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Status of Implementation of the Authorized OECD Approach into Domestic Tax Law and Tax Treaties – Part 1

This article examines profit/loss allocation in a headquarter/branch scenario. Part 1 discusses the actual split between a head office and branch from a theoretical perspective, discusses basic concepts derived from public international treaty law, the notion of Key Entrepreneurial Risk-Taking Functions versus Significant People Functions and the Authorized OECD Approach (AOA). Part 2, to be published in *European Taxation* 9 (2015), continues to analyse the AOA, looks at the question of whether adequate capital is allocated to the branch as a fictitious separate entity and outlines court cases, tax policy and advance pricing agreement/mutual agreement procedure implications.

1. Introduction to Articles 7 and 9 of the OECD Model (2014)

In 2010, the OECD released a landmark report on the treatment of intra-company transactions, i.e. transactions between a head office and a branch (PE) within legal entities.[1] The need to consider special features associated with such intra-group dealings arose due to certain theoretical concepts on the characterization of head office-branch operations. The Preface to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) (the Guidelines)[2] makes reference, in paragraph 11, to the draft 2008 Report, which preceded the 2010 Report.[3]

The OECD Model (2014)[4] lays down the arm's length principle in article 9 exclusively in relation to transactions between associated enterprises. This is based on the fundamental principle that a comparison should be made with two independent entities dealing with each other on an arm's length basis. Independent entities pass through consecutive stages of the bargaining process with the result that the setting of the price or profit allocation will end up being an appropriate choice between alternative business opportunities. The doctrine contained in the Guidelines is summarized in paragraphs 1.1 through 1.5. Paragraph 1.2 provides that:[5]

> [...] when associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other, as discussed in paragraph 1.5 below.

Paragraph 1.5 adds the following language:[6]

> It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs sometimes have a considerable amount of autonomy and can often bargain with each other as though they were independent enterprises.

In essence, the said considerations, including all their subtleties, emphasize that the separate entity approach philosophy prevails over any approach to a comparability analysis regarding intra-group price determination.

Over the years, permanent establishment (PE) issues have bothered the tax community. In this connection, the focus has been on article 5 instead of on article 7, the former article only defining PE typologies. The legal nature of a PE obscures any conclusions regarding a defendable profit allocation split between a head office and branch due to the peculiar economic characteristics of dealings between different parts of a single legal entity. The OECD, however, has now reversed the sequence, with the focus now initially being on article 7, which became apparent in its successive 2008 and 2010 Reports.

The present article highlights core issues relating to profit/loss allocation in a headquarter/branch scenario and the respective modes of implementation of the authorized OECD approach (AOA) by the relevant tax authorities. The "functionally separate entity approach" prevails in ascertaining an entity's functions and risks, as well as allocating assets to the respective parts of the legal entity.

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1. OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), (hereinafter 2010 Report).
2. OECD, *Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations* (OECD 1995) (hereinafter Guidelines). The latest version is OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), available at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm (hereinafter 2010 Guidelines).
3. The issues discussed in these Guidelines also arise in respect of the treatment of PEs as discussed in the 2010 Report, *supra* n. 1.
4. *OECD Model Tax Convention on Income and on Capital* (15 July 2014), Models IBFD.
5. Guidelines, *supra* n. 2, at para. 1.2, fourth to sixth line.
6. Id., at para. 1.5, first to sixth line.

Section 2. deals with the actual split between a head office and branch and elaborates on the underlying theoretical concepts in more detail, including the historical background to this issue. Section 3. focuses on basic concepts derived from public international treaty law, in particular the Vienna Convention on the Law of Treaties (Vienna Convention)(1969).[7] With regard to the topic of this article, a static versus dynamic interpretation of treaty provisions is of particular importance. Section 4. concentrates on the notion of key entrepreneurial risk-taking functions (KERT) versus significant people functions (SPF) as utilized in different business sectors. This section addresses the implications of the recent BEPS initiatives on the SPF/KERT notions and "control over risk" concepts. Section 5. describes the important concept of the AOA, which forms the foundation of and is the working principle for the OECD attribution report project. Section 6. deals with a peculiar topic, notably the question of whether adequate capital is allocated to the branch as a fictitious separate entity. Section 7. addresses court cases, tax policy and APA/MAP implications. Section 8. provides concluding remarks. Sections 5.6. to 8. are contained in Part 2 of this article, to be published in *European Taxation* 9 (2015).

The OECD ignored, for some time, the specific characteristics of PEs for the purpose of intra-group relationships. Starting in the late 1990s, awareness of important PE-related topics emerged inside OECD circles and the organization steered its members towards a focus on the particular features underlying the allocation of functions, assets and risks between a head office and its branch(es). In particular, similarities and differences in comparison to the principles of article 9 of the OECD Model had to be clarified.[8] In essence, the resulting (draft) reports are divided into four separate sections, i.e. "General Guidelines", "Banking Practice", "Global Trading" and "Insurance Practice". The AOA prevails as the leading principle, but is refined or fine-tuned having regard to particular aspects or process determinants of the entrepreneurial environment.

The AOA is a two-step approach pursuant to which the business community is required to identify economically significant activities and responsibilities of a head office and PE by way of a factual and functional analysis and to apply to the resulting split of functions, assets and risks an appropriate arm's length remuneration. At first glance, this approach will not deviate from the application of the general arm's length principle under article 9 of the OECD Model. A paradigm change took place, however, in respect of the conceptual basis for tax and transfer pricing purposes regarding the relationship between a head office and a PE.

As indicated herein, the functionally separate entity approach has been acknowledged by the OECD, which implies that the alternative separate business activity principle has been rejected. The latter is at odds with the domestic sovereignty of national tax administrations, as it enables cross-national loss compensation for each separate business activity. Most industrialized countries already preferred the functionally separate entity principle, but the OECD has now made their ultimate recommendation for future reference. Therefore, in the end, business transactions between a head office and its PE are to be recognized as dealings to be assessed in a similar way as transactions between separate legal entities for transfer pricing purposes.

Another point of consideration concerns the treatment of internal rent, royalties and interest charges. More specifically, if ownership of intellectual property (IP) is attributed to the PE, an internal royalty paid to the PE by other parts of the enterprise for the use of that IP should be recognized.[9] A couple of jurisdictions hitherto refused to recognize rent, royalty or interest flows for taxation purposes.[10] These jurisdictions might be tempted to (re) negotiate their tax treaties along the lines of the guidelines set out in the 2010 Report.

A third point marking the difference in perspective between the old and the new version of the OECD approach to profit allocation concerns the "free capital" discussion. This discussion boils down to the most appropriate method to fix adequate equity for the PE so as to mark the line between equity and debt funding and the connected interest-free (equity) or interest-bearing (debt) flow streams between the head office and PE. As a normative theory for a proper solution to this problem is missing, the relative part of the 2010 Report provides for a set of conceptual approaches. Apart from the various approaches set out in the 2010 Report, a specific process for resolving conflicts between countries is also provided. Baker and Collier (2009) describe this solution in the following words:[11]

> The updated commentary seeks to balance the existence of different approaches with the desire to avoid unrelieved double taxation by adopting a form of symmetry. The residence state of the enterprise is asked to accept, for the purpose of determining the interest deduction to be used in computing the double taxation relief, the attribution of capital in accordance with the approach used by the host state of the PE. This is subject to two conditions: it must result from two different domestic law methods of capital attributions, and the approach adopted must produce a result that is consistent with the arm's length principle.

The last item, typically a consequence of the adoption of the separate enterprise principle, concerns the changing view towards the "dependent agent PE" model. Dependent agents, acting on behalf of and for the account of the principal company, could, according to domestic law, be qualified as PEs, attracting functions, risks and assets in the first AOA step. The 2010 Report explicitly acknowledges a dependent agent PE, whether or not embodied within the corporate veil of another (associated) company, resident in a host country. The question of whether profits can be attributed to such a dependent agent PE over and above an arm's length remuneration for the dependent agent

7. *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties IBFD.
8. *See* P. Baker & R. Collier, *2008 OECD Model: changes to the Commentary on Article 7 and the attribution of profits to permanent establishments*, 63 Bull. Intl. Taxn. 5, p. 199 (2009), Journals IBFD.
9. Id., at p. 200.
10. The Netherlands only recognized such flows if occurring within the financial sector.
11. Baker & Collier, *supra* n. 8, at p. 2.

itself[12] or, alternatively, whether a single taxpayer approach should apply, divides the professional tax community.[13]

Domestic jurisdictions will consider the nature and scope of the 2010 Report and develop a mind set as to the implementation of the new principles.[14] In fact, OECD reports are not self-executing in the sense that national states are, per se, bound by their contents. OECD reports tends to be characterized as soft law. In that connection, the 2010 Report is considered to serve as a roadmap to implementation. No gratuitous observance is permitted, however, as the domestic courts may, as the case may be, according to their own judgment, apply the principles of the 2010 Report. In order to assess the material interest of countries in the 2010 Report, it would be useful to provide a framework for rethinking aspects and concepts and present a short overview of the state of the art of the respective countries on the newly developed profit allocation PE rules.

2. Branch: A Separate Entity?

2.1. What is a "permanent establishment"?

A PE is not a separate legal entity of the parent corporation. Generally, the standard PE definition notes that an enterprise residing in one country will have a PE in the other country if it has a fixed place of business (for example, a branch, place of management, office, factory, etc.) in the other country or is represented by a dependent agent in the other country that is authorized to conclude relevant business contracts. It also often defines whether, and how, tax should be levied on a particular entity.

2.2. What is the difference between a PE and subsidiary?

A branch is generally defined as a fixed site through which the business of the company is wholly or partly carried on within that territory, while a subsidiary is a separate legal entity, meaning that its liabilities cannot be claimed against another company in the group. As such, businesses are keen to make use of branches primarily for financial purposes. Branches, however, can also be, operationally wise, more valuable than subsidiaries. These advantages include, but are not limited to, the following:

- reduced operating costs, as subsidiaries require separate accounts, consolidation, individual tax returns and individual legal contracts, while a PE does not call for some of these requirements;
- a PE can be easier to establish and close down if unsuccessful; and
- no VAT arises between branches of the same legal entity.

2.3. The main issue in relation to PEs

The main challenge in relation to a PE is that an entity cannot contract with itself. The relationship between the group's subsidiaries is clearly defined and legally authorized (i.e., risks, as well as legal and economic ownership of assets, are clearly defined and allocated and legal contracts are in place to justify intra-group transactions). A head office and PE, however, belong to the same legal entity and, therefore, no legal contracts to validate their complex relationships are used. This creates a challenge in terms of how, and how much of the, company profits should be attributed to a PE.

2.4. Efforts made to tackle these challenges

The PE concept has a history as long as the history of tax treaties and can be traced back to the late 1800s, when European nations negotiated tax treaties to govern the tax treatment of cross-border economic activity. The modern version of the rule was created after World War I when nations expressed their concern that international double taxation was slowing down international trade and investment.

Due to growing concerns, the League of Nations formed a group of tax specialists to develop a mechanism to guarantee the avoidance of double taxation. The group arrived at a consensus, developing the PE concept that became enshrined in a 1927 Model Tax Convention, which was later included in the OECD Draft (1963).[15]

Currently, the international tax principles on attributing profits to a PE are laid down in article 7 of the OECD Model (2014). Earlier versions of article 7 caused considerable variations in the interpretation of the general principles and, therefore, the Committee on Fiscal Affairs spent considerable time and effort to ensure a more consistent interpretation and application of the rules of the article. Minor changes to the article, and a considerable number of changes to the Commentary,[16] were made when the OECD Model (1977)[17] was adopted. The fact that the determination of profits attributed to a PE had raised uncertainties drew the Committee's attention. The Committee reviewed the question, resulting in the adoption of the 1993 version of the Report[18] – and to subsequent changes to the Commentary.

The interpretation of article 7 in various countries differed considerably, however, and, therefore, the Committee, in the Guidelines, noted that further work would address the application of the arm's length principle to PEs. Such work resulted in the 2008 version of the Report.[19] The focus of the 2008 Report was on formulating the preferred approach to attributing profits to a PE under article 7 given modern-day multinational operations and trade.

12. In that case, a two-layer tax return (independent agent and dependent agent PE) has to be filed with the host country tax authorities.
13. Baker & Collier, *supra* n. 8, at p. 2.
14. *See*, for instance, ATO Board of Taxation Discussion Paper, *Review of Tax Arrangements applying to Permanent Establishments* (Oct. 2012).
15. *OECD Draft Tax Convention on Income and on Capital* (30 July 1963), Models IBFD.
16. *OECD Model Tax Convention on Income and on Capital: Commentary* (1 Apr. 1977), Models IBFD.
17. *OECD Model Tax Convention on Income and on Capital* (1 Apr. 1977), Models IBFD.
18. OECD, *Report of the Committee on Fiscal Affairs on the Attribution of Income to Permanent Establishments*, DAFFE/CFA(93)10/REV2 (OECD 1993).
19. OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2008), International Organizations' Documentation IBFD (hereinafter 2008 Report).

The Committee also decided that a new version of article 7 should be included in the next update to the OECD Model to allow for full incorporation of these principles. The new article 7 was included in the OECD Model (2010).[20]

3. Dynamic versus Static Interpretation of Article 7

Treaty interpretation follows a couple of basic rules that can be traced back to the framework laid down by the Vienna Convention.[21] For the purposes of this article, articles 31 to 33 are relevant. These articles set forth general principles as a framework for interpretation. The fundamental rules and concepts equally apply to all aspects of international law, including international tax law.

