems, or the improvements the intangible makes to existing products does not equate to an increase in sales commensurate with the cost of the acquired intangible. In such instances the risk associated with failure appears to fall more on the user, i.e. the user is the key entrepreneurial risk-taker.

238. A further consideration that the discussion may need to take account of is the fact that trade intangibles may be acquired at various stages of development. It could be that the acquired intangible is fully developed as assumed in the preceding paragraph. Or it might be that there is still some way to go before the intangible is fully developed. This may affect the analysis of the key entrepreneurial risk-taker.

Marketing intangibles

239. Similar issues arise in respect of marketing intangibles, in particular the name and logo of the company or the brand. Does the name of a well-known company belong equally to all parts of the enterprise, such that each PE can be said to share in the name by analogy with the fact that in Parts II & III it is said to share in the capital of the enterprise? Is it one of the internal conditions of the enterprise like creditworthiness? And if this is so what are the consequences?

240. It would appear more difficult under the first step of the authorised OECD approach to attribute the sole or joint ownership of the marketing intangibles to one part of the enterprise under a factual and functional analysis. This may be especially so where those marketing intangibles are global in nature. The connection between the performance of functions, the initial assumption and subsequent bearing of risks and the creation of a global marketing intangible may be more remote than for trade intangibles so that it may be more difficult to identify which functions and risks actually relate to the creation and ongoing maintenance of the global marketing intangibles. The key entrepreneurial risk-taking functions leading to

the decision to create a global marketing intangible may have been made a long time ago for well known brands or to be relatively unimportant compared to the ongoing costs of maintaining a global marketing intangible such as a brand. Moreover, brands generally require constant maintenance in terms of advertising and other promotional expenditures and, again, these activities may be dispersed within the enterprise. In terms of ongoing risk- management this may be dispersed within the enterprise or simply related to the sharing of advertising costs.

241. On the other hand, where the marketing intangible is specific to the PE's host country, it may be possible to determine the "sole or joint ownership" of the intangible. This is because the specific nature of the marketing intangible should make it easier to identify the key entrepreneurial risk-taking functions leading to the creation and ongoing maintenance of the specific marketing intangibles. Further, it should be easier to identify where these functions are performed as they are unlikely to be dispersed within the enterprise but are likely to be performed either in the PE or in head office.

242. In conclusion, the same principles should apply to determine the sole or joint "economic" ownership of marketing intangibles as trade intangibles. However, factual differences mean that it may not normally be possible to identify one part of the enterprise as the owner of the global marketing intangibles although it may be possible in some circumstances to identify one part of the enterprise as the owner of the marketing intangibles specific to the host country of the PE.

2. *Impact of intangible property on the profits to be attributed to the PE*

243. If it is determined under the functional and factual analysis that the PE has performed, at least in part, the function of creating the intangible or bears extraordinary marketing expenditure in relation to the intangible, the PE would be entitled to a comparable return to that of an independent enterprise performing a similar function. Where the functional and factual analysis attributes sole or joint ownership of the intangible asset to the PE the guidance in Chapter VI on special considerations for intangible property should be followed, by analogy, when making the attribution of profit to the PE performing that function, or the guidance in Chapter VII, in respect of any services provided in connection with the development of the intangible property.

244. The conditions under which the PE performs that function also need to be taken into account and, in particular, whether the PE is the "sole or joint owner" of the intangible. If the conditions were comparable to those of a contract researcher within the meaning of paragraph 7.41 of the Guidelines, the contract researcher PE would be attributed a profit consistent with that earned by independent enterprises performing a similar function as contract researchers and not as "owners". Another possibility might be that both the PE and other parts of the enterprise have jointly contributed to the development of the intangible property, for their joint purposes, in which case profit would be attributed between the contributing parties, based on what would happen between independent parties participating in a comparable "CCA" type activity. The guidance given in Chapter VIII of the Guidelines would be followed, by analogy. The rest of this section looks in more detail at some of the key issues in determining the impact of intangible property on the profits of the PE.

245. The return on intangible property is part of the overall return to the enterprise from its transactions with third parties and the issue is not to determine that return but rather to attribute the return within the enterprise in accordance with the arm's length principle. For example, the existence of a proprietary trading model may have enabled traders at a financial institution to generate more profits. The profit from the transaction with third parties that has been properly attributed to the PE as a result of functions performed by the PE (including use of intangible assets) may therefore already include an element relating to the return on the intangible property used by the PE. Therefore in such cases there would normally be no need to impute any additional return to intangible property, but rather the issue to be

determined will be whether the PE has recognised appropriate expenses associated with the creation, development or maintenance of the intangible that it has used.

246. The focus of Article 7 is on attributing profits to the PE and in the context of rewarding intangible property, the focus is on ensuring that the intangible owner is attributed an arm's length return. There are a number of ways of ensuring that the return to intangible property is appropriately attributed within the enterprise, only one of which that attributes the return in a manner similar to a royalty transaction between independent enterprises in similar circumstances. It must be noted, however, that in the context of the authorised OECD approach, the use of the word "royalty" is not meant to convey either an actual payment or a formal license agreement between two parts of the same enterprise but is intended to refer to the arm's length compensation that one would have had to pay (and deduct from income) for the use of the intangible if the provider of the intangible were a distinct and separate enterprise. The recognition of the notional royalty is relevant only to the attribution of profits to the PE and should not be understood to carry wider implications as regards withholding taxes, which are outside the scope of this Report. Between independent enterprises other ways of rewarding the owner of the intangible include incorporating the reward in the price of goods sold by the intangible owner, or by sharing part of the overall profit with the intangible owner, for example through a residual profit split method. If such arrangements were replicated in a PE situation, then the "royalty" issues discussed above would not be in point.

247. A PE of a well-known MNE which provides goods or services under the MNE's brand name but does not contribute to the MNE's reputation outside the host country would be fully remunerated for any share in the ownership of the name under the authorised OECD approach by receiving the third party income generated by the functions it performs less the expenses incurred in performing those functions, as the price paid by third parties would reflect the value of the name and the volume of third party sales would likewise be affected by that name. Therefore, in such cases there would normally be no need to impute any additional return to the marketing intangible but again the issue to be determined will be whether the PE has recognised sufficient expenses associated with the creation, development or maintenance of the marketing intangible that it has used.

248. However, there may be some circumstances in which an additional return might be justified. For example, it may be that the PE has carried out particular functions that have led to an increase in the value of the brand name outside the host country and these functions had not already received an arm's length reward. Further, if exceptionally it is found that another part of the enterprise is the "owner" of the brand name, then the guidance in Chapter VI of the Guidelines on marketing activities undertaken by enterprises not owning trademarks or trade names may be capable of application by analogy to the PE undertaking such marketing activities.

249. Importantly, if the PE has not contributed to the value of the brand name, but has benefited from global marketing costs outside the host country, it should compensate the other part of the enterprise through a sharing of the costs or otherwise in determining its profits to the extent that those costs are related to the use of the intangible in the PE's host country. This determination would have to be made on a case-by-case basis because of the different types of brands and different market conditions etc. Not all global brand names are valuable and nor do all global marketing campaigns benefit individual jurisdictions.

250. Additionally, whilst the existing Commentary focuses on royalty income from licensing intangibles and on cost sharing, it is also possible to attribute the return from intangible property without any internal "royalty" by means of a profit method. For example, if the intangible property is closely associated with an integrated global trading business which is remunerated via a profit split method, it would be possible to attribute the return to the intangible property within the profit split calculation either

explicitly by including it as a factor in its own right or implicitly by virtue of its impact on other factors. In this case there is therefore no need to calculate royalty income per se, or to infer the existence of a cost sharing agreement. In short, the objective of the analysis is to ensure the appropriate attribution of the return on intangible property, rather than on whether an internal “royalty” should be recognised.

251. Finally, where the PE is determined as the economic owner of intangible property, capital, including free capital is attributed to support any significant risks associated with the development of the intangible property. As discussed in the section dealing with the attribution of capital, it can be difficult to measure precisely the risk associated with the creation of intangible property, however the exercise should be performed where those risks are significant. Where the PE is determined not to be the economic owner of the intangible, but, say, a contract R&D service provider, it will still require funding to meeting researcher’s salaries etc, but given that the significant risks lie with the economic owner, it will be attributed little free capital the funding being more in the way of stage payments from the economic owner of the intangible.

3. *Internal dealings relating to use of an intangible*

252. Just as in the case of capital assets, even more difficult questions can arise when an intangible property that is “solely owned”, say, in head office, is provided to one or more of its PEs for use in its business. For example, a PE may begin to make use of a trade intangible developed in the past by activities in the head office, and exploited in the past by the head office. This situation commonly arises because of business changes, for example, the PE moving into a new business area. Under the authorised OECD approach, a functional and factual analysis of the situation might show that the PE should be treated as engaging in a dealing with the head office, in respect of that intangible property. Profit would be attributed in respect of this dealing by reference to comparable transactions between independent enterprises (e.g. a royalty) and would depend on a factual and functional analysis of the dealing, the type of interest obtained or notional rights acquired (exclusive or non-exclusive) etc. Guidance on these issues is given in Chapters VI and VIII of the Guidelines. It is worth reiterating that, as noted in the previous section, an “internal royalty” is only one of a number of possible ways of rewarding intangible property.

253. As stated above, unlike the situation involving capital assets, it is common for intangible property to be used simultaneously by more than one part of the enterprise. Making an intangible asset available to a PE does not imply that other parts of the enterprise have ceased to be able to exploit that same asset or may not be able to do so in the future. Such a change in use could result in the PE being treated as having obtained not the intangible asset itself or an exclusive notional right to use the intangible, but rather a beneficial interest in that asset or a non-exclusive right to use the intangible. Thus, under the authorised OECD approach, the PE would be treated as having acquired an interest in the intangible or a notional right to use the intangible at the time of the change of function.

254. The value of the interest acquired (joint ownership, outright ownership or a beneficial interest) would be determined by reference to comparable transactions between independent enterprises. The PE might be treated as having acquired the intangible or an interest in the intangible at fair market value and so is entitled to depreciate/amortise the interest in the acquired asset using that value, subject to host country depreciation/amortisation rules. This would put the position of intangibles (where the facts and circumstances suggest that the treatment discussed in this paragraph should apply) on a par with that of tangible assets transferred for the use of the PE and not for resale.

255. Another possible outcome of the analysis of the dealing involved in making an intangible available to a PE could result in the PE being treated as having obtained a notional right to use the intangible property analogous to a licensing agreement. Depending on the factual circumstances and the comparability analysis, the PE might be entitled to deduct an amount equivalent to the arm’s length charge

(notional royalty) for a license arrangement that would have been agreed upon between independent enterprises had they entered into a comparable transaction.

256. Similar principles to those discussed above apply to dealings recognised in respect of intangibles acquired by an enterprise through licensing from a third party. As discussed at paragraph 196, an enterprise's right to use an intangible under a license may constitute an asset whose economic ownership can be attributed to a part of the enterprise and can be the subject of a dealing with another part of the enterprise. Economic ownership of this asset is attributable to that part of the enterprise performing the key entrepreneurial risk-taking functions related to the right to use the licensed asset. Where the economic owner makes the licensed intangible available for use by another part of the enterprise so that a dealing between these parts is recognised, the factual and functional analysis will determine the character of that dealing, e.g. as an outright transfer or a licensing of those rights to use, for purposes of attributing profit from that use.

257. It should be noted that the analysis in the preceding paragraph deals only with the direct consequences of the transfer of the intangible asset itself or a beneficial interest in an existing intangible asset. In circumstances where an intangible developed by one part of the enterprise is to be further developed by the enterprise as a whole, it might be that such further development would be conducted in a "CCA" type activity to which the PE is a participant. In such circumstances the PE would be treated for tax purposes as if it had acquired an interest in the pre-existing intangible property (a buy in) and any subsequent dealings related to the further development of the intangible property would be determined by following, by analogy, the guidance given in Chapter VIII of the Guidelines. If, by following, by analogy, the guidance of Chapter VIII, the PE were found to have acquired only the notional right to use the pre-existing intangible that is subject to the "CCA" type activity and did not obtain a beneficial interest in the intangible property itself, a notional royalty may be attributed based, by analogy, on the guidance in Chapter VI.

(c) Internal services

258. A considerable head office support infrastructure is often necessary in order to carry out a business conducted through PEs. These can cover a wide range of activities from strategic management to centralised payroll and accounting functions. The existence of these support functions needs to be considered when attributing profit to the various parts of the enterprise.

259. The Commentary on Article 7 at paragraph 17.7, presumes that services which are related to the general management activity of the enterprise should normally be allocated at cost. The provision of a mark up (or more strictly an arm's length price) is restricted to certain cases (see the comments at paragraph 17.5 and 17.6), for example where it is the trade of the enterprise to provide such services to third parties or where the main activity of the PE is the provision of services to the enterprise as a whole and where those services are both a significant part of the expenses of, and provide a real advantage to, the enterprise.

260. In respect of this view, it is important to consider that the Guidelines have, since 1996, significantly updated the principles cited in the Commentary on Article 7 concerning the situations in which associated enterprises should be permitted to transfer property or services to each other without realising a profit. The Commentary on Article 7 uses an interpretation of the arm's length principle that pre-dates the Guidelines. Under the former interpretation, specific factual circumstances were established in which associated enterprises might deviate from the arm's length principle and transact with each other

at cost⁸. The factual circumstances related to whether the transaction involved goods/services offered regularly to third parties: the “direct or indirect approach”. Chapter VII of the Guidelines have revised this interpretation, so that associated enterprises are now always required to comply with the arm’s length principle.

261. One area where there is a difference between the authorised OECD approach and the existing position in the Commentary arises from the fact that under the authorised OECD approach, the arm’s length principle is applied to determine the reward for performing that service. Application of that principle will take account not only of the price applied to the service but following the guidance in Chapter VII, whether, at arm’s length, both parties would have contracted for the provision of the service. The tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm’s length principle may indicate a price for the service rendered that is above or below the costs incurred by the head office in providing it (see paragraph 7.33 of the Guidelines).

262. The authorised OECD approach is to attribute profits to a PE in respect of services performed by the PE for other parts of the enterprise (and vice versa) by following, by analogy, the guidance given in the Guidelines, especially in Chapters VII and VIII, in order to determine whether, and if so, to what extent, the support functions should be rewarded. In some cases, the PE and the other parts of the enterprise can be considered as acting in a comparable manner to economic co-participants in a “CCA” type activity involving the provision of those services. The internal dealings within the enterprise would be treated for tax purposes in a like manner as a provision of comparable services between independent parties in a comparable “CCA” type activity, following, by analogy, the guidance given in Chapter VIII of the Guidelines. Most of the services provided by the head office of an enterprise are little different from those provided by the parent, or centralised service provider, of a MNE group. Similar techniques can be used as for associated enterprises. If CUPs are unavailable, cost plus methods may be particularly useful.

263. Finally, it is worth recalling paragraph 7.37 of the Guidelines which is reproduced below:

“While as a matter of principle tax administrations and taxpayers should try to establish the proper arm's length pricing, it should not be overlooked that there may be practical reasons why a tax administration in its discretion exceptionally might be willing to forgo computing and taxing an arm's length price from the performance of services in some cases, as distinct from allowing a taxpayer in appropriate circumstances to merely allocate the costs of providing those services. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations where the provision of a service is a principal activity of the associated enterprise, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price.”

(d) Documentation

264. The authorised OECD approach would also apply, by analogy, the guidance on documentation in Chapter V of the Guidelines. In particular, the same standards would apply to the documentation of dealings as currently apply to the documentation of transactions and the summary of recommendations at paragraphs 5.28 and 5.29 of the Guidelines should be followed. Compliance requires the non-resident enterprise to document contemporaneously the attribution of profit to the PE and ensure that the

8. See paragraphs 81-83 of the 1984 OECD Report, “Transfer Pricing and Multinational Enterprises - Three Taxation Issues; The Allocation of Central Management and Service Costs”.

documentation is consistent with how the different parts of the enterprise subsequently behave, establishing the true nature of the economic relationships. In short, in the PE context, information on the attribution of profits to the PE in the home country should be readily available to the host country and vice versa.

265. However, as dealings have not always been recognised for the purposes of attributing profits to PEs, taxpayers may not be in the habit of documenting dealings to the same extent as they would document transactions with associated enterprises. This may explain some of the potential difficulties in applying the authorised OECD approach in practice that have emerged from the testing process. It may therefore be necessary for tax administrations to educate taxpayers in this matter so as to ensure that dealings are in fact adequately documented in accordance with the guidance in Chapter V of the Guidelines. Tax administrations and taxpayers should also follow the general guidance in Chapter V on these issues.

(v) Dependent agent PEs

Introduction

266. As already stated in paragraph 6, this Report does not examine the issue of whether a PE exists under Article 5 (5) of the Model Tax Convention (a “dependent agent PE”) but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. However, certain business arrangements have facilitated the growth of business models that may meet the threshold conditions and so give rise to dependent agent PEs within the meaning of Article 5(5).

267. The current lack of guidance on how to determine the profits to be attributed to a dependent agent PE has created uncertainty as to the consequences of finding dependent agent PEs under Article 5(5). There is a concern from business that in the absence of such guidance a “force of attraction” rule may become the default position; so that, for example, the finding of a dependent agent PE would have the automatic effect of drawing in profits to the host country irrespective of whether those profits are generated by, or as a consequence of, activity undertaken by the dependent agent. This section is intended to remedy the current unsatisfactory situation by providing specific guidance on the attribution of profits to a dependent agent PE using the same principles that are applied to attribute profits to other types of PEs. Moreover, as will be seen below, the authorised OECD approach, grounded in a factual and functional analysis of the activities of the dependent agent and emphasising the importance of determining the key entrepreneurial risk taking functions, provides a measurement of the amount of profits attributable to a dependent agent PE that is consistent with the arm’s length principle. Consequently, there is no presumption that a dependent agent PE will have profits attributed to it. In some circumstances, the functional and factual analysis may determine that the amounts to be attributed to the dependent agent PE is a negligible profit, nil or a loss.

268. The situation where global trading in financial instruments is conducted by a dedicated agent (“dependent agent enterprise”) which is itself a wholly owned subsidiary of the global trading group and results in a dependent agent PE under Article 5(5) is discussed in detail in Part III of the Report. The example discussed below primarily focuses on situations where the dependent agent is an associated enterprise. However, the same principles are applicable to situations where the dependent agent is not an associated enterprise.

The authorised OECD approach for dependent agent PEs

269. In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities - the dependent agent enterprise (which is a resident of the host country) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises, e.g. commission paid to dependent agent enterprise based on volume of product sold, were conducted on an arm's length basis.

270. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (i.e. as a result of activities which have been carried out by the dependent agent enterprise on the non-resident enterprise's behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident enterprise where the functions performed in the host country on behalf of the non-resident enterprise meet the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to operations performed through the dependent agent PE in the host country.

271. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a factual and functional analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient free capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital. The analysis would also focus on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the key entrepreneurial risk-taking functions. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether negotiating or risk management functions are being performed by the dependent agent on behalf of the non-resident enterprise. In general the factual and functional analysis focuses on the nature of the functions carried out and in particular whether key entrepreneurial risk-taking functions are carried out by the dependent agent enterprise on behalf of the non-resident enterprise, such that the associated assets and risk of the non-resident enterprise should be attributed to its dependent agent PE (in which case the profits associated with those assets and risks would be taxable in the host country) rather than to another part of the non-resident enterprise (in which case the associated profits would not be taxable in the host country).

272. In practice the dependent agent enterprise may not perform key entrepreneurial risk taking functions and if it does not then the attribution of the assets, risks and profits to the dependent agent PE, are correspondingly reduced or eliminated. In particular, it should be noted that the activities of a mere sales agent may well be unlikely to represent the key entrepreneurial risk-taking functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the "economic owner" of that intangible.

273. In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has

been given to the dependent agent enterprise. In accordance with the principles outlined above (and illustrated in the example below) the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.

274. Before moving on to the example, it is worth first considering an alternative approach put forward by some commentators (referred to here as the “single taxpayer” approach), which contends that in all circumstances the payment of an arm’s length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE. The reasoning behind this approach is that the compensation to the dependent agent enterprise, if arm’s length under Article 9, is considered to adequately reward the dependent agent enterprise for its functions performed, assets used and risks assumed, and since there are no other functions performed, assets used and risks assumed in the host country there can be no further profits to attribute. The functional and factual analysis may show that certain risks, for example, inventory and credit risks under a sales agency arrangement, belong not to the dependent agent enterprise but to the non resident enterprise which is the principal. Although it is agreed that the risks are legally borne by the non-resident enterprise, the difference between the two approaches is that under the “single taxpayer” approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the authorised OECD approach would attribute those risks to the dependent agent PE for tax purposes if, and only if, the dependent agent performed the key entrepreneurial risk-taking functions in respect of those risks.

275. Whilst superficially attractive the “single taxpayer” approach in fact contains a number of fundamental flaws. Firstly, this approach would not result in a fair division of taxing rights between host and home jurisdictions as it ignores assets and risks that relate to the activity being carried on in the source jurisdiction simply because those assets and risk legally belong to the non-resident enterprise. Indeed, such an approach would go against one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source jurisdiction. The “single taxpayer” approach simply does not consider that if the risks (and reward) legally belong to the non-resident enterprise it is nonetheless possible to attribute those risks (and reward) a PE of the non-resident enterprise created by the activity of its dependent agent in the host country.

276. A second problem with the “single taxpayer” approach is that if accepted it would mean the authorised OECD approach being applied differently depending on what type of PE was involved. For PEs other than dependent agent PEs, the authorised OECD approach attributes assets and risks to the PE that are created or economically owned as a result of functions carried on by the PE, and attributes profits accordingly, notwithstanding the fact the assets and risks legally belong, of course, to a non-resident enterprise. In contrast, under the “single taxpayer” approach outlined above, no profits would be attributed to a dependent agent PE in respect of the risks and assets of the non resident enterprise, even though they arise from activities carried out through the dependent agent PE. Such a distinction between enterprises carrying on business through dependent agent PEs and enterprises carrying on businesses through fixed place of business PEs, would seem inconsistent with Article 7 and the arm’s length principle. Moreover, drawing a distinction along those lines may result in inconsistent application of the authorised OECD approach in the financial sector, given that where broker/dealers transact business in a local market through a PE they generally do so through a dependent agent PE, whereas banks in the same position generally do so through a fixed place of business PE.

277. Or to look at this issue from another perspective, the “single taxpayer” approach would lead to the same result in terms of profit attribution for dependent agent PEs, even where the facts are substantially different. The attribution of profits to a dependent agent PE would be the same in situations where the

factual and functional analysis demonstrated that the PEs activities generated risks and assets for the enterprise and in situations where the factual and functional analysis determined that the activities did not generate such risks and assets.

278. Finally, it is recognised that a basic principle of statutory interpretation is that the drafters of a statute (or treaty) intend every word to have a meaning and consequently, the text should not be interpreted in a manner that renders a portion of it superfluous. The “one taxpayer” approach to attributing profits, however, would mean that there would never be profit consequences resulting from the finding of a dependent agent PE, thereby making the Article 5 (5) largely redundant.

Practical illustration of the application of the authorised OECD approach - dependent sales agents

279. The following illustrations are intended to better explain the approach taken under the authorised OECD approach. It is recognised that in practice most situations will be significantly more complex and difficult to deal with. The objective however is to illustrate the principle that the host country’s taxing rights are not necessarily exhausted by ensuring an arms length compensation to the dependent agent enterprise under Article 9 (the following example is one where the dependent agent is an associated enterprise).

280. Under a typical sales agency agreement, the dependent agent enterprise never takes title to the goods, which remain the property of the non-resident enterprise in whose name the contracts with customers are concluded. Thus where the dependent agent enterprise warehouses a stock of goods belonging to the foreign enterprise in order to fulfil the customer orders generated by the dependent agent’s sales activities, the associated inventory risk is assumed by the non-resident enterprise. An arm’s length agency fee paid by the non-resident enterprise to the dependent agent enterprise would not therefore include an element to reward the assumption of these risks – they are assumed by the non-resident enterprise.

281. The question is whether any of the reward for the assumption of inventory risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by the identification of whether the key entrepreneurial risk-taking functions are undertaken by the non-resident enterprise itself or by the dependent agent enterprise on behalf of the non resident enterprise. This analysis should be undertaken on a case-by-case basis given the wide variety of risk management strategies used by different types of business. The creation and management of inventory risks may involve different entrepreneurial risk taking functions in different business sectors, and even different businesses within the same sector. Those functions may be undertaken in the non resident enterprise, or they may be undertaken by the dependent agent enterprise on behalf of the non-resident enterprise. Moreover, the result of some business models, for example “just in time” manufacturing, may be to eliminate such risks as inventory risk (though such business models may create new risks – the risk for example that the sale is lost because the goods are not available at the time the customer wants it).

282. Having said all this, and for the purpose of illustrating the application of the authorised OECD approach to a dependent agent, suppose that previously the enterprise operates as a full-fledged distributor (i.e. it buys and sells on its own account) and assumes and subsequently manages the inventory risk, including the risk that inventory may become obsolete. Suppose further that there is a business restructuring under which this enterprise converts into a dependent agent enterprise as described in paragraph 269 above. Assume finally that the functional analysis shows that the personnel that used to perform the key entrepreneurial risk taking functions in respect of inventory risk are still employed in the dependent agent enterprise and are still performing those functions, albeit now on behalf of the non-resident enterprise. This would mean that the “economic ownership” of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach to the

dependent agent PE. And, of course, under the authorised OECD approach, so is the associated profit or loss.

283. The above result is determined under the functional and factual analysis. There is no presumption that assets or risk should be attributed to the dependent agent PE. In other circumstances, the functional and factual analysis might show that the key entrepreneurial risk taking functions are now undertaken by people in the Head Office of the non-resident enterprise, and the former decision takers in the associated enterprise are either no longer employed by the dependent agent enterprise in the host country or do not carry out activities on behalf of the non-resident enterprise. In such circumstances the economic ownership of the inventory and the reward for the assumption of the associated inventory risk would not be attributable under the authorised OECD approach to the dependent agent PE of the non-resident enterprise but to its Head Office.

284. A similar analysis can be carried out on a case-by-case basis in respect of other types of risks, e.g. the credit risk in respect of the customer receivables of the non-resident enterprise. Again, under a typical sales agency agreement customer receivables and the associated credit risk legally belong to the non-resident enterprise, not the dependent agent enterprise and so the remuneration paid by the non-resident enterprise to the dependent agent enterprise should not reward the assumption of this risk. Once again the key question is whether any of the reward for the assumption of credit risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by reference to the identification of where the key entrepreneurial risk-taking functions are undertaken, i.e. in the dependent agent or the non-resident enterprise.

285. Dependent agent PEs may well arise in situations where following a business re-structuring, MNE Groups have arranged their business in a way that seeks to convert a “full-fledged” operation to a “risk stripped” operations in the host jurisdiction. What emerges from the discussion above is that even where contractual arrangements successfully remove, “risks” from the dependent agent enterprise so that they belong to another enterprise – the non-resident enterprise - that does not assist in answering the key question – should any of the risks that have been “stripped” to the non-resident enterprise nevertheless still be attributed to its dependent agent PE in the host jurisdiction. The authorised OECD approach answers this question by undertaking a functional and factual analysis and, in particular, by identifying which enterprise is undertaking the key entrepreneurial risk-taking functions. In this context, it is worth recalling that under the authorised OECD approach it is not possible within a single enterprise to strip risks from the key entrepreneurial risk-taking functions that give rise to those risks.

Administrative matters and documentation

286. The danger of overlooking the assets used and risks assumed in the performance of the functions in the PE jurisdiction are minimised if the existence of the dependent agent PE is formally recognised so that it is clear that the host country has taxing rights over two different legal entities - the dependent agent PE and the dependent agent enterprise and an attribution of profit based on a functional analysis is made to the dependent agent PE on the basis described in this section. This should also ensure that any other tax consequences arising from different rules for PEs and subsidiaries in the PE jurisdiction are taken into account. One way to formally recognise the existence of dependent agent PEs is to require the filing of tax returns for all such PEs. However, nothing in the authorised OECD approach would prevent countries from using administratively convenient ways of recognising the existence of a dependent agent PE and collecting the appropriate amount of tax resulting from the activity of a dependent agent. For example, where a dependent agent PE is found to exist under Article 5(5), a number of countries actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. Such administrative matters

related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the authorised OECD approach to address.

287. Dependent agent PEs may sometimes give rise to documentation issues that are often not found in other types of PE. A fixed place of business PE, which is typically an economically distinct business unit, may have its own set of financial accounting records that provide a starting point for the attribution of profit for tax purposes. This may well not be the case with the dependent agent PE, particularly where the taxpayer has not set out with the intention of creating a dependent agent PE. Even without this complicating factor, difficulties can arise for tax administrations in trying to obtain the information necessary to determine the profits attributable to the dependent agent PE of the non-resident enterprise in the host jurisdiction. The non-resident enterprise may have no physical presence in the host jurisdiction and the dependent agent enterprise may ordinarily have little information about the operations of the non-resident enterprise. However, under the authorised OECD approach the non-resident enterprise would, just as for other types of PEs, be required to document how it has attributed profit to its dependent agent PE.

D. Interpretation of paragraph 3 of Article 7

288. In attributing profit to a PE in accordance with the arm's length principle, regard must be given to the wording of Article 7(3), which provides that:

“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.”

289. Article 7(3) is open to varying interpretations, and the Member countries have considered a range of possibilities. The perspectives on Article 7(3) tend to focus on two competing interpretations. One interpretation is that the provision is aimed primarily at ensuring expenses of a PE's activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the PE's jurisdiction, or is not incurred exclusively for the PE. The other view is that Article 7(3) modifies the arm's length principle articulated in Article 7(2), in that (1) costs allocable to a PE should be deductible even if they exceed what an arm's length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties. In analysing these positions, regard has been given to the history of Article 7(3); to the original intent of the provision; to the practice of Member countries in applying the provision; and the views of Member countries as to the ideal role of the paragraph.

290. The history of Article 7(3) would tend to support the view that the original intent of the provision was simply to ensure that relevant expenses would be deductible against the income of a PE, and that no conflict with the arm's length principle was intended. Indeed, it appears from the history that Article 7(3) was not intended to modify the arm's length principle. Questions about the allocation of profit for head office activities were specifically mentioned in the League of Nations draft of 1933, many years prior to the origin of Article 7(3), so the issue was certainly known and could have been articulated in connection with the issuance of Article 7(3) had that been the intent. However, when Article 7(3) makes its first appearance in the 1946 League of Nations London Model, the expressed purpose is unrelated to the profit issue: “There are indeed in most enterprises with two or more establishments, certain items of expenses that must necessarily be apportioned in order to achieve the object of separate accounting, which is to place branches of foreign enterprises on the same footing as domestic enterprises.”

291. Subsequently, the historical grounding of Article 7(3) was somewhat confused by efforts to address the profits attribution question in Commentary to the 1963 Draft Double Taxation Convention on Income and Capital. That Draft Commentary discussed aspects of the profit attribution issue under the caption of Article 7(3). The question addressed was whether the deductions allowed in computing the profits of a PE for particular kinds of expenses (e.g. internal “interest” and “royalty” payments) should be the actual costs incurred or arm’s length prices. However, paragraph 14 of the Commentary qualifies that: “it is convenient to deal with them here”, presumably because the general discussion on allocating expenses is found under the same heading. The original version of paragraph 13 of the Commentary demonstrates the limited role intended for Article 7(3): “This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. *It is valuable to include paragraph 3 if only for the sake of removing doubts* (emphasis added).” The wording of Article 7(2) was then changed in the 1977 OECD Model Double Taxation Convention on Income and Capital so as to make it: “subject to paragraph 3”. This change helped create the misleading impression of a conflict of principle between Article 7(2) and Article 7(3).

292. The changes made in the Model Commentary in March 1994 tried to clarify the intention of Article 7(3) by stating in paragraph 17 that: “there is no difference in principle between the two paragraphs”. It then went on to say that Article 7(2) should not be interpreted as requiring: “that prices between the permanent establishment and head office be normally charged on an arm’s length basis whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual costs of those expenses.” Unfortunately, the language from paragraph 14 of the Commentary to the 1963 Draft Double Taxation Convention on Income and Capital (“it is convenient to deal with them here”) referring to the placing of the discussion, was lost in the changes.

293. In sum, it appears that the original intent of Article 7(3) was to ensure that expenses of a PE’s activity could be deductible against a PE’s attributed profits regardless where incurred (in the jurisdiction of the PE, of the head office or of another part of the enterprise). The original drafting does not appear to have contemplated a modification of the arm’s length principle. However, given the wording of the Commentary to Article 7 and the proviso “subject to paragraph 3” that has been included in Article 7(2), it is possible to interpret Article 7(3) otherwise. In particular, the practice of some Member countries has been to interpret Article 7(3) to provide the two modifications to the arm’s length principle of Article 7(2), namely that: (1) costs allocable to a PE should be deductible even if they exceed what an arm’s length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties.

294. All Member countries, including those that interpret Article 7(3) as requiring the above-named modifications to the arm’s length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm’s length principle, which may in appropriate circumstances involve the sharing of costs. Accordingly, under the authorised OECD approach the role of Article 7(3) should be just to ensure that the expenses of a PE’s activity are taken into account in attributing profits to a PE, in particular where the expense is incurred outside the PE’s jurisdiction, or is not incurred exclusively for the PE. It will be noted from the discussion of Article 7(2) that the authorised OECD approach does not mandate an attribution of profit (see paragraph 245 above). Furthermore, the authorised OECD approach only determines which expenses should be attributed to the PE. It does not go on to determine whether those expenses, once attributed, are deductible when computing the profit of the PE. That will be determined under the domestic law of the host country.

E. Interpretation of paragraph 4 of Article 7

295. The OECD Model Tax Convention contains in Article 7(4), another provision for attributing profits to a PE:

"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."

296. There is concern that the language of Article 7(4) does not require the use of the purely transactional profit methods authorised by Chapter III of the Guidelines and nor does it follow the hierarchy of methods outlined in that Chapter, as profit methods are allowed if customary, rather than as a last resort. Additionally, Article 7 (4) refers to "an apportionment of the total (added emphasis) profits of the enterprise to its various parts" and could therefore only be transactional in nature if the total profits to be split could be aggregated from individual transactions in accordance with the principles set out by Chapter I, Part C (iii) of the Guidelines. This is very unlikely unless the PE carries on the full range of activities conducted by the whole enterprise or the enterprise itself only carries on a single activity.

297. However, there are safeguards against too widespread an adoption of the Article 7(4) approach. The Commentary on Article 7 at paragraph 25 makes clear that such a method is:

"not as appropriate as a method which has regard only to the activities of the permanent establishment and should only be used where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory."

298. This would appear to prevent it being applied by countries that have not used such methods to date or in new business areas. There also is an implication in the above language, which is borne out by the historical background, that the use of Article 7(4) has only become customary in areas where it has not proved possible to apply the distinct and separate enterprise approach of Article 7(2). The Commentary also makes clear at the end of paragraph 25 that in bilateral treaties the provision "may be deleted where neither State uses such a method."

299. The approach described by Article 7 (4) is also distinguishable from the global formulary apportionment method rejected by Chapter III of the Guidelines. This is because the last sentence of the provision makes clear that the result of an apportionment under Article 7(4) should be in conformity with the other principles in the Article. These include, amongst other things, the arm's length principle, as applied to PEs by Article 7(2). However, the fact that an attribution under this provision starts off from an attribution of total profits means that, in practice, it may be very difficult to achieve such a result.

300. Given the above caveats, its possible use in a very small number of cases should not weaken the commitment to transactional methods contained in Chapters II and III of the Guidelines. However, the Member countries are of the opinion that such an apportionment method is not consistent with the guidance on the arm's length principle in the Guidelines, or that it is extremely difficult to ensure that the result of applying that method is in accordance with the arm's length principle. Member countries are also of the opinion that methods other than an apportionment of total profits could be applicable, even in the most difficult cases. Accordingly, under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE. A possible exception to the above

conclusion, relates to the attribution of profit to a PE of an enterprise carrying on an insurance business. The Working Party has not yet finalised Part IV of the Report on the insurance industry but the view of most countries is that (given that under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE) there is no continuing need for Article 7(4).

F. Interpretation of Paragraph 5 of Article 7

301. Another example where there are problems in applying the “functionally separate entity” approach in the special situation of an enterprise carrying on its business through a PE, is described by Article 7(5) of the OECD Model Tax Convention, which prohibits an attribution of profits to a PE “by reason of the mere purchase of goods or merchandise for the enterprise.” The Commentary at paragraph 30 states that the provision is concerned with a PE that “although carrying on other business, also carries on purchasing for its head office.” The Commentary makes clear that all profits and expenses that arise from the purchasing activities will be excluded from the computation of taxable profits.

302. This does not necessarily accord with the situation that would occur where one independent enterprise “merely purchases” goods or merchandise on behalf of another independent enterprise. In those circumstances the purchaser would be remunerated on an arm’s length basis for its services as a purchasing agent of the other enterprise. There also is a practical problem in deciding which expenses of the PE relate to the purchasing activities and so should be excluded. In addition, it is not clear why the restriction on attributing profits in Article 7 (5) is limited to the case where the PE merely purchases goods or merchandise. There seems little difference in principle if, instead of purchasing goods or merchandise, the PE carries on another of the activities mentioned in Article 5(4), such as the collection of information, which are not sufficient by themselves to create a PE.

303. The Working Party is of the opinion that Article 7(5) is not consistent with the arm’s length principle and is not justified. The authorised OECD approach is that there is no need to have a special rule for “mere purchase”. There should be no limit to the attribution of profits to the PE in such cases, apart from the limit imposed by the operation of the arm’s length principle.