



The Attribution of Profits to Permanent Establishments: Recent OECD Developments

This article addresses recent developments on the interpretation and application of Article 7 of the OECD Model Tax Convention (the MTC) and the official OECD commentary to that article.

Article 7 of the MTC provides that the business profits of an enterprise may only be taxed in the State of residence unless that enterprise carries on business in another State through a permanent establishment (PE). If a PE exists, the profits of the enterprise may be taxed by that other State, to the extent that the profits “are attributable to that permanent establishment”.

The previous commentary to Article 7 did not provide any detailed instructions as to how this attribution exercise should be carried out and member States have adopted a variety of practices. In an attempt to form consensus, the OECD has released a number of discussion documents in relation to Article 7 over the last seven years, culminating in a final paper, *Report on the Attribution of*

Profits to Permanent Establishments (the OECD Report) released on 17 July 2008.¹ The different approaches that had been adopted and the approach favoured in the OECD Report are addressed below.

The conclusions in the OECD Report have been implemented in two tranches. First, changes were made to the commentary to the existing Article 7 as part of the 2008 model convention update² (the 2008 Commentary). These changes are relevant to existing double tax agreements, which may now need to be interpreted in accordance with the 2008 revisions (this point is addressed in more detail below).

The second tranche of changes will introduce a new Article 7 that is compatible with the recommendations of the OECD Report, along with new commentary on that article (the 2010 Commentary). The new article and commentary have been released in draft form³ and, if approved, are scheduled to be included in the MTC in 2010. These changes will only be effective for States that specifically adopt the new Article 7, either by updating existing treaties or by entering into new treaties.

CAMPBELL PENTNEY, Senior Solicitor, Bell Gully.

¹ Available at <http://www.oecd.org/dataoecd/20/34/41032078.pdf>.

² *2008 Update to the OECD Model Tax Convention* (OECD, 18 July 2008).

³ *Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention* (OECD, 7 July to 31 December 2008).

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The changes made in the 2008 Commentary are not intended to conflict with the existing wording of Article 7, unlike the 2010 Commentary which is more closely aligned with the recommendations of the OECD Report and the revised Article 7. Accordingly, some matters are approached differently between the two commentaries.

Two different approaches to profit attribution

Historically two approaches to the attribution of profits under Article 7 have emerged (although with a number of variations to each approach). These two approaches are broadly referred to as the “functionally separate entity” and “relevant business activity” approaches. The OECD’s concern has been that treaty partners may apply different attribution methods to the same PE and double taxation or non-taxation could arise. The OECD Report (along with the new Article 7 and related commentaries) therefore endorses a single method of attribution, the “functionally separate entity” approach. In New Zealand, Inland Revenue has historically preferred the second method – the “relevant business activity” approach.

Functionally separate entity approach

The functionally separate entity approach involves treating the PE as if it were a self-contained entity that is legally separate from the rest of the enterprise of which it forms a part. This exercise involves identifying the “functions” of the PE within the enterprise and then allocating to it the assets, risk and capital of the enterprise that relate to those functions. Under this approach, profits can arise from deemed transactions between the PE and the rest of the enterprise, which are valued at arm’s length prices in accordance with transfer pricing principles.

Relevant business activity approach

In contrast, although the relevant business activity approach also attempts to isolate the PE’s business activities from the rest of the enterprise, profits can only arise from real transactions with third parties. Essentially, the PE’s “relevant business activity” is identified and, based on that activity, an appropriate proportion of the enterprise’s overall profits (or losses) are allocated to that PE.

Comparison of approaches

At first glance these two approaches might seem similar. However, in practice they can produce quite different outcomes, for example:

- Under the relevant business activity approach, the profits of a PE are limited to the profits actually earned by the enterprise. This means that if an enterprise as a whole is in a loss position, then the PE must also be in a proportionate loss position. However, under the functionally separate entity approach, it is possible for a PE to be treated as deriving profits even though the rest of the enterprise is making losses.⁴
- Timing differences can arise between the two methods – for example, under the functionally separate entity approach, profits can be recognised merely from the transfer of goods between an enterprise’s head office and the PE, irrespective of when those goods are sold outside the enterprise to a third party.
- The OECD Report considers that the functionally separate entity approach removes any possible application of the “force of attraction” principle.⁵ This is the concept that where an enterprise has a PE in a State, all profits derived from that State can be attributed to the PE, irrespective of whether the PE had any involvement in generating those profits. It is worth noting that this principle is explicitly provided for in the United Nations Model Tax Convention and is therefore present in New Zealand’s tax treaties that are based on that model.⁶

Functionally separate entity approach explained further

The OECD Report contains a detailed analysis of the functionally separate entity approach. These concepts are reflected in the draft 2010 Commentary and (to a more limited extent) in the 2008 Commentary.

Attribution using the approach involves two steps:

- First, it is necessary to consider the PE as a separate entity and to determine the economically significant activities that it carries out and functions it performs. Once these functions are determined,

⁴ See 2008 Commentary, para 11.

⁵ OECD Report, para 69; and 2008 Commentary, para 10.

⁶ For example, see the New Zealand/Singapore Double Tax Treaty, article 5(1).

the PE is allocated assets, risks and capital of the enterprise by reference to those functions.

- Secondly, the dealings that the separate PE would have had with the remainder of the enterprise are valued on arm's length terms in accordance with transfer pricing principles. Profits are then attributed to the PE by reference to both actual transactions with third parties and also deemed transactions with the rest of the enterprise.

Some of these elements require further explanation:

Functions

The "functional analysis" of a PE focuses on the functions of the personnel within the PE (referred to as "people functions") and the extent to which these functions are relevant in producing the profits of the enterprise. With some exceptions for specific industries,⁷ people functions can include a wide spectrum of roles, from ancillary functions to top level executive functions.

Once these functions are identified, the PE is attributed with the assets, risks and capital of the enterprise which are relevant to those functions. By way of example, the risks of an enterprise would be allocated to the part of the enterprise that carries out the relevant people functions involving the decision-making process that leads to the assumption of that risk.

Attribution of assets – tangible and intangible

The OECD Report proposes different methods for the attribution of assets to a PE depending on whether the asset is tangible or intangible.

For tangible assets, the starting point is that ownership should be allocated to the part of an enterprise that uses the asset, meaning that the physical location of the asset will generally be determinative (unless the facts suggest that attribution on this basis is clearly inappropriate).⁸

The treatment of intangible assets is more complicated. The 2008 Commentary (and previous commentaries) provide for the costs of the intangible asset to be shared between the parts of that enterprise by reference to use.⁹ On the other hand, the OECD Report advocates for intangibles to be allocated by reference to the functions of an enterprise – ie, intangibles are allocated to the part of the enterprise which carries out the decision-making functions relating to managing the risk of either developing or acquiring those intangibles.¹⁰ The 2010 Commentary is silent on this point but it is logical to assume that the approach under the new Article 7 would reflect the comments of the OECD Report.

Under a functional analysis the relevance of assigning intangible assets to one part of an enterprise is important because other parts of the enterprise that use intangible assets which have not been assigned to them would be deemed to have made arm's length payments for the use of those assets. This would have the effect of shifting those profits to the part of the enterprise that is considered to own the asset. Accordingly the "use" approach may result in a different amount of profits being attributed to a PE than under a "functional" approach. In this context the OECD's approach would have the effect of shifting profits out of New Zealand which, being a technology "importing" country, is more likely to have enterprises that use intellectual property developed overseas.

Attribution of general costs

As a starting point, the costs of a PE should be determined by reference to the functions it performs. However, there are special considerations for internal/notional costs that arise from dealings with the rest of the enterprise. As already noted above, the general rule promoted by the OECD Report is that internal dealings are priced at arm's length in accordance with transfer pricing rules.

One deviation from the attribution of profits from internal transactions is that the notional interest costs on internal "loans" between a PE and the rest of its enterprise cannot be taken into account.¹¹ The OECD considers that internal advances of funds are incompatible with the true legal and economic nature of a loan. This stance may also be informed by avoidance concerns on the basis that enterprises could structure their internal funding in such

7 See OECD Report at para 19: in relation to banks, global traders in financial instruments and insurance companies.

8 OECD Report, para 104.

9 2008 Commentary, para 34.

10 OECD Report, paras 105 to 128, and 234 to 245.

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a way that profits are artificially shifted between States by way of deemed interest payments.

One difficult question is whether a percentage of profits earned through a PE should be allocated to head office to represent a fee paid for “good management”. While this might seem appropriate in the context of treating the PE as a separate entity, both the 2008 and 2010 Commentaries, without reaching an absolute view on the point, state that practical considerations weigh against this approach.¹²

Free capital and debt funding

The PE is allocated appropriate notional funding. This comprises interest-bearing debt and “free” equity funded capital.¹³ This funding allocation exercise involves determining the amount of capital which the PE would require to support its various functions, assets and risks and then applying transfer pricing principles to determine how much of this funding should be “free” capital. This will also determine the amount of third party debt and the related interest cost which should be attributed to the PE.

New Zealand’s position

The observations to the 2008 Commentary explicitly state that New Zealand does not agree with the general approach promoted by the OECD Report.¹⁴ As observations are merely acknowledgements by States that they do not agree with the certain elements of a commentary, this raises the question as to what extent Inland Revenue would be required to apply the principles outlined in the 2008 Commentary.

Although the opening paragraphs of the 2008 Commentary suggest that the approach promoted by the OECD Report is merely the “better approach” and therefore not compulsory, other statements are more prescriptive. For example, para 11 of the Commentary makes it quite clear that profits can be attributed to a PE even when the enterprise as a whole is not in a profit position, a view that would be incompatible with the relevant business activity approach.

The extent to which commentaries need to be taken into account by a Court when interpreting the wording of a treaty based on the MTC has been considered by the New Zealand Court of Appeal

in *CIR v JFP Energy Inc.*¹⁵ The Court held that any interpretation of double tax agreements should have “appropriate regard” to the relevant commentaries. However, the trend in international decisions appears to go somewhat further by requiring commentaries to be taken into account when interpreting model tax conventions.¹⁶

A subsidiary question is whether amendments to a commentary should be relevant for pre-existing treaties, where the States could not have been aware of those future amendments at the time of signing. The introduction to the MTC takes the view that amendments to commentaries should be applicable to pre-existing treaties on the basis that those changes reflect the consensus of OECD members as to the proper interpretation of existing treaties.¹⁷ Two recent decisions from the United Kingdom (*Smallwood Trust v Revenue & Customs*¹⁸) and Canada (*The Queen v Prévost Car Inc*¹⁹) have considered this issue and concluded that the relevance of revised commentaries depends upon the context in which those changes are made. Significantly, while the Canadian Federal Court of Appeal in *Prévost* did hold that it could rely on commentary released 35 years after the relevant agreement was signed, that treatment might not be appropriate if either State has registered an objection to the contents of the relevant commentary (which New Zealand has already done), or if the revisions conflict with the previous wording of the commentary.

From these cases, it appears that Inland Revenue would have scope to argue that it should not be required to follow every aspect

11 Some special considerations are afforded to banks on the basis that their core business involves the advancing of money.

12 See 2008 and 2010 Commentaries at paras 38 to 40.

13 See 2008 Commentary, paras 44 to 48 and the OECD Report at para 85.

14 2008 Commentary, para 74.

15 (1990) 12 NZTC 7,176.

16 For example, see *Smallwood Trust v Revenue & Customs* [2008] UKSPC SPC00669 (19 February 2008) and *The Queen v Prévost Car Inc* (2009) FCA 57.

17 Paras 35 and 36 of the introduction to the *Model Tax Convention on Income and on Capital* (OECD, 17 July 2008).

18 [2008] UKSPC SPC00669 (19 February 2008).

19 (2009) FCA 57.

of the 2008 Commentary when applying Article 7. However, the lack of any definitive direction on these issues leaves the result open to debate.

The new Article 7

The current draft of the proposed new Article 7 features several distinct changes from the current version.

The wording of the first two paragraphs of the article have been reworked to make it clear that States must attribute profits in accordance with the OECD's preferred functionally separate entity approach. For example, para 1 no longer states that the "profits of the enterprise may be taxed in the other State" but instead states "the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in the other State". The second paragraph now specifically alludes to the OECD promoted approach by requiring States to take into account "the functions performed, assets used and risk assumed" by the enterprise through its PE.

A number of later paragraphs have been removed from the new Article 7 on the basis that their effect was already implied by the first two paragraphs.²⁰

A new para 3 has been added which provides for a "tie-breaker" test where two States apply a different method under their domestic

law for determining the amount of "free" capital to attribute to a PE and where Article 23 does not apply to provide relief for any double taxation that results. Very generally, the new para 3 requires States to adopt the method used by the State in which the PE is located, provided that both States agree that this method produces an arm's length result.

Conclusion

The findings of the OECD Report and subsequent revisions to the MTC clearly shift the interpretation of Article 7 away from the approach preferred by New Zealand Inland Revenue.

It is debatable to what extent, if any, the changes to the 2008 Commentary will affect New Zealand's ability to attribute profits to PEs as it sees fit. However, where New Zealand's treaty partners have adopted the OECD promoted approach, an unwelcome mismatch may arise in the profit that is allocated to PEs under Article 7. Taxpayers that are subject to double taxation as a result of this mismatch may need to apply for relief under Article 23 (which provides tax credits in certain cases) or Article 25 (which provides for a mutual agreement procedure).

Other States may introduce the new version of Article 7 (once approved) into new double tax treaties or as an update to their existing double tax treaties. It remains to be seen how New Zealand's expected resistance to these changes will play out in terms of negotiating new agreements with these States.

²⁰ Discussed at in paras 37 to 39 of the 2010 Commentary.