In the following section an overview of the rules of interpretation applicable to cross-border (tax) regulations embodied in treaty language are examined. First article 31(1) emphasizes the "ordinary meaning" of treaty terms. Such an ordinary meaning, however, is to be determined in its context and in the light of the object and purpose of the treaty, provided that the specific interpretation can be justified in accordance with the "good faith" of the parties involved.

The principal rule of interpretation, embodied in article 31 of the Vienna Convention (1969), does not apply if the parties attach a special meaning to the wording applied by the treaty at issue.[22] The special meaning option has a limited scope, as it has to be demonstrated that the parties did have an obvious intent to deviate from the ordinary meaning set forth by the context, object or purpose of the relevant treaty.

The notion of "ordinary meaning", which supersedes and, therefore, restricts the "special meaning" exception, is further elaborated on in the Vienna Convention (1969). For instance, the significance of "context" is detailed in section 31(2) and (3). Section 31(2) mentions "text, including preamble, annexes, connecting agreements and other instruments, agreed upon by the parties" whereas section 31(3) refers to "other instruments, agreed upon by the parties, subsequent agreements, practices and relevant rules of international law".

International tax treaty law primarily draws upon the existence and development of the OECD Model, being the reference framework for the language of tax treaties. The OECD Model is being adapted, on a regular basis, to absorb new insights and interpretations and in order to cope with new doctrines of international tax law.

A legal issue relates to the binding nature of tax treaty provisions. It is generally accepted that direct recourse may be had to the contents of the OECD Model. This stated practice implies that, absent other observations, each negotiating party must be presumed to have the intention to act in conformity with the Commentaries, as updated over time, for the purpose of interpretation. So the crucial point is the correct method of interpretation. In this connection, two rules of interpretation should be recognized. The first holds that a valid interpretation must exclusively be derived from the text, prevailing at the date the relevant tax treaty is concluded. The second holds that interpretation must be based on the latest update to the Commentaries, which is deemed to embody the latest insights. This issue is framed by the international tax community as a choice between a static and dynamic interpretation. Put more simply, a static interpretation concentrates on the meaning of a term at the moment the tax treaty is signed, whereas a dynamic interpretation focuses on the meaning of a term at the moment of application.

The introduction to the Commentary on the OECD Model (2010) provides that: "existing conventions should as far as possible be interpreted in the spirit of the revised commentaries even though the provisions of these conventions did not include the more precise wording of the actual version".[23]

Further on, it states that, "amendments of the articles are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended articles".[24]

The Netherlands Ministry of Finance, in its Decree of 15 January 2011, no. 2010/457m, applies a dynamic approach to the interpretation of tax treaties, pursuant to which revisions to the Commentaries are only applied to older tax treaties if the revision constitutes a clarification. The Netherlands Supreme Court (*Hoge Raad*) has not expressed a clear preference for the dynamic method, sometimes applying the dynamic method and sometimes the static method.[25] Therefore, the position of the Decree, i.e. that the AOA should also apply to older tax treaties, can only be upheld if the AOA and the related revisions to the Commentary on Article 7 of the OECD Model clarify the existing Commentary. In this context, it must be observed that the pre-2010 Commentary did not deal with the allocation of capital to a PE and did not indicate that the PE should be treated as a separate entity. Therefore, it is not arguable that the 2010 changes to the Commentary on Article 7 of the OECD Model merely clarify the previous Commentary.[26]

The Netherlands tax administration is prepared to accept the inclusion of a provision in a tax treaty that provides that the competent authorities may decide, at a later stage, on the application of the AOA.[27]

20. *OECD Model Tax Convention on Income and on Capital* (15 July 2014), Models IBFD.
21. Which entered into force on 27 January 1980.
22. Art. 31(4) of the *Vienna Convention* (1969).
23. *See OECD Model Tax Convention on Income and on Capital: Commentary on Introduction* para. 33 (22 July 2010), Models IBFD.
24. Id., para. 35.
25. Examples of a dynamic approach include NL: HR, 4 July 1989, No. 25.660, BNB 1987/274, Tax Treaty Case Law IBFD; NL: HR, 12 June 1991, No. 27.310, BNB 1991/312, Tax Treaty Case Law IBFD. Examples of a static approach include NL: HR, 2 Sept. 1992, No. 27.252, BNB 1992/379, Tax Treaty Case Law IBFD and NL: HR, 20 April 1983, No. 21.047, BNB 1983/204, Tax Treaty Case Law IBFD.
26. In the same sense *see* H. Pijl, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, 65 Bull. Intl. Taxn. 6, p. 306 (2011), Journals IBFD.
27. Netherlands tax treaty policy Memorandum of 11 February 2011, p. 45, available at http://www.eerstekamer.nl/mobiel/behandeling/20110211/

The view of the German Ministry of Finance does not seem to be in line with that of the German Supreme Court (*Bundesfinanzhof*), which, in various decisions, has decided that a change to the OECD Model can only be taken into account if it was adopted before the treaty was signed.

The preface to the 2010 Report provides for a chronological overview of the deliberations by the "Committee on Fiscal Affairs" ("the Committee") of the OECD to coordinate the various amendments of (the Commentary on) Article 7 of the OECD Model in order to align these with the contents of the respective OECD PE reports.

First, the Committee considered it appropriate to align, as far as possible, the contents of the 2008 Report[28] with the revised Commentary on Article 7 of the OECD Model. It therefore advocated a degree of harmonization in order to prevent interpretation conflicts in particular related to tax treaties that were in existence before the introduction of the 2008 Report. In 2010, a new article 7 was introduced. In its turn, the introduction of a new article 7 caused inconsistencies with the contents of the revised Commentary on the former article 7 and the 2008 Report. For that reason, the 2010 Report was adopted to bring the intent and wording of the Report in line with the (Commentary on) the new article 7. As a result, the 2010 Report serves as guidance for future post-2010 tax treaties containing similar wording as the new article 7.[29] In conclusion, it seems apparent that the Committee has a preference for the application of the static method of interpretation.

OECD Member States have taken different positions on the implementation of the Report, as well as on the issue of static versus dynamic interpretation. In the following table the authors provide a survey of country positions taken in this regard.

Table 1: Country-wise matrix on domestic positions taken by domestic tax administration/tax court

	Administration		Case law	
Country	*Dynamic*	*Static*	*Dynamic*	*Static*
Austria	X[1]			X
Belgium	Unclear	Unclear	Unclear	Unclear
Canada			X[2]	
Denmark	X[3]	X	X	X
Germany	X		X	X
Greece	X		X	
Ireland	X		X	
Italy	X			X
Luxembourg	X		X	
Netherlands	X		X	X
Norway	X		X	
Portugal		X		X
Spain	X		X	
Sweden	Unclear	Unclear	Unclear	Unclear
United Kingdom	X		X[4]	
United States	X[5]		X	X

1. The tax authorities refer to the latest comments unless a different meaning is given under a tax treaty.
2. The Canadian courts have, over time, emphasized a dynamic interpretation and the OECD Model: Commentary is regarded as an intrinsic aid to treaty interpretation.
3. A dynamic approach is followed unless the treaty text differs substantially.
4. The dynamic approach is only not applied if substantial changes were made to the Commentary subsequent to the signing of a treaty.
5. The Courts were reluctant, but in US: Taisei Fire and Marine Insurance Co., Ltd., I 04 TC 535 (1995), where the issue was whether a US agent accepting reinsurance on behalf of foreign insurance companies was a US PE of those companies, a dynamic approach was applied based on a prior text of the UN fiscal Committee.

Source: E.C.C.M. Kemmeren et al., *Tax Treaty Case Law Around the Globe* (IBFD/Linde 2014); and M. Schilcher & P. Weninger, *Fundamental issues and practical problems in tax treaty interpretation* (Linde Verlag 2008)

As can be seen, the majority of tax authorities adhere to the dynamic approach. Case law, incidentally, deviates from the official position. Some jurisdictions provide unclear results. Therefore, more clear responses from the various countries must be awaited in the context of the 2010 Report. New case law will shed some light on the positions taken by the courts and encourage the enactment of new legislation if, in the end, the dissenting positions cannot be reconciled.

The OECD, in 2014, published "A multilateral instrument to modify bilateral tax treaties",[30] one of its deliverables in respect of the OECD Action Plan,[31] which is intended to absorb, over time, the contents of all BEPS deliverables into existing and new tax treaties. This multilateral instrument could have a significant bearing on the basic philosophy underlying the interpretation of the approximately 3,500 treaties involved. Section 7., to be published in Part 2 of this article, will summarize some relevant points in this respect.

The main question, however, is whether or not this multilateral instrument will convert all article 7 interpretations into existing tax treaties in order to be fully compliant with the "more enhanced reasoning" of the 2010 Report.

4. The Distinction between SPF and KERT versus "Control over Risk"?

The allocation of functions, risks and assets to a head office or PE can be based on three realities:

– *Accounting reality:* Based on the current accounting standards, this allocation can easily be manipulated and, therefore, the OECD rejects this as a leading concept.

– *Legal reality:* Between unrelated enterprises, the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts

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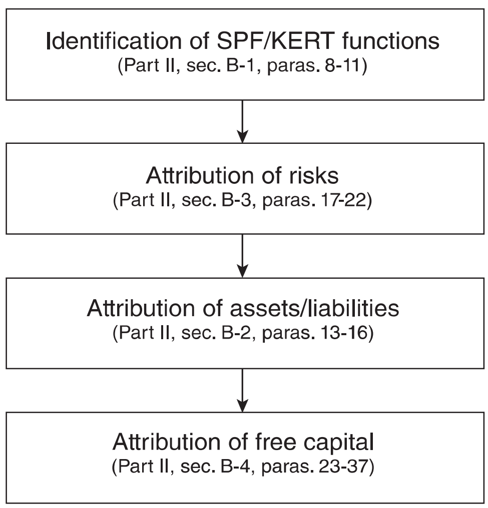
28. 2010 Report, Preface, para. 7.
29. Id.
30. OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* (OECD Publishing 2014), available at http://www.oecd.org/tax/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-9789264219250-en.htm.
31. OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD.

or other ascertainable legal arrangements. Since the head office and PE are part of the same legal entity, the use of such a distinction to allocate functions, assets and risks between a head and PE is also not possible and, therefore, another solution must be sought; and

– *Economic reality:* The OECD defines economic reality as a broad consensus that assets generally are to be attributed to that part of the enterprise (head office versus PE) that performs the significant people functions relevant to the determination of economic ownership of assets.

Diagram 1 ranks the approaches suggested by the OECD.

Diagram 1: OECD suggested sequence of analysis and resulting steps in attributing profits to a PE



A more detailed description of the ranking and the OECD's two-step approach is provided in sections 5.2. and 5.3. of this article.

Significant people functions are classified into two major categories:
– significant people functions related to the economic ownership of assets; and
– significant people functions related to the management of risks associated with that economic asset.

Generally, significant people functions relevant to the assumption of risk and to the economic ownership of assets can vary from business sector to business sector and from enterprise to enterprise within sectors. For example, a SPF could relate to managing a production plant. Another SPF can relate to the "people functions" regarding management of the capital risk of that same production plant. Additionally, more than one significant people function relevant to the assumption of risks and to the economic ownership of assets can exist.

Because of the special relationship between risk and financial assets in the financial industry, the AOA uses the KERT function as the most relevant function to attribute both risks and assets to the head office versus PE.

Below is an example of how the creation and management of a financial asset is analysed.

Diagram 2: Creation and management of a financial asset

Loan origination	Loan management	Risk management
– *Sales/trading function constitutes a KERT function.*	– *Loan support;* – *Monitoring risks assumed as a result of entering into the loan;* – *Managing risks initially assumed and subsequently borne as a result of entering into the loan;* – *Treasury; and* – *Sales/trading.*	– *Function of managing risks constitutes a KERT function.*

Source: TPA following the 2010 Report, *supra* n. 1.

The concepts of SPF/KERT reflect the fact that "people functions" are less vulnerable to manipulation by taxpayers.

The OECD has introduced a similar "people functions" concept referred to as the "control over risk" concept. The OECD states:[32]

> In the absence of comparables evidencing the consistency with the arm's length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances.

In this instance, "control" is understood as the capacity to make decisions on what level of risk is acceptable, as well as decisions on whether and how to manage those risks. This means that the company should have people (employees or directors) who have the authority and capability to effectively perform "control over risk" functions. In other words, in order to control a risk they should be able to assess the outcome of the day-to-day monitoring and organize the administrative functions needed to manage those risks.

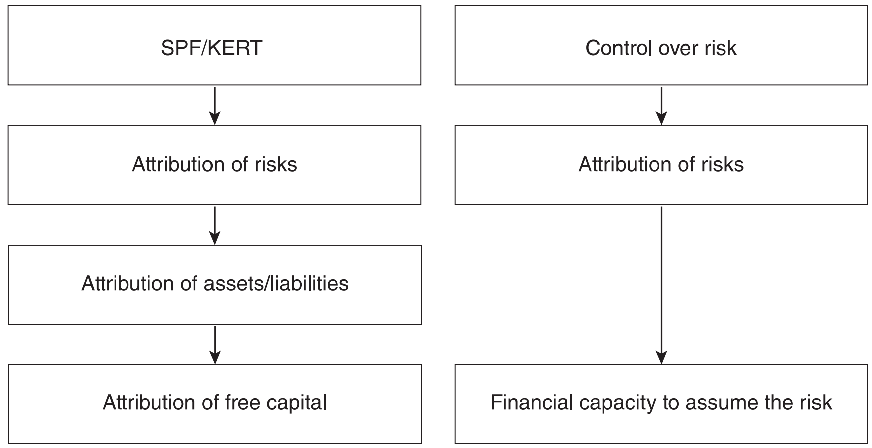
The OECD subsequently provides three "control over risk" examples:

Example 1

An investor hires a fund manager to invest funds on its account. The manager is given the authority to make all investment decisions on behalf of the investor on a day-to-day basis, although the risk of loss in terms of the value of the investment is borne by the investor. In this situation, the investor controls its risks through three relevant decisions: (1) the decision to hire that particular fund manager; (2) the decision regarding the extent of authority it gives to the fund manager; and (3) the decision regarding the amount of the investment. In such a scenario, the fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk and illustrates the fact that an investor who gives to another person the authority to make all day-to-day investment decisions does not necessarily transfer the investment risk to the person making these day-to-day decisions.

32. OECD, *Report on the transfer pricing aspects of business restructurings: Chapter IX of the transfer pricing guidelines of 22 July 2010*, section 9.22.

Diagram 3: Convergence of SPF/KERT and "control over risk" concepts



Example 2

A principal hires a contract researcher to perform research on its behalf. The principal, on the one hand, is the owner of the results of the research and, as such, makes a number of important decisions to control its risks (for example, continuation/termination of the contract with selected contract researchers, the type of research and the relevant objectives associated therewith, budget allocation, etc.). The researcher, on the other hand, carries out day-to-day research work and is allocated a guaranteed remuneration irrespective of whether the research is a success or failure. In this situation, the contract researcher's own operational risk is distinct from the risk of failure borne by the principal entity.

Example 3

A principal hires a contract manufacturer to manufacture products on its behalf, using technology that belongs to the principal. The principal guarantees that it will purchase 100% of the products manufactured by the contract manufacturer and, as such, to control its market and inventory risk the principal makes a number of important decisions, i.e. continuation/termination of the contract, type of products to manufacture and their technical specifications, production volume and timing of delivery. The contract manufacturer, on the other hand, performs the day-to-day manufacturing activities and is allocated a guaranteed remuneration irrespective of whether and if so at what price the principal is able to re-sell the products on the market. Similar to Example 2, the contract manufacturer's operational risk (for example, the risk of losing a client, penalty for not meeting set quality standards or other requirements) is distinct from the market and inventory risk borne by the principal.

Besides the "people functions", the "control over risk" concept is also similar to the SPF/KERT function concepts, as it assumes the party carrying the risks needs to have the functional capacity to absorb those risks once they materialize. Diagram 3 illustrates the comparison between these two concepts.

The above suggests that, although SPF/KERT are concepts used in article 7 of the OECD Model, while "control over risk" is a concept used in article 9 of the OECD Model, there is a convergence between the application and interpretation of the two concepts.

A recent OECD report, "BEPS Action 10: Discussion draft on the use of profit splits in the context of global value chains" ("Discussion draft on global value chains")[33] makes a few relevant references to "people functions". It states that:

> Where there is significant integration involving parties to a specific transaction or transactions within that value chain, for example in the effective sharing of key functions and risks, the reliability of one-sided methods may be reduced. One-sided methods may not be able to account reliably for the interdependence of the key functions and risks, or for the synergies and benefits created by such integration. In such cases transactional profit split methods may be an appropriate means of determining an arm's length outcome, which takes into account the specific contributions of the parties to value creation.

This is particularly important where an MNE's business operations are highly integrated. In such instances, strategic risks may be jointly managed and controlled by more than one enterprise in the group, making the key functions and risks between the parties interdependent. For example, assume there are three associated original equipment manufacturing enterprises (OEMs) in the durable goods industry that are located in different territories in Europe. In this scenario, all OEMs are represented by one leadership board, which is responsible for a wide variety of business decisions, such as what new products to develop, where to develop them, where to build them, what plant investment is to be made and what strategic marketing actions need to be taken.

Additionally, OEMs also buy and sell both components and finished goods to each other. This marks a high level of cooperation and interdependence between OEMs, meaning that it may be very difficult to find reliable comparables to justify the arm's length pricing of such a complex web of transactions.

Another recent OECD report, "BEPS actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)"[34] indicates that "risk can give rise to dif-

33. OECD, *Public Discussion Draft: BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, 16 December 2014 – 6 February 2015 (OECD 2014).
34. OECD, *Public Discussion Draft: BEPS actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk,*

ficulties in transfer pricing analyses", since (1) it is difficult for the party assuming risk to evaluate the required additional expected return when the factors affecting the risk outcomes are determined by another party and (2) there would likely be considerations of moral hazard in an arm's length situation were one party assumes risk without safeguards to manage the behaviour of the party creating its risk exposure.

This report provides the following framework for risk management:
– the capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
– the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and
– the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

This layered approach to risk management is also addressed in paragraph 56 of the OECD *Public Discussion Draft: BEPS actions 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)*, as referred to in footnote 39. An example of the risk management attributed between head office and PE or between two group entities provided by the OECD indicates that risks should be analysed with specificity, i.e. they do not automatically follow the owner of the asset. This seems to more explicitly follow the performance of "relevant people functions".

5. Authorized OECD Approach

5.1. Introductory remarks

The AOA was introduced by the OECD to align the rules for business profits under tax treaties with those of the arm's length principle of article 9 of the OECD Model and the Guidelines.[35] Under the AOA, the profits of the different parts of an enterprise are allocated based on a fiction that the PEs are distinct and separate entities.

The core principles of this "functionally separate entity" approach were included in various reports by the OECD and combined into a consolidated version in 2008.[36] Partial implementation into the Commentary on the OECD Model (2008) ultimately lead to a new wording of article 7 and a revised Commentary on the OECD Model (2010). In addition, the OECD, in 2010, released a new version of its Report on the Attribution of Profits to a PE, i.e. the 2010 Report.[37]

Under the AOA, profit allocation to a PE is based on the following principles:
– the PE is a separate enterprise engaged in the same or similar activities; and
– the PE is independent from the rest of the enterprise of which it forms a part and any other legal person, which means that its profits must be determined by means of the arm's length principle.

The new article 7(2) of the OECD Model (2010/2014) provides that the profits attributable to a PE are:

> The profits that the PE might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, the assets used and the risks assumed through the PE and through other parts of the enterprise.

Under the AOA, the profit allocation between the PE and the head office is calculated in two stages. In the first stage, the SPF of the PE must be determined, i.e. the functions that the employees of the PE actually carry out compared to the rest of the enterprise and the related responsibilities. Based on this analysis, the assets needed to perform those activities, as well as the changes and related risks, must be attributed to the PE. Subsequently, the free capital to be allocated to the PE must be determined.

Under the second step, the business relations between the PE and its head office must be determined, as well as the arm's length transfer prices in respect of those relationships. This calculation will be made by reference to the functions performed, assets used and risk assumed by the theoretical enterprises.

The result of this two-step approach will be to allow for a calculation of the profits or losses of the PE from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises and dealings with other parts of the enterprise.

An important difference between the old and new approach is that, under the new one, profits may be allocated to the PE even if the company, as a whole, was loss making and vice versa.

In addition, it should be noted that the two-step approach under the AOA needs to be followed by the implementation of appropriate accounting standards. This reality has not yet been realized by the AOA and, therefore, it is necessary to determine a consistent base for the application of the AOA.

5.2. Determination of SPFs

Under the first step of the AOA, in line with the Guidelines, various factors must be taken into account in determining the SPFs, including a functional analysis, the characteristics of property or services, contractual terms, economic circumstances and business strategies.

5.2.1. Allocation of risks to a PE

Under the AOA, a PE must be considered to be assuming any risks in respect of which the SPFs relevant to the assumption of risk are performed by the personnel of a PE at a PE's location. Depending on the functions performed by a PE, the risk could, inter alia, consist of a financial and/or operational risk. Examples include direct business risks,

recharacterisation, and special measures), 1 December 2014 – 6 February 2015 (OECD Publishing 2014).

35. *See supra* n. 2.
36. 2008 Report, *supra* n. 19 (Parts I to IV).
37. 2010 Report, *supra* n. 1.

inventory risks, credit risks, currency risks, interest rate risks, market risks, product liability, warranty risks, regulatory risks, etc.

In line with paragraph 1.52 of the Guidelines, the division of risks and responsibilities within the enterprise must be deduced from the conduct between the head office and PE and the economic principles that generally govern relationships between independent enterprises. Relevant factors are the internal practices of the enterprise, such as compensation arrangements and documentation on the allocation of risks between a head office and PE. *See*, in this regard, the diagrams in section 4. of this article.

5.2.2. Allocation of assets to a PE

Based on the determined SPFs of a particular PE, it must be decided which assets that PE uses for the exercise of these functions and whether economic ownership of those assets can be allocated to that PE.

With regard to the allocation of tangible assets, the allocation can be based on a determination of the SPFs relevant to the economic ownership of the said assets, by means of a functional and factual analysis of the case or on the basis of the place of use of the assets.

With regard to the allocation of intangibles, a distinction is made between trade and marketing intangibles. Concerning internally developed trade intangibles, the allocation must be made by means of active decision-making with regard to the assumption and management of individual risks and portfolios of risks associated with the development of intangible property. This requires a description of the research and development programme of the enterprise, the critical decision-making process and the level at which these decisions are made. In allocating purchased trade intangibles, it must be determined in which part of the enterprise the SPFs related to active decision-making relating to the assumption and management of risks are undertaken. Relevant factors are the evaluation of the acquired intangible, the performance of any required follow-up development activity, and the evaluation of and management of risks associated with deploying the intangible asset concerned.

Example 4

Assume a group company has commissioned another company to develop software. In this instance, the developing company does not automatically become the legal owner of the software. In contrast, what is decisive is which group company acts as entrepreneur with regard to assuming and bearing the risk related to the software.

The allocation of marketing intangibles will, under the AOA, take place in the same manner as trade intangibles. Relevant indicators are functions related to the creation of and control over branding strategies, trademark and trade name protection and maintenance of established marketing intangibles.[38]

5.2.3. Allocation of rights and obligations

Rights and obligations are allocated to the PE by identifying transactions of the enterprise with separate enterprises that may be deemed to have been entered into by the PE.

5.2.4. Allocation of capital to the PE

The 2010 Report first mentions the capital allocation approach, pursuant to which capital is allocated on the basis of the proportion of assets and risks attributed to the PE under the functional analysis. The application of this method may be problematic if the activities of the PE differ substantially from those of the head office, when the market conditions in the PE country are very different or when the enterprise is thinly capitalized. A distinction is made between the capital allocation method, under which free capital is allocated on the basis of risk and the thin capitalization method, under which a PE should have the same amount of free capital as an independent enterprise carrying on similar activities under similar conditions.

With regard to funding, a distinction is made between a tracing method and the fungibility method. Under a pure tracing method, all internal movements of funds provided to a PE are traced back to the original provision of funds by third parties.

Under a pure fungibility approach, money borrowed by a PE of an enterprise is presumed to contribute to the whole enterprise's funding needs. A portion of the whole enterprise's actual interest expense paid to third parties on some pre-determined basis is allocated to each PE.[39]

5.3. Determination of the profits of a PE

As a second step, the profits of the PE must be determined by means of an accepted transfer pricing method mentioned in the Guidelines, such as the CUP and resale-minus method. In line with the Guidelines, a comparable price or profit must be determined based on the following factors: the characteristics of the property or services at issue, a functional analysis, contractual terms, economic circumstances and business strategies.

For dealings between the head office and a PE or another group company and a PE, in particular, a change in the use of a tangible asset, the use of intangible assets, cost contribution arrangements and the provision of internal services must be taken into account.

If an asset is economically transferred due to a change of use, the AOA suggests that the depreciation in the host country should be based on the fair market value at the time of transfer. If consideration is received for the assets transferred, the cost base for depreciation purposes generally does not have to be determined unless a new activity is carried out to which the AOA does not apply. If economic ownership is not attributed to the part of the enterprise using the assets, a lease or license situation may exist, in

38. The allocation rules are influenced by the new chapter 6 of the 2010 Guidelines and they have to be aligned with paragraph 9 of those Guidelines.

39. For further details on the allocation of capital and debt *see* section 6. of this article, to be published in *European Taxation* 9 (2015).

which instance the profits of the PE must be reduced by an arm's length charge for a lease or license.

If the PE has created an intangible or bears extraordinary marketing expenditure in relation to the intangible, the guidance in Chapter VI of the Guidelines on special considerations for intangible property should be followed. In allocating the profits, a royalty transaction between independent enterprises may also be presumed to exist or a profit split-method may be used.

In the event of a cost contribution arrangement, the cost can be divided analogously to Chapter VIII of Guidelines.

Regarding the provision of internal services, based on the arm's length principle, not only must the price applied to the service be taken into account, but also, following the guidance in Chapter VII of Guidelines, whether, at arm's length, both parties would have contracted for the provision of the service.

5.4. Implementation of the AOA by OECD member countries

5.4.1. Policy statements on the implementation of the AOA

Until now, about half of the 34 OECD member countries have provided guidance with regard to the application of the AOA. The member countries that have provided the clearest guidance include Denmark, Germany,[40] Japan, Korea (Rep.), the Netherlands,[41] Poland and the United States.[42] Furthermore, in the past, the Czech Republic,[43] Italy[44] and the United Kingdom[45] introduced provisions and/or resolutions and rulings that are partially compatible with the AOA. In Belgium, the AOA has been applied in several rulings of the Belgian Ruling Commission.[46] In a published report on discussions between the competent authorities of Canada and the United States, Canada and the United States have agreed to apply the AOA under the Canada-United States Income and Capital (1980).[47,48] Furthermore, in a published report on discussions between the competent authorities of Belgium and the United States, Belgium and the United States have agreed to apply the AOA under the Belgium-United States Income Tax Treaty (2006).[49,50]

Japan, in 2013, also issued a proposal on the implementation of the AOA, which has meanwhile been implemented.[51] The most important aspects of the proposal include the following:

- income attributable to a PE will be referred to as income that a PE would have earned at arm's length taking into consideration the functions performed, assets used and risks assumed as if the PE were a distinct and separate enterprise; and
- internal dealings, including internal royalty and interest for non-financial institutions, will generally be recognized with the exception of internal guarantees or internal reinsurance between a PE and its head office. All internal dealings are subject to the arm's length principle. However, internal interest for a non-financial institution continues not to be recognized under the old article 7 of the tax treaties concluded by Japan.

Further proposed changes in respect of internal dealings include:

- profits/losses from internal dealings will be recognized at the moment when the internal dealing takes place;
- the setting-up of a provision for bad debts is not allowed for internal loans;
- earning stripping rules might apply;
- neither the foreign dividend exclusion system nor the tax consolidation system will apply;
- an actual transfer of funds for internal dealings (as hypothetical transactions) is not required;
- an advance pricing arrangement (APA) can be applied in respect of internal dealings; and
- internal dealings are not subject to withholding tax;

40. Originally, the AOA was included in article 5 of the 2013 of the Draft Budget BT. Drucks. 17/1000 for 2013. The Budget law was rejected. Meanwhile, however, the AOA has been implemented by DE: Tax Act implementing the Administrative Cooperation Directive and amending tax regulations (*Gesetz zur Umsetzung der Amtshilferichtlinie sowie zur Änderung steuerlicher Vorschriften*) of 29 June 2013 and, on 13 August 2013, the German Ministry of Finance released for public comment draft Regulations (PE Regulations) on how the AOA will apply in practice (*Verordung zur Anwendung des Fremdvergleichsgrundsatzes auf Betriebsstätten nach § 1 Absatz 5 des Außensteuergesetzes; Betriebstättengewinnaufteilungsverordung – BsGaV*).
41. Decree IFZ 2010/457M of 15 January 2011 Official Gazette no. 1375 (2011).
42. The US Treasury Department Statement released on 7 June 2007 states that:
    While we fully support the Authorised OECD Approach (AOA) for attributing profits to a PE (PE), it will not apply to most existing U.S. tax treaties. We generally provide in Article 7(3) for a "reasonable allocation" of certain expenses, which is not consistent with the arm's-length approach of the AOA. We have, however, specifically incorporated the AOA in a few (e.g., U.K. and Japan) recent treaties and it is now in the 2006 U.S. Model Income Tax Convention. The draft Revised Commentary on Article 7 of the OECD Model Tax Convention (released on April 10, 2007), incorporating only so much of the AOA as does not conflict with the existing Commentary, will not apply to any U.S. treaties. We cannot apply the AOA to most existing treaties. Where we do apply the AOA, it will apply in its entirety.
43. CZ: Income Tax Act, section 23(11), National Legislation IBFD, contains a specific provision regarding the tax base of Czech PEs of non-resident taxpayers.
44. IT: Italian Income Tax Code, article 152, National Legislation IBFD, Circular letter no. 32/9/2267 of 22 September 1980 on the Implementation of the OECD Transfer Pricing Guidelines and Ruling No. 44/2006.
45. The separate entity principle was introduced by UK: Corporation Tax Act 2010, section 21, National Legislation IBFD, which was the result of UK: Taxation (International and Other Provisions) Act 2010 (TIOPA), which was part of the Finance Act 2011, National Legislation IBFD.
46. For example, Advance Ruling 2010.372 of 14 December 2010, Advance Ruling No. 2011.072 of 3 May 2011, Advance Ruling No. 2011.289 of 9 August 2011 and Advance Ruling No. 2011.378 of 8 November 2011, all published at http://www.minfin.fgov.be.
47. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 2007), Treaties IBFD.
48. *See* http://www.cra-arc.gc.ca/tx/nnrsdnts/ntcs/cndntdstts-cmptntgrmt-2012-eng.html and http://www.irs.gov/pub/irs-irbs/irb12-34.pdf.
49. *Convention between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (27 Nov. 2006), Treaties IBFD.
50. The agreement was published in the Belgian Official Gazette of 6 August 2013.
51. Ministry of Finance, *Tax reform regarding a change from then Entire Income Principle (the Force of Attraction Principle) to the Attributable Income Principle* (AOA Report) (October 2013).

- actual costs allocated on a reasonable basis from the head office to the PE are deductible, provided that the requirements for supporting documents are met;
- capital can be attributed to a PE through capital allocation or thin-capitalization methods. The amount of capital attributable to a PE will only be used for the purpose of interest deduction. An APA can be applied in respect of the allocation of free capital;
- moreover, the current provision stating that a PE that merely purchases goods and merchandise for its head office does not generate profits, is not considered to be consistent with the arm's length principle and, therefore, is expected to be abolished;
- it is proposed that a foreign tax credit be introduced for income arising in a third country, but derived by a non-resident company through its PE in Japan. In determining the foreign tax credit, the foreign source income must be ascertained, which includes income that would have been treated as foreign source income had such income not been attributed to a PE;
- documents proving internal dealings and external transactions attributable to a PE include contracts, receipts and invoices, documents describing details of internal dealings, as well as documents setting out functions performed and risks assumed by the PE and its head office. Documentation is also required to demonstrate the compliance of internal dealings with the arm's length principle;
- if the head office establishes a PE in Japan and transfers assets to the PE so established, the transfer of assets must take place at fair market value (no built-in gains or losses will be assumed by the PE);
- upon the winding-up of a PE, all the gains or losses from the sale of assets or built-in gains or losses should be attributed to the PE and are taxed accordingly; and
- an anti-avoidance measure will be introduced.

On 20 June 2014, the Spanish Ministry of Finance introduced its long-awaited tax reform plans.[52] These plans were included in the Budget for 2015 and provide for the implementation of the AOA from 1 January 2015. With regard to income allocation to a PE, it is indicated that the PE will be treated as a separate entity. Furthermore, the proposal provides for the recognition of interest and royalty payments between a head office and a PE, but this has not yet been introduced. Further guidance has yet to be published.

In Australia, on 31 October 2012, the Board of Taxation announced the commencement of consultations on a review of the PE attribution rules. The Board has completed its review of the PE attribution rules and provided its report to the Assistant Treasurer in April 2013. The timing for release of the Board's report to the public is a matter for the government to decide. In line with past practice, it is expected that the report will be available at the time the government releases its response to the report. This has not yet happened.

52. *Anteproyectos de Ley para la reforma fiscal de 20 junio 2014.*

Chile, Greece, Mexico and Turkey have indicated that they will not endorse the AOA. These countries, therefore, have made a reservation to the new article 7 of the OECD Model (2010).[53] New Zealand and Portugal have adopted a similar approach and have reserved the right to include in their tax treaties the text of article 7 as it was phrased prior to the 2010 update to the OECD Model.[54] With regard to Portugal, this reservation is of a temporary nature and is related to necessary changes to be made to the Portuguese domestic legislation. Slovenia has indicated that it reserves the right to apply the adjustment in article 7(3) only if it considers the adjustment to be justified.[55] Similarly, the Czech Republic has reserved the right to add to article 7(3) a provision limiting the potential corresponding adjustment to bona fide cases.[56] It appears from these statements that these two OECD member countries, in principle, follow the AOA. Austria has clarified, in a Decree, that the AOA will not be applied before Austria has amended its tax treaties.[57] Therefore, Austria also seems to be willing to apply the AOA and has no objections to including the new article 7 in new or amended tax treaties. In fact, some new Austrian treaties do contain the new article 7 and, in that event, the AOA is applied.

The position of the other OECD member countries remains unclear at this point. With regard to the application of the AOA under tax treaties, guidance has also only been given by a few countries. While Austria, Denmark, Japan and the United States are of the opinion that the AOA cannot apply to old treaties signed before 2008 that do not contain the new article 7, both Germany and the Netherlands take the opposite position. To provide certainty in all situations, both countries reason that the AOA should apply to all tax treaties. This view constitutes a treaty override that is not in line with the treaty practice and case law of these countries.

5.5. Conclusions on Part 1 of the article

Part 1 of this article addressed the actual split between a head office and a branch from a theoretical perspective, including the historical background of this matter, discussed basic concepts derived from public international treaty law, presented the notion of KERT functions versus SPF and the AOA. Part 2 will continue to analyse the AOA, in particular, by looking at the question of whether adequate capital is allocated to the branch as a fictitious separate entity. In addition, Part 2 will outline court cases in the context of profit allocation between a head office and its branches and discuss in more detail tax policy, as well as advance pricing agreement/mutual agreement procedure implications.

53. Para. 96 *OECD Model: Commentary on Article 7* (2010).
54. Paras. 95 and 97 *OECD Model: Commentary on Article 7* (2010).
55. Para. 98 *OECD Model: Commentary on Article 7* (2010).
56. Para. 94 *OECD Model: Commentary on Article 7* (2010).
57. Decree GZ BMF-10221/2552-IV/4/2010 of 28 October 2010, published at http://www.bmf.gv.at.

International

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Status of Implementation of the Authorized OECD Approach into Domestic Tax Law and Tax Treaties – Part 2

This article examines profit/loss allocation in a headquarter/branch scenario. Part 1, which was published in *European Taxation* 8 (2015), discussed the actual split between a head office and branch from a theoretical perspective, basic concepts derived from public international treaty law, the notion of Key Entrepreneurial Risk-Taking Functions versus Significant People Functions and the Authorized OECD Approach (AOA). Part 2 continues to analyse the AOA, looks at the question of whether adequate capital is allocated to the branch as a fictitious separate entity and outlines court cases, tax policy and advance pricing agreement/mutual agreement procedure implications.

5.6. Application of the AOA by the various Member States

In the following section an overview is given of the countries that have issued guidelines on the application of the AOA in the form of rulings, legal amendments and/or decrees. What emerges is that implementation steps have mainly been taken by Denmark, Germany, Japan, Korea (Rep.), the Netherlands, Poland[58] and the United States.

5.6.1. Functional analysis

In line with the AOA, the starting point for Germany, the Netherlands, the United States and the Belgian Ruling Commission is that dealings between a head office and permanent establishment (PE) must be based on the separate entity approach, which means that the conditions underlying such dealings must be the same as those that would have existed had the PE acted as a functionally distinct and separate enterprise, carrying out the same or similar functions and acting under the same or similar conditions. Austria is also now prepared to apply the AOA unless the relevant tax treaty provides otherwise.

5.6.1.1. Austria

Paragraph 98(1) of the Austrian Income Tax Act[59] provides that all profits derived by a PE are taxable. The profits of the PE are calculated by means of the Austrian profit calculation rules. Austria is prepared to base this calculation on the separate entity approach unless the tax treaty with the country of the parent company contains the old article 7 provision.[60]

5.6.1.2. Belgium

To date, the Belgian government and the tax administration have not yet provided any guidance on the AOA, but the Belgian Ruling Commission apparently fully endorses the AOA and uses it to confirm whether or not transactions between a head office and a PE are at arm's length. Reference is made to significant people functions (SPFs), i.e. the main activities carried out by the employees of the PE. In determining these functions, the Commission, inter alia, looks at the business strategy of the PE and the extent to which it is involved in product research and development (R&D), production and quality control, marketing, sales, storage of goods and storage management, transport of goods, after sales services and financing and managerial activities. In addition, the Ruling Commission has repeatedly indicated that the determination of SPFs underpins the application of the arm's length principle of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) (the Guidelines).[61]

In addition, Belgium and the United States entered into an agreement on 17 June 2013 (United States) and 16 July (Belgium)[62] concerning the application of the AOA under the Belgium-United States Income Tax Treaty (2006) (the Belgium-United States Treaty).[63] The agreement states that the Guidelines apply, by analogy, in determining the busi-

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58. Poland has no provisions or guidelines on the AOA. The common practice of Poland, however, is that, in cross-border situations, the AOA is followed by the Polish tax authorities. *See* A. Leszczyńska-Mikulska Wardyński & Partners, *Poland – Permanent Establishments*, Topical Analyses IBFD.
59. AT: Income Tax Act 1988, National Legislation IBFD.
60. E&Y D-A-CH newsletter, 2nd quarter 2014, *Die Besteuerung von Betriebsstätten in Deutschland, Österreich und der Schweiz.*
61. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), available at http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm (hereinafter the Guidelines).
62. *Competent Authority Agreement in respect of the Convention between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (17 June 2013), Treaties IBFD. The agreement was published in the Belgian Official Gazette of 6 August 2013.
63. *Convention between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (27 Nov. 2006), Treaties IBFD.

ness profits attributable to a PE. According to the competent authority agreement, the following understandings have been reached:

– as per article 7(1) of the Protocol (2006) to the Belgium-United States Treaty, the full AOA applies without a need to wait for the OECD Report to be finalized;
– article 7 of the Belgium-United States Treaty must be interpreted in a manner entirely consistent with the full AOA;
– all other provisions of the Belgium-United States Treaty that require a determination of whether or not an asset or amount is effectively connected or attributable to a PE must be interpreted in a manner entirely consistent with the full AOA;
– when a contracting state adjusts the profit of a PE, the other state will make a corresponding adjustment if it agrees with that adjustment. If not, the contracting states will enter into a mutual agreement procedure; and
– relief from double taxation continues to be subject to the provisions and limitations of each country's domestic law, as provided for in article 22 (Elimination of Double Taxation) of the Belgium-United States Treaty.

5.6.1.3. Canada

Canada has not yet indicated whether it will apply the AOA, but Canada and the United States entered into an agreement on 26 June 2012[64] concerning the application of the AOA under the Canada-United States Income and Capital Tax Treaty (1996) (Canada-United States Treaty).[65] The agreement concerns the Second Exchange of Notes to the Fifth Protocol to the Treaty, which states that the Guidelines apply, by analogy, in determining the business profits attributable to a PE.

Under the competent authority agreement, the following understandings have been reached:

– the full AOA applies without waiting for the OECD Report to be finalized;
– article 7 of the Canada-United States Treaty must be interpreted in a manner fully consistent with the full AOA;
– all other provisions of the Canada-United States Treaty that require a determination of whether an asset or amount is effectively connected or attributable to a PE must be interpreted in a manner fully consistent with the full AOA; and
– relief from double taxation remains subject to the provisions and limitations of each country's domestic law, as provided in article 24 (Elimination of Double Taxation) of the Canada-United States Treaty.

5.6.1.4. Denmark

Denmark is willing to apply the AOA unless a tax treaty provides otherwise. No specific provisions or guidelines on the allocation of assets and risks have, however, been released. Therefore, in practice, a determination is made of the assets that are economically owned by the PE and in what capacity.

5.6.1.5. Germany

Under the proposed new article 1(5) of the German Foreign Tax Law (*Außensteurgesetz* – AStG)[66] transactions between a head office and a PE are regarded as internal dealings. Such a transaction must be treated as a transaction between two separate entities, which means that the significant functions of a PE, carried out by its employees, have to be determined.[67] Further clarification is provided in the Decree on the allocation of profits to a PE.[68] It is indicated that the allocation of profits to a PE must take place by means of a function and risk analysis of the business activities of the PE. In determining the arm's length pricing, the business activities of the PE must be compared with those of a separate entity. Based on the function and risk analysis, personnel functions, both tangible and intangible and financial assets, participations and equity and debt are allocated to the PE.

5.6.1.6. Japan

Under the former Japanese domestic tax law, which is based on the "force of attraction" principle, all income arising from sources within Japan was fully taxable regardless of whether such income was attributable to the PE. Under the revised Japanese domestic tax law, income attributable to a PE will be taxable regardless of the source. In addition, income attributed to a PE is calculated in line with the AOA, pursuant to which transactions between a head office and a PE will be regarded as internal dealings. Such transactions must be treated as occurring between two separate entities, which means that the significant functions of a PE, carried out by its employees, have to be determined.

64. *Competent Authority Agreement in respect of the Convention Between Canada and the United States of America with respect to Taxes on Income and on Capital* (26 July 2012), published in the United States Internal Revenue Bulletin: 2012-34.
65. *Convention Between Canada and the United States of America with respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 2007), Treaties IBFD.
66. DE: Foreign Tax Law (*Aussensteuergesetz* – AStG), National Legislation IBFD. Originally, the AOA was included in article 5 of the 2013 Draft Budget BT. Drucks. 17/1000 for 2013. The Budget law was rejected. Meanwhile, however, the AOA was implemented by the Tax Act implementing the Administrative Cooperation Directive and amending tax regulations" (*Gesetz zur Umsetzung der Amtshilferichtlinie sowie zur Änderung steuerlicher Vorschriften*) of 29 June 2013 and on 13 August 2013, the German Ministry of Finance released for public comment draft Regulations (PE Regulations) on how the AOA will apply in practice (*Verordnung zur Anwendung des Fremdvergleichsgrundsatzes auf Betriebsstätten nach § 1 Absatz 5 des Außensteuergesetzes; Betriebsstättengewinnaufteilungsverordnung* – BsGsaV), which were adopted in October 2014.
67. Art. 1(5) AStG.
68. Article 1 of the Decree on the separate entity approach to PEs in accordance with section 1, paragraph 5 of the Foreign Transactions Tax Act (OE profit allocation Decree) (*Verordnung zur Anwendung des Fremdvergleichsgrundsatzes auf Betriebsstätten nach § 1 Absatz 5 des Außensteuergesetzes; Betriebsstättengewinnaufteilungsverordnung – BsGsaV*).

5.6.1.7. Korea (Rep.)

The AOA has been applied since 1 January 2014.[69] All transactions between a headquarters and a PE must be at arm's length, except interest expenses on loans to a non-bank branch and guarantee fees.

5.6.1.8. Netherlands

The Netherlands, in its Decree of 15 January 2011, no. IFZ 2010/457m, has defined SPFs as functions related to active decision making connected with the making and management of risks of activities within a company. It is mainly day-to-day activities that play a leading role in the operational management of a business. Furthermore, reference is made to the "control over risk" concept of the Guidelines, i.e. that: "in arm's length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control".[70]

The Decree takes the view that, despite the fact that these terms might be interpreted differently, substantial overlap may exist between the concepts of SPFs and control. This means that risk allocation to a PE is, to a large extent, comparable with risk allocation to a comparable unrelated company that is in equivalent circumstances.

5.6.1.9. United States

The United States also endorses the AOA, as can be deduced from the US Technical Explanation to article 7(3) of the US Model (2006),[71] except in respect of the avoidance of double taxation, which the United States regards as an article 23 of the OECD Model (2014)[72] issue. The Technical Explanation, however, does not contain guidelines on the determination of SPFs.

5.6.1.10. Countries that partially follow the AOA

Countries that do not yet follow the AOA but already have provisions or resolutions providing for the separate entity approach include, inter alia, the Czech Republic, Italy, Switzerland and the United Kingdom.

The Czech Income Tax Act[73] contains a specific provision that establishes that the tax base of a PE must not be less than the tax base of an identical or similar activity by a taxpayer that is a tax resident of the Czech Republic.[74] This provision further establishes the methods for determining the tax base and indicates that in respect of the ratio of income/losses for the determination of gross revenues of comparable taxpayers, a comparable profit margin or a similar benchmark may be used. It also provides that the allocation method regarding overall profits or losses of the non-resident may be used.

From a 2006 Italian Ruling[75] if follows that Italy is willing to apply the separate entity approach, but further guidelines on its application and relevant case law are lacking. Further, article 152 of the Italian Income Tax Code provides that the income attributable to an Italian PE of a non-resident company must be determined in the same manner as for resident companies, i.e. on the basis of a separate profit and loss account of the PE.

Section 21 of the UK 2009 Corporation Tax Act[76] provides that the profits of a PE must be determined by means of a separate entity approach, under which the PE trades independently.[77] The UK approach, in substance, seems to be in line with the basic principles of the AOA, as, first, a functional and factual analysis must be undertaken of the activities carried out by the PE and other parts of the enterprise. Thereafter, the remuneration for dealings with the PE must be determined by means of the Guidelines. A substantial deviation, however, is that, under UK domestic law, royalties and financing costs paid to a foreign PE are not deductible and payments from a foreign PE to a UK head office are not recognized.

Under Swiss practice, the profits of a PE are calculated by means of an object method under which the PE is treated as a separate entity. This means that the taxable profit of the PE is equal to the profits that a separate entity would have realized. Swiss profit allocation to a PE, therefore, resembles the AOA.[78]

5.6.2. Method to allocate risks, equity and debt

Full guidance on this aspect of the AOA is only provided by Germany, the Netherlands and, to a substantial extent, Japan and the United States.

5.6.2.1. Belgium

The Belgian Ruling Commission first, in line with the first step of the AOA, allocates assets, risks, debts and equity to a PE by means of a functional analysis of the activities carried out by the PE. The assets are allocated to a PE by means of a functional analysis of its economically important activities and responsibilities and the risk borne with regard to the underlying transactions. In allocating risks, the Ruling Commission considers a variety of factors including the product, R&D, market, guarantees, storage, bad-debt and currency exchange risks.

After the allocation of assets and risks is made, the Commission allocates the debt on the basis of the assets and risks allocated to the PE that need to be financed. This seems to imply a preference for a tracing approach that reflects the specific circumstances of the PE, as the allocation specifically considers the functions that are carried out by the PE.

69. KR: Corporate Income Tax Act, Presidential Decree, articles 130D and 132(2)(9).
70. Para. 1.49 Guidelines, *supra* n. 4.
71. *US Model Tax Convention on Income* (15 Nov. 2006), Models IBFD.
72. *OECD Model Tax Convention on Income and on Capital* (15 July 2014), Models IBFD.
73. CZ: Income Tax Act, National Legislation IBFD.
74. Id., sec. 23(11).
75. Circular letter 32/9/2267 of 22 September 1980 on the implementation of the OECD Transfer Pricing Guidelines and Ruling 44/2006.
76. UK: Corporation Tax Act 2009, National Legislation IBFD.
77. This approach was included in UK: Taxation (International and Other Provisions) Act 2010 (TIOPA) 10/S43, which was part of UK: Finance Act 2011, National Legislation IBFD.
78. *Supra* n. 3.

With regard to the allocation of free capital, sometimes the capital allocation method and sometimes the thin capitalization method is used based on the specific facts of the case. The Ruling Commission has not, however, expressed a preference for the application of one of the two methods.

5.6.2.2. Denmark

Risks are allocated to a PE to the extent that the PE exercises active decision-making with regard to the acceptance and/or management of risks. No guidance has yet been issued on the allocation of equity and debt, but what is decisive is the amount of equity and debt required to exercise the functions of the PE. Furthermore, capital attribution is determined according to Danish thin capitalization rules based on a fixed debt-equity ratio. The Danish tax authorities have yet to decide on which method to apply from the OECD approach.

5.6.2.3. Germany

Germany has adopted various guidelines, in particular by means of a Decree. The new article 1(5) of the AStG provides that the separate entity method requires that assets, changes in the value of assets, risks and the required equity must be allocated to the PE. The methods to be used are clarified in articles 4 to 15 of a Decree of 13 October 2014.[79] With regard to the allocation equity, the Decree provides for the application of the capital allocation method. Under this method, the allocated capital is based on the participation of the PE in assets, changes and risks (article 12). With regard to the allocation debt, the tracing method is used, under which debt used for the financing of assets and risks by the PE (article 15) is allocated.

The Explanatory Memorandum to the German budget law for 2013 contains the following two guidelines:[80]
– a PE has the same credit rating as its head office, which would point to the application of the capital allocation method; and
– a loan granted by a head office to a PE, and vice versa, must be treated as an "intercompany dealings relationship".

These points were repeated in the Explanatory Memorandum to the Tax Act implementing the Administrative Cooperation Directive and the amending tax regulations.[81] Furthermore, from 18 October 2014, a Decree on the allocation of profits to a PE applies.

This Decree, inter alia, provides that an auxiliary or ancillary account for the PE must be prepared.[82] The account must contain all of the components that are to be attributed to the PE on the basis of its personnel functions, including assets, "free capital" and liabilities, as well as the related business revenue and expenses. This includes deemed business revenue and expenses based on such dealings. In addition, the Decree contains provisions to substantiate the allocation of assets, opportunities and risks, "free capital" and liabilities to the PE. In principle, this allocation is made in accordance with the personnel functions of the PE.

Concerning the allocation of chances and risks, it is indicated that those related to assets or a business activity of a PE are allocated to that PE.[83] In other instances, chances and risks are allocated on the basis of the personnel functions of the PE.

The allocation of assets and related financing costs is based on the allocation of risks and chances.[84]

With regard to the allocation of equity to the PE, the Decree indicates that such an allocation should be based on the capital allocation method.[85] With regard to a foreign PE of a German company, a minimum amount of capital may be allocated that is necessary for the carrying out of the SPFs of the PE. A higher amount of equity may only be allocated to the foreign PE if this allocation is more in line with the allocation of capital to an unrelated separate entity or required under the legislation of the country were the PE is established.

With regard to a German PE of a foreign company, the allocation may also be based on foreign accounting rules if:
– those rules do not substantially differ from German accounting rules; or
– a difference in outcome is adjusted such that the outcome is not substantially different from that under German accounting laws.

With regard to the allocation of debt, the Decree seems to favour the application of the tracing method under which the allocation is based on the debt funding acquired by the enterprise and the asset/risk that had to be financed.[86] What is particularly relevant is which assets are allocated to the PE.

5.6.2.4. Japan

From 2016, Japan will allocate assets, risks and capital to the PE, recognize dealings with the enterprise's other parts that include the PE and recognize dealings as if the PE were a separate and independent enterprise.[87] The allocation of assets and risks is based on the functions that the PE exercises. Risks are allocated to a PE to the extent that the PE exercises active decision-making in respect of the acceptance and/or management of risks. In allocating capital, the following two methods may be used:
– the capital allocation method, under which capital is allocated to the risk weighted asset ratio. This ratio

79. *Supra* n. 9.
80. Page 109 of the Explanatory Memorandum to the Budget Law 2013. The Budget Law was rejected, but meanwhile the AOA was implemented by the Tax Act implementing the Administrative Cooperation Directive and amending tax regulations.
81. DE: Explanatory Memorandum to the Tax Act implementing the Administrative Cooperation Directive and the amending tax regulations (*Gesetz zur Umsetzung der Amtshilferichtlinie sowie zur Änderung steuerlicher Vorschriften (Amtshilferichtlinie-Umsetzungsgesetz* – AmtshilfeRLUmsG) of 26 June 2013, BGBl. I 2013, S. 1809 and BGBl. II 2013, S. 1120).
82. Art. 3 Decree.
83. Art. 10 Decree.
84. Arts. 14 and 15 Decree.
85. Arts. 12 and 13 Decree.
86. Art. 16 Decree.
87. JP: Corporation Tax Act, art. 138(1)(i), National Legislation IBFD.

is calculated by means of credit, market, operational and other risks. Assets may also be used as an allocation basis; or
- the thin capitalization method, under which the debt-to-equity ratio of a comparable company is used.

If the amount of equity (net assets) attributable to a PE is lower than the equity of the foreign corporation, interest expenses on debt of the PE corresponding to the deficiency of equity are not deductible.[88]

5.6.2.5. Korea (Rep.)

The allocation of capital to a PE is based on the thin capitalization rule. In this respect, it should be noted that article 14 of the Law for the Coordination of International Tax Affairs provides for a 3:1 safe-harbour ratio or the application of an arm's length ratio to a foreign controlling shareholder and debt borrowed from a third party based on the guarantee of the foreign controlling shareholder. There are no specific rules yet for the allocation of assets and risks, but based on transfer pricing rules, the functions performed, assets used and risks assumed by the PE have to be taken into account.

A special rule applies to the price that the PE uses for intra-company intangible assets. In determining the arm's length price, the expected additional income or amount of cost reduction, the existence of use restrictions and the permissibility of sublicensing are taken into consideration.[89] Furthermore, the fees are compared with the price that an independent third party would pay in order to determine whether a royalty payment or receipt is in line with the arm's length principle.

5.6.2.6. Netherlands

The Netherlands Decree indicates that the allocation of equity to the PE should be based on the capital allocation approach because, in the State Secretary's view, this method best reflects whether a PE has the same creditworthiness as its head office. The thin capitalization approach will, therefore, only be applied when the entire enterprise is excessively financed with debt.

Regarding the allocation of debt to a PE, the Netherlands Decree prefers the application of the fungibility method, under which a risk-weighted portion of the total interest expenses of the enterprise is allocated to the PE. The argument is that the tracing method, under which the allocation is based on the historic relationship between the debt funding acquired by the enterprise and the asset/risk that had to be financed, might not result in an arm's length attribution of interest to a PE because the specific circumstances of the PE are taken into account to a lesser extent. Based on Netherlands case law, it is questionable whether or not this statement is correct. In contrast, the tracing method takes the exact circumstances of the PE into account because, under this method, a specific loan is linked to a PE only if it was taken up to finance assets that are deemed to be owned by the PE.

The Netherlands Supreme Court's starting point for its analysis is to attribute the debt, with the remainder qualifying as "free capital" on which interest is not deductible. Secondly, Netherlands case law generally uses the tracing method for the allocation of interest.

The expressed preference for the capital allocation method is, however, in line with Netherlands case law. The Supreme Court has decided that the application of the thin capitalization method results in an arbitrary outcome, since it depends on the specific circumstances of a case and the choices that an entrepreneur has made with regard to the financing of his business.[90]

5.6.2.7. United States

In the United States, with regard to the allocation of free capital, an explanation is given in the US Technical explanation on article 7(3) of the US Model (2006), which seems to resemble the AOA. Both this explanation and the notes or protocol accompanying a treaty specify that a PE cannot be entirely debt-funded, but needs sufficient capital to carry on its activities as if it were a distinct and separate enterprise. Insofar as the PE does not have such capital, a contracting state may attribute such capital to the PE and deny an interest deduction to the extent necessary to reflect that capital attribution. Treasury Regulations section 1.882-5 describes the capital allocation method. Under this section, the primary method for a foreign corporation to determine its allocable US interest expense is the "adjusted US-booked liabilities method" (the AUSBL method). Under this method, the only interest that can be deducted by the US branch is interest paid or accrued on liabilities booked through the US branch, as adjusted by reference to the interest incurred on "US-connected liabilities" of the US branch determined by comparing US assets to worldwide assets or by applying a percentage ratio specified in the regulations.

The notes or protocol that accompany a tax treaty allow a taxpayer to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it does business. In particular, with regard to financial institutions other than insurance companies, the amount of capital attributable to a PE is determined by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them.

Furthermore, the concept of free capital was introduced in the US Model (2006) Technical Explanation, which is in line with the first step of the AOA approach. It hypothesizes the PE as a functionally-distinct entity with suffi-

88. Id., art.142-4.
89. Art. 6(6) Presidential Decree of the Corporate Income Tax Act.

90. NL: SC, 7 May 1997, no. 30.204, BNB 1997/263. In that case, the Supreme Court indicated that the capital allocation method, which provides for a pro rata allocation of capital, is less arbitrary than a thin capitalization method, which depends in the specific circumstances of a case and the choices that an entrepreneur has made with regard to the financing of his business.

cient free capital to support its operations as a notionally separate entity.

Finally, the US methods provide for a "reasonable allocation" of certain expenses, which is not entirely consistent with the arm's length approach of the AOA, as it is not in line with the tracing method or with the fungibility method.

The US Treasury Regulations also contain rules for determining which assets of a foreign corporation are treated as belonging (or not belonging) to its US branch (Treasury Regulations sections 1.882-5(b)(1) and 1.884-1(d)). In general, an asset is treated as a US asset if it produces income effectively connected with the United States (US ECI). Rules are provided for specific categories of assets, for example, property that is depreciable or capable of being amortized, inventory, instalment obligations, receivables, bank deposits and debt instruments.

It is also specified that transactions between separate offices or branches of the same taxpayer (i.e. an inter-branch transaction) do not create US assets.

5.6.3. *Allocation of profits and losses – Determination of "choice of method"*

5.6.3.1. Belgium

Belgian Rulings regarding the application of the AOA to determine an arm's length price for transactions between a head office and a PE first determine the extent of comparability between the related transactions between a head office and a PE and free market transactions and then investigate the completeness and accuracy of the available data.[91] Based on the outcome, a transfer pricing method is chosen, which must be the most reliable standard for the determination of an arm's length result.

5.6.3.2. Denmark

In Denmark, PEs are subject to mandatory tax consolidation with all other group companies.

5.6.3.3. Germany

Article 5 of the Tax Act implementing the Administrative Cooperation Directive and amending tax regulations, which inserts a new paragraph 5 in article 1 of the AStG, indicates that the PE is to be treated as a separate entity. This means that the business relationships between a head office and a PE must be determined and the arm's length transfer price for those relationships. The term business relationship is defined by the proposed article 1(4) of the AStG as single or several connected economic transactions between a taxpayer and a related party that are not based on company law agreements, a part of the income of which qualifies as income from agriculture, trade or business, independent services or letting and leasing. Because a head office and its PE cannot conclude civil law contracts, the German concept is based on a deemed contractual relationship, which must be at arm's length. This means that in allocating profits and losses the transactions between a head office and PE are treated as contracts between independent parties.

The Decree on the allocation of profits to a PE of October 2014 provides that business revenue and expenses will be determined on the basis of the personnel function. Furthermore, the Decree contains provisions on a deemed contractual relationship ("dealings") between the PE and its parent company and/or group companies.

5.6.3.4. Japan

Under the new tax reform, the PE is to be treated as a separate entity. This means that the business relationships between a head office and a PE must be determined, as well as the arm's length transfer price for those relationships.

Under the new domestic rules, internal dealings within a single entity are recognized (for example, an internal royalty, internal interest, internal service fees (including appropriate markups), etc., need to be charged in calculating Japanese corporate tax).[92] A mere purchase by a PE of goods for its head office generates profits. Furthermore, prices of internal dealings not in line with the arm's length principle will be adjusted. Finally, a PE may claim a foreign tax credit on its Japanese corporate tax return.

A reasonable cost allocation from a head office to a PE, such as the allocation of overhead expenses related to administrative functions performed by the head office for the benefit of the PE, without any markups, continue to be deductible. In addition, some documentation requirements (including documentation similar to transfer pricing documentation) are imposed on PEs.

5.6.3.5. Korea (Rep.)

Under the new tax reform, a PE is to be treated as a separate entity. This means that the business relationships between a head office and a PE must be analysed and an arm's length transfer price for those relationships established.

5.6.3.6. The Netherlands

Regarding the allocation of profits, the Netherlands Decree confirms that the attribution of profits to a PE must take place by means of a functionally separate entity approach. This means that dealings between the PE and other parts of the enterprise must be identified, assessed and priced in accordance with the arm's length principle of article 9 of the OECD Model (2014) and the Guidelines. In comparing similar transactions carried out between unrelated parties under similar circumstances, the products and services, functions of the PE, including assets and risks, the terms of any contracts, the industry concerned and the business strategy must be taken into account.[93] Thereafter, it must be determined which transfer pricing method

91. For example, Ruling No. 2010.289 of 9 August 2011, p. 91.

92. Art. 138(2) Corporation Tax Act.

93. J. Dijkman, S. de Buck & D. Brouwers, *Guidance Issued on Profit Attribution to Permanent Establishments*, 18 Intl. Transfer Pricing J. 3, p. 209 (2011), Journals IBFD.

is the most appropriate to obtain an arm's length profit allocation for the situation at hand.

5.6.3.7. United States

The US concept is also based on the functionally separate entity approach. The US Model (2006) incorporates the arm's length standard and the Guidelines in determining the profits attributable to a PE. Under article 7(2) of the US Model, the amount of income "attributable to" a PE is the business profits that the PE would have earned had it been 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 in relation to which it is a PE.

The profits attributable to a PE may be from sources within or outside the country in which the PE is located. The profits attributable to a PE include only those profits derived from the assets used, risks assumed and activities performed by the PE.

In contrast, however, sections 871(b) and 882 of the Internal Revenue Code provide that, if a non-resident alien or a foreign corporation is engaged in trade or business in the United States, the taxpayer is taxable on any income that is "effectively connected" (ECI) with the conduct of a trade or business in the United States.

The Technical Explanation also notes that transactions between the foreign corporation and its US branch (i.e. internal dealings) are not generally recognized under US domestic law, but may be taken into account in situations in which the dealings accurately reflect the allocation of risk within the enterprise.

Furthermore, on 6 December 2013, the Office of the Associate Chief Counsel (International) of the US Internal Revenue service issued Memorandum ILM 201349015 of 16 September 2013, which, inter alia, deals with the determination of the profits of a PE. The Memorandum states, that, under US tax treaties that adopt the AOA, profits of a US PE may be based on all of the PE's dealings, including transactions between the US PE and the foreign cooperation of which it forms a part, even though such inter-branch dealings would not give rise to income, gains, profits, or losses of the foreign corporation under the US Internal Revenue Code.

5.6.3.8. Countries applying the separate entity approach

In Austria, the Czech Republic, Italy and the United Kingdom, the profit allocation to a PE also, to a substantial extent, resembles that of the AOA. The provisions of those countries, however, contain substantial deviations from the AOA concerning the treatment of remuneration for transactions between a head office and a PE.

5.7. Avoidance of double taxation in situations in which a different allocation method is used by the contracting states

Because Germany and the Netherlands take the view that the AOA can also be applied to treaties signed before 2010 that do not contain the new article 7, the avoidance of double taxation constitutes the area where both the Netherlands and German approach is clearly in conflict with the AOA. To provide certainty, the Netherlands Decree specifies that the Netherlands will also apply the AOA to pre-2010 treaties that do not contain the new article 7 provision. This view clearly disregards the position of the other treaty partner and disregards the fact that the Netherlands Supreme Court does not generally favour the application of a dynamic approach to treaty interpretation and only applies a subsequent Commentary on the OECD Model if it constitutes a clarification of the existing Commentary.

In order to soften its strict approach, the Netherlands is prepared to accept that a provision be included in tax treaties to the effect that the competent authorities will decide at a later stage on the application of the AOA.[94]

Furthermore, the Netherlands Decree mentions that the Netherlands is not prepared to automatically make a corresponding adjustment if the same profits are also taxed in the country of the PE. The Netherlands is only willing to enter into a mutual agreement procedure in the event of a different allocation of interest, but not in respect of a different allocation of equity. With regard to treaties that contain a pre-OECD Model (2010) article 7 provision, the Decree specifies that the Netherlands will only follow the allocation method of the PE state if the following requirements are met:

- the different approach of the country is based on domestic legislation;
- the method used by the PE country is a method authorized by the OECD; and
- the outcome is at arm's length.

No clear motivation is given for this restriction, which seems to contradict Netherlands treaty policy, which aims to include mandatory arbitration in its tax treaties to solve cases of double taxation.

If the other country does not follow the Netherlands approach of applying the AOA to existing treaties, often the result is not more certainty, but double taxation. As the Netherlands is only willing to enter into a mutual agreement procedure, i.e. there is no commitment to reach a solution, it is expected that the matter will reach the courts with regard to the application of a dynamic approach to interpretation of the Commentary on the OECD Model (2010).

German legislation takes the same approach, but this is not in line with the case law of the German Supreme Court, which in various decisions has decided that a change to the OECD Model can only be taken into account if it had already been adopted at the time the relevant tax treaty was signed.[95] Article 1(5)(8) of the AStG generally provides

94. Page 45 of the 2011 Dutch tax treaty policy Memorandum. Such a provision is included in article VII of the Protocol to the *Convention between the Kingdom of the Netherlands and the Republic of Panama for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (6 Oct. 2010), Treaties IBFD.

95. For example, DE: Supreme Court (*Bundesfinanzhof* – BFH), 9 Feb. 2011, I R 54, 55/10, IStR, p. 435 (2011), Tax Treaty Case Law IBFD and DE: BFH, 25 May 2011, I R 95/10, IStR, p. 688 (2011).

for the application of the AOA also to pre-2008 tax treaties and only provides for the application of the outcome agreed under such a tax treaty if the application is based on that treaty and the taxpayer provides proof to the tax authorities that the other contracting state is exercising its rights in accordance with the tax treaty.

The German approach, therefore, could, in many situations, also result in uncertainty and a conflict with a pre-2008 tax treaty that does not contain the new article 7 of the OECD Model. Furthermore, various German scholars take the view that the German approach may also result in treaty override if the taxing rights under a tax treaty are allocated to the other contracting state, but that state does not exercise its taxing rights because a tax is not levied under its domestic tax rules.[96]

Austria, Denmark, Japan[97] and Korea (Rep.) explicitly provide that if an income tax treaty not incorporating the AOA is applicable, internal interest for non-financial enterprises and internal royalties will not be recognized, and a mere purchase of goods will not generate profits for the PE.

The United States takes the view that the avoidance of double taxation is not an article 7 issue, but an article 23 issue.[98] This means that no automatic corresponding adjustment is made. Because, however, the United States has provisions on the avoidance of double taxation in its tax treaties in combination with domestic relief provisions, sufficient tools should exist to avoid double taxation.

The same conclusions can be drawn in respect of Germany because the AOA will only not be applied if the other contracting state exercises its taxing rights in accordance with the treaty. This approach would also result in treaty override if the taxing rights under a tax treaty are allocated to the other contracting state, but that country does not exercise its treaty rights because a tax is not levied based on domestic tax rules.[99]

5.8. Tax treaties containing the new article 7

The number of tax treaties containing the new article 7 is very limited. To date, the provision is included in the following treaties:

– Luxembourg-Andorra Income and Capital Tax Treaty (2 June 2014);
– Barbados-United Kingdom Income and Capital Tax Treaty (26 April 2012);
– Belgium- Norway Income and Capital Tax Treaty (14 April 1988);
– United States-Belgium Competent Authority Agreement (17 June 2013);
– Canada-United States Competent Authority Agreement (26 June 2012);
– Guernsey-Cyprus Income and Capital Tax Treaty (15 July 2014);
– Norway-Cyprus Income Tax Treaty (24 February 2014);
– Cyprus-Switzerland Income and Capital Tax Treaty (25 July 2014);
– Germany-Liechtenstein Income and Capital Tax Treaty (17 November 2011);
– Germany-Luxembourg Income and Capital Tax Treaty (23 April 2012);
– Germany-Netherlands Income Tax Treaty (12 April 2012);
– Norway-Germany Income Tax Treaty (4 October 1991);
– Guernsey-Liechtenstein Income and Capital Tax Treaty (5 June 2014 (Guernsey), 11 June 2014 (Liechtenstein));
– Guernsey-Luxembourg Income and Capital Tax Treaty (10 May 2013);
– Guernsey-Monaco Income Tax Treaty (7 April 2014);
– United States-Hungary Income Tax Treaty (4 February 2010);
– United Kingdom-Iceland Income Tax Treaty (17 December 2013);
– Switzerland-Iceland Income and Capital Tax Treaty (10 July 2014);
– Isle of Man-Luxembourg Income and Capital Tax Treaty (8 April 2013);
– Israel-Panama Income Tax Treaty (8 November 2012);
– Hong Kong-Italy Income Tax Treaty (29 November 2013 (Hong Kong), 18 June 2015 (Italy));
– United Kingdom-Japan Income Tax Treaty (2 February 2006);
– Jersey-Luxembourg Income and Capital Tax Treaty (17 April 2013);
– United States-Malta Income Tax Treaty (8 August 2008);
– United Kingdom-Netherlands Income Tax Treaty (26 September 2008);
– Norway-United Kingdom Income and Capital Tax Treaty (12 October 2000);
– United Kingdom-Panama Income Tax Treaty (29 July 2013);
– Poland-United States Income Tax Treaty (6 August 2013);
– Switzerland-Slovenia Income and Capital Tax Treaty (12 June 1996);
– Barbados-United Kingdom Income and Capital Tax Treaty (26 April 2012); and
– United Kingdom-Liechtenstein Income Tax Treaty (11 June 2012).

96. The same conclusion was arrived at by K.-M. Wilke, *Referentenentwurf des JStG 2013 durch das MF. Die geplanten Änderungen in § 1 AStG*, who, based on DE: BFH, 24 Aug. 2011, I R 46/10, indicates that a treaty right can also be exercised such that no tax is levied based on domestic law.
97. Art. 139 Corporation Tax Act indicates that a deviating tax treaty prevails over deviating domestic rules on the AOA.
98. The US Treasury Department Statement released on 7 June 2007 states that: "We disagree with the "symmetry" requirement set forth in paragraph 44 of the draft Revised Commentary on Article 7 of the OECD Model Tax Convention. We believe that relief from double taxation is an Article 23, not Article 7, issue, and that a home state computes the amount of PE income to be exempted from tax according to its domestic laws. However, our disagreement with the symmetry requirement should not adversely affect taxpayers to any significant extent in practice. The "overall" limitation provided for in our foreign tax credit rules (as compared to a "per-country" or "item-by-item" limitation) makes it unlikely that double taxation of PE income will occur with respect to capital attribution and interest allocation".
99. *See supra* n. 39.

5.9. Final remarks

As was discussed in section 3., OECD member countries seem to take differing positions on the implementation of the OECD Report on the Attribution of Profits to a PE (2010 Report)[100] including in their respective guidelines to their tax administrations on the topic of static versus dynamic interpretation. The majority of tax administrations follow the dynamic approach while some jurisdictions do not take an explicit position on the matter. In addition, the case law seems to deviate from the official line.

As part of BEPS Action Point 15, the OECD aims to analyse the tax and public international law issues related to the development of a multilateral instrument that will enable jurisdictions to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, the OECD seeks to develop a multilateral instrument that will provide an innovative approach to international tax matters and will reflect the rapidly evolving nature of the global economy and the need to cope quickly with these changes.

6. Adequate Capital

6.1. Introduction to the concept of "free capital"

Tax considerations aside, and in the absence of regulatory requirements, there is ordinarily no need for any "free" capital to be formally attributed 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 AOA, 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, under thin capitalization rules, to have some equity or "free" capital. Under the AOA, the PE needs, for tax purposes, to have attributed to it an arm's length amount of "free" capital, irrespective of whether or not any such capital is formally attributed to the PE.

There is the issue, however, of how to attribute an appropriate amount of "free" capital and interest-bearing debt to the various parts of the enterprise. A number of approaches to determining funding costs are considered in section 6.2.

6.2. Free capital allocation approaches suggested by the OECD

Before profits can be attributed to a PE, there is an important issue concerning the allocation of capital or the determination of the "free" capital of the PE. The OECD makes a distinction between the methods, yet considers that the application or determination of free capital cannot be carried out only through one approach; instead, a combination of approaches is possible in light of fulfilling the arm's length principle.

According to the 2010 Report, there are at least six methods for determining adequate "free" capital at the level of the PE:
(1) capital allocation approach;
(2) economic capital allocation approach;
(3) thin capitalization approach;
(4) safe harbour approach – quasi thin capitalization/regulatory minimum capital approach;
(5) attribution of capital to the PE of a thinly capitalized enterprise; and
(6) other similar methods.

6.2.1. *Capital allocation approach – Proportionate to asset/risk profile*

This approach suggests that the capital allocation should be based on a functional analysis pursuant to which the assets owned and risks assumed by the PE are compared to the enterprise as a whole. Thus, the proportion of people functions, assets and risks allocated to the PE give rise to the free capital to be allocated at the level of the PE (for example, if the PE has 15% of the enterprise's assets and/or risks, 15% of the enterprise's "free" capital will be attributed to it). Accuracy adjustments can be made on the basis of differences in market conditions, the definition of capital, or activities performed by the PE.

Table 1: Advantages and disadvantages of a capital allocation approach

+ Pros	- Cons
– Where enterprises have capital structures that are consistent with those observed in comparable independent enterprises, an arm's length result ensues. – Where the enterprise of which the PE forms a part is resident in a different jurisdiction from the group parent company, the thin capitalization rules can ensure that the enterprise is adequately capitalized and an appropriate starting point for allocating "free" capital to the PE is provided.	– Differences in the definition of capital between home and host countries can result in the attribution of more or less than the total amount of capital of the enterprise. – Differences in the type of business of the PE and an enterprise as a whole or in market conditions can result in capital allocation outside the arm's length range if those differences are not appropriately reflected in the measurement of risk or reasonably accurate adjustments are not applied.

6.2.2. *Economic capital allocation approach*

This approach is explicitly based on the measurement of risk. The allocation of free capital depends on risk measurement systems and the risks undertaken by the PE. Here the economic approach or economic value of capital can be measured.

100. OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010) (2010 Report).

Table 2: Advantages and disadvantages of an economic capital allocation approach

+ Pros	- Cons
– Provides a useful starting point when the PE assumes significant risks, as 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.	– This method may mainly be relevant for financial institutions. – The question arises of how to attribute an appropriate amount of "free" capital and interest-bearing debt to the various parts of the enterprise. – This approach also requires a number of well-defined measures and sophisticated risk measurement systems.

6.2.3. Thin capitalization approach – A comparability analysis of independent funding structures

Under the thin capitalization approach, the PE should have the same amount of free capital as an independent enterprise carrying out similar activities under similar conditions. Relevant factors for allocating the amount of debt and free capital under this method are:
(1) the capital structure of the enterprise as a whole; and
(2) 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.

Table 3: Advantages and disadvantages of a thin capitalization approach

+ Pros	- Cons
– Can be applied in respect of non-financial entities, but requires the determination of the arm's length amount of funding that should be attributed to the PE to support its functions, assets and risks. Thereafter, the comparable debt-to-equity ratios in the host country can be used to determine which part of the arm's length funding should be made up of "free" capital. – Helps to avoid some of the issues that arise in determining the amount of "free" capital to be attributed in situations in which the enterprise, as a whole, is entirely debt-funded.	– Requires observing a wide range of debt-to-equity ratios and raises a concern regarding whether it is possible to take into account all the factors that underlie such different debt-to-equity ratios. – The effect of attributing only the regulatory minimum to each of the countries where an enterprise has PEs can result in less than single taxation. – The aggregated amount of "free" capital attributed by this method to individual PEs may be greater than the amount of free capital in the enterprise as a whole.

6.2.4. Safe harbour approach – Quasi thin capitalization/regulatory minimum capital approach

The safe harbour approach requires that the PE have at least the same amount of "free" capital required for regulatory purposes as an independent banking enterprise operating in the host country would. This approach is not authorized by the OECD, as it ignores the fact that, for example, the PE generally has the same creditworthiness as the enterprise as a whole. It may be acceptable only in situations in which the attribution of profits to the PE does not result in a greater amount of profits than would be attributed under an AOA.

Table 4: Advantages and disadvantages of a safe harbour approach – Quasi thin capitalization/regulatory minimum capital approach

+ Pros	- Cons
– The quasi thin capitalization/regulatory minimum capital may be used in conjunction with safe harbours.	– Difficulties in finding sufficiently objective benchmarks outside the regulated financial sector. – Relies on sector benchmarks that may not meet comparability standards, and the more refined and wide-ranging the approach becomes the less administrative simplicity it has.

6.2.5. Other methods

In the highly regulated banking and insurance sectors other regulatory measures (for example, solvency margins, minimum regulatory asset requirements, etc.) can potentially be used as keys to allocate total investment assets. In addition, quasi thin capitalization/regulatory minimum capital or thin capitalization/adjusted regulatory minimum capital approaches could also potentially be used as keys to allocate the actual investment assets (hybrid approaches). Hybrid approaches are discussed in more detail in sections 6.2.5.1. and 6.2.5.2., as well as in section 6.2.6.

6.2.5.1. Thin capitalization/adjusted regulatory minimum approach

The thin capitalization/adjusted regulatory minimum capital approach, as a starting point, takes the regulatory minimum of the host country and adds an additional arm's length "free" capital by comparison with local financial institutions operating in a similar manner, assuming similar risks and enjoying the same credit rate.

Table 5: Advantages and disadvantages of a thin capitalization/adjusted regulatory minimum approach	
+ Pros	**- Cons**
– Under certain facts and circumstances, the PE's regulatory reserves and minimum surplus may constitute an arm's length amount, without material adjustments.	– The amount of the regulatory reserves and surplus of the PE is not necessarily a reliable metric under the AOA, given that it may not reflect an arm's length amount of investment assets in relation to the risk-weighted liabilities.
	– Adjustments are usually needed to ensure that this approach is used in an acceptable manner (i.e. the amount of reserves and surplus attributed to the PE is comparable to the reserves and surplus held by the business as a whole and the amount of investment assets allocated to the PE is not excessive in comparison to the business as a whole).

6.2.5.2. *Safe harbour – Quasi thin capitalization/regulatory minimum approach*

The quasi thin capitalization/regulatory minimum approach requires the PE to have an amount of investment assets that is at least equal to its reserves (as determined under the host country's regulatory regime) plus the same minimum amount of surplus required for regulatory purposes (regulatory minimum surplus) as an independent enterprise conducting its business in the host country would.

Table 6: Advantages and disadvantages of a safe harbour – quasi thin capitalization/regulatory minimum approach	
+ Pros	**- Cons**
– It is an administratively simple way of ensuring that the PE cannot have less assets than its regulatory reserves and the regulatory minimum surplus for an independent enterprise conducting an insurance business in the same jurisdiction.	– It does not provide information concerning which of the assets that satisfy the minimum requirements are subject to taxation, which income and gains will be taxed or what rate of return should be obtained on those assets. – It ignores important internal conditions of the AOA, for example, that the PE generally have the same creditworthiness as the enterprise as a whole.

6.2.6. *Attribution of capital to the PE of a thinly capitalized enterprise*

This is a combination between two approaches, namely the thin capitalization approach and the capital allocation approach. The thin capitalization approach looks at the capital structures of comparable independent enterprises in comparable circumstances, etc. A second approach suggests first adjusting the "free" capital of the enterprise of which the PE forms a part through a capital allocation approach so that the PE receives an arm's length amount. It is also important, in determining whether any of the approaches mentioned arrives at an arm's length result for a PE, to consider why the enterprise as a whole is thinly capitalized.

Table 7: Advantages and disadvantages of a combination of the thin capitalization approach and the capital allocation approach	
+ Pros	**- Cons**
– If the commercial reasons for the enterprise being thinly capitalized are not related to the business operations of the PE, the attribution to the PE of more than the enterprise's "free" capital may be consistent with the arm's length principle.	– If the commercial reasons for the enterprise being thinly capitalized are related to the business operations of the PE, reliable comparables must be applied to account for such an effect in seeking to benchmark the PE's capitalization. If the available comparables data cannot reliably be used, another authorized OECD approach that is more consistent with the arm's length principle should be applied.

6.3. Final remarks

While the ranking is clear, i.e. (1) SPF/KERT are identified, (2) risks are allocated, (3) assets/activities are allocated and (4) free capital attributable to the branch is calculated, the various methods outlined under section 6.2. cover the whole gamut of application options. What taxpayers are looking for, in respect of the guidance published by the tax authorities, is a consistent approach to these options.[101]

101. Example: With regard to the determination of the capital attributable to a PE, the German Ministry of Finance proposes an asymmetric approach maximizing the German tax base, which has been subject to criticism, as it is a potential source of double taxation. For a domestic PE of a foreign enterprise, in general, the capital allocation methodology has to be applied, which allocates the whole of the equity, determined according to German tax regulations, to the different parts of the enterprise, taking into account the SPFs, assets and risks attributable to the PE. For the sake of simplicity, the equity of the foreign balance sheet can be used if the taxpayer can demonstrate that this equity amount does not significantly deviate from the equity determined based on German tax law or, if appropriate, adjustments can be made for deviations. If the whole entity is undercapitalized, the capital allocation has to be based on the debt-equity ratio of the consolidated group. With regard to a foreign PE of a German enterprise, the draft PE regulation stipulates that the thin capitalization methodology is applied, as capital can only be attributed to the PE if the taxpayer establishes that the capital is required based on, for example, legal or regulatory requirements. A higher capital amount can only be attributed to the PE if this better reflects the arm's length principle – up to the amount resulting from the application of the capital allocation method. If the capital recorded in the accounts of the German PE is higher than the amount resulting from the application of a reasonable allocation method, the draft PE regulation stipulates that the capital of the German PE cannot be reduced retroactively. The opposite is true for a foreign PE of a domestic enterprise, which can only be attributed to the capital recorded in the accounts. A retroactive increase isn't possible. Therefore, it is important

7. Court Cases and Tax Policy Implications

7.1. Court cases

The following court decisions address profit allocation between a head office and branches.

7.1.1. *The decision in* VOMAC *(2007): Withholding tax on cross-border transactions*

Van Oord ACZ India Private Limited ("VO India"), a wholly owned subsidiary of Van Oord ACZ Marine Contractors BV, Netherlands ("VOAMC"), a Netherlands company, was responsible for carrying out dredging, contracting, reclamation and other marine activities.

VOAMC was awarded a dredging contract at a port in India, which in turn was assigned to and executed by VO India. In completing the contract, VO India reimbursed any mobilization and demobilization charges to VOAMC based on the invoices of the non-resident service providers. VO India had earlier made an application to the tax authorities of India under section 195(2) of the Income tax Act, 1961 (the Act)[102] for the issuance of a nil withholding certificate for the above payments. The tax authorities held that VO India was a dependent agent PE of VOAMC in India and issued directions to withhold tax on a certain proportion of the reimbursement. VO India deducted the tax and paid the balance to VOAMC. Later, VO India reimbursed the charges to VOAMC without withholding tax and claimed the expenditure in the income tax return. The tax authorities, however, disallowed the reimbursement on the basis that VO India failed to withhold tax.

On appeal, the Delhi Income Tax Appellate Tribunal, relying on the 1999 decision of the Supreme Court in *Transmission Corporation of AP*,[103] held in favour of the tax authorities and confirmed the disallowance. This decision was questioned by VO India and the high court, in the end, ruled that VO India cannot be liable to withhold tax on the reimbursement of mobilization and demobilization charges to VOMAC.[104]

7.1.2. Mashreqbank *(2001): Restrictions on allowance of various business expenses*

Mashreqbank PSC ("Mashreqbank") is a banking company that was incorporated in the United Arab Emirates (UAE). Mashreqbank was carrying on business in India through its PE and was assessable to tax in India in respect of any profits attributable to the PE. For the relevant tax year, the Assessing Officer disallowed some of the expenses claimed by Mashreqbank under sections 37(2A), 37(3) and 43B of the Income Tax Act and also added certain amounts to the income of Mashreqbank under sections 36(1)(va) and 40A(3) of the Income Tax Act.

On appeal, Mashreqbank contended that, in view of the provisions of article 7(3) of the India-United Arab Emirates Income and Capital Tax Treaty (1992)[105] all expenses attributable to business activities carried on in India by Mashreqbank were allowable as a deduction, without restricting the allowance of such expenses under various provisions of the Income Tax Act. The Commissioner held that the profits attributable to the PE of Mashreqbank, in terms of article 7(3), would have to be determined in accordance with the domestic laws of India and all restrictions on allowance of various business expenses, as contained in the Act, would, accordingly, apply.[106]

7.1.3. Siemens *(1997): Does the hiring of labour by a German entity to work in Norwegian territory constitute a PE?*

Siemens AG (SAG) is the largest engineering company in Europe and is headquartered in Germany. SAG has complete control of the Norwegian company Siemens AS (SAS) through its 100% ownership of Sibag AG, which is also resident in Germany.

Norwegian company Siemens AS (SAS), which is under the complete control of SAG through its 100% ownership of Sibag AG, which is also resident in Germany, entered into a contract with the Norwegian company Norsk Hydro Produksjon AS (Hydro) in 1984. The aim of the contract was to deliver to Hydro a distributed supervision, control and safety system (Disco). This Disco system was an electrical installation that controlled and steered production and security systems on the oilrigs Oseberg A and Oseberg B in the North Sea. These oilrigs were operated by Hydro.

SAG took part in the delivery of the system, mainly by providing the necessary personnel. Twenty SAG employees assisted in the completion of the contracts from 1985-1989 in Norway. The employees never stayed in Norway for more than 183 days per year.

The tax authorities argued that SAG's contribution to the delivery of the system was comprehensive and that, for tax purposes, SAG should be regarded as a participant in fulfilling the contract with Hydro, with the result that SAG participated in the activities in Norway. The tax authorities took the position that the activities of the 20 employees constituted a PE in Norway. As a result SAG was taxed on the profits earned as a result of the income generated by the contract, as well as the employees in respect of the wages earned from their activities in Norway.[107] The Court first observed that the mere delivery of a system by a foreign entity to a supplier in Norway does not constitute a PE. If, however, the foreign entity adapts, develops or installs the system in Norway, the delivery may constitute a PE. The Court based this view on paragraph 8 of the Commentary

for taxpayers to analyse the methodology applied for the capital allocation and evaluate any compliance with the new ruling.

102. IN: Income Tax Act, 1961, National Legislation IBFD.
103. IN: SC, 17 Aug. 1999, *Transmission Corporation of A.P v. Commissioner of Income Tax*, A.P., case no. 594-96, 239 ITR 587 (SC).
104. IN: Income Tax Appellate Tribunal (ITAT) Delhi, 30 Nov. 2007, Case no. 2126/D/2007, *Van Oord ACZ India (P.) Ltd. v. ACIT*, Tax Treaty Case Law IBFD.
105. *Agreement Between the Government of the Republic of India and the Government of the United Arab Emirates for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (29 Apr. 1992), Treaties IBFD.
106. IN: ITAT Mumbai, 13 Apr. 2007, Case no. 2153 (MUM.) of 2001, *Mashreqbank PSC v. Deputy Director of Income Tax*, Tax Treaty Case Law IBFD.
107. NO: SC, 29 Apr. 1997, Case no. RT. 1997 s 653, *Siemens AG (SAG) and 20 employees v. Ministry of Finance and Customs*, Tax Treaty Case Law IBFD.

on Article 5 of the OECD Model, which reads: "if the personnel have wider responsibilities than merely operating or maintaining the equipment, their activity may constitute an entrepreneurial activity and hence a PE". Thereafter, the Court noted that the specific role and responsibilities of the SAG and the SAG personnel concerning the delivery of the system went far beyond the mere supply of labour.

Consequently, according to the Supreme Court, Siemens was taking part in a business activity through a PE in Norway. The Court did not find it decisive that the entity is not directly liable to the client for the result of the activity and the activity was not carried out for the account of the foreign entity.

7.1.4. NCC AB *(1999): Direct versus indirect HQ/overhead charges to Norwegian PE*

NCC AB, a Nordic construction company, was a limited company resident in Sweden. In 1989, the taxpayer operated its business in Norway through a branch of the company's 100% subsidiary NCC Bygg AB, a Swedish resident limited company. The activities in Norway were primarily managed from a branch office in Gothenburg, Sweden.

The branch office in Gothenburg engaged Aker Entreprenør AS, an unrelated Norwegian company, to perform a significant part of its functions (i.e., accounting, financial management and administration of personnel). The costs incurred in Gothenburg had been allocated on an indirect basis, in proportion to the income in Norway and Sweden, respectively.

In 1992, the Norwegian tax authorities denied part of the NOK 4,889,612 in deductions for overhead expenses related to the Gothenburg branch office activities in computing the taxable income of the Norwegian branch, as a major part of the branch activities in Norway in 1989 related to a collaboration with the Norwegian company Aker Entreprenør AS.

The Court held that the taxpayer's method for allocating the expenses was not in accordance with what was customary in Norway and, therefore, the method applied by the taxpayer was not permitted by article 7(4) of the Nordic Convention.[108,109] The Court held that only costs that were not directly deductible, i.e. that could not be allocated to a specific part of the business, could be regarded as deductible overhead expenses. The taxpayer had the burden of proof both as to the question of whether costs could be allocated directly and as to whether the choice of method led to a reasonable result. The Court held that an indirect method could be applied only in respect of costs for which no direct allocation could be made.

7.1.5. Pirelli Cavi E Sistemi Telecom project office (PE) in India: Offshore versus onshore income attributable to PE

Pirelli Cavi E Sistemi Telecom Spa (Pirelli Telecom) was tax resident in Italy and was engaged in the business of setting up a telecommunication infrastructure in India. It had entered into the following three contracts for setting up a fibre optic system:

- offshore supply contract (for equipment to be supplied from outside India);
- onshore supply contract (for equipment to be supplied from within India); and
- onshore services contract (for work to be carried out in India).

Pirelli Telecom had established a project office (PE) in India. It paid tax in India only income from onshore supply and services contracts. The tax authorities treated all three contracts as a composite contract. The tax authorities estimated that:

- as regards the income attributable to the PE in India for the onshore supply and services contracts, 10% of the contract value was taxable in India; and
- 5% of the gross value of the offshore supply contract was income taxable in India.

In an initial appeal, the Commissioner of Income Tax (Appeals) ("the CIT(A)") agreed with the tax authorities that even the income from the offshore supply contract was taxable in India, but reduced the estimate of taxable income to 1% of the value of the offshore supply contract.

The Income Tax Appellate Tribunal (ITAT), however, accepted Pirelli Telecom's position that the Indian PE did not play a role with regard to the offshore supply contract and, therefore, Pirelli Telecom's income from that contract was not attributable to the PE.[110] Hence, that income was not taxable in India. With regards to onshore supply and services contracts, according to the ITAT it was difficult to examine the books of Pirelli Telecom due to the passage of time. ITAT concluded that the tax authorities' estimate of 10% of the contract value as taxable income was reasonable.

7.1.6. Dell *(2011): Dependent versus independent commissionaire*

A subsidiary of Dell Computer Corporation was an Irish-resident company ("Dell Ireland") that sold Dell computers to large customers in Norway through Dell AS, a Norwegian company that acted as the commissionaire for the taxpayer.

Dell Ireland claimed that it was not liable to tax in Norway, as it did not have a PE in Norway. The tax authorities assumed, however, that Dell AS constituted a PE under article 5(5) of the Ireland-Norway Income and Capital Tax Treaty (2000)[111] and concluded that 60% of the profits from

108. *Convention for the Avoidance of Double Taxation with respect to taxes on Inheritances and Gifts* (*Nordic Convention*) (12 Sept.1989), Treaties IBFD.
109. NO: District Court Stavanger (*Tingrett*), 8 Sept. 1999, Case no. 98-0237, *Nordic Construction Company v. Government of Norway*, Tax Treaty Case Law IBFD.
110. IN: ITAT Hyderabad, 28 May 2014, Case no. ITA No. 160/Hyd/2006, *Pirelli Cavi E Sistemi Telecom S.P.A. (India Project Office) v. ACIT*, Tax Treaty Case Law IBFD.
111. *Convention between the Kingdom of Norway and Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes*

the taxpayer's net sales in Norway should be attributable to the PE, while the remaining part should be attributed to the head office in Ireland.

This case was brought before the Oslo District Court, which decided in favour of the tax authorities. Dell Ireland appealed the decision of the Oslo District Court to the Court of Appeal arguing that it never had any legal obligations towards Dell AS' customers and, therefore, Dell AS did not enter into contracts that bound Dell Ireland. In addition, Dell Ireland did not have any control or instructional authority over Dell AS and, therefore, Dell AS was not dependent on it. Conversely, the tax authorities took the view that Dell AS had only one principal, being Dell Ireland, and was instructed and extensively controlled by it. Also, Dell Ireland was, in reality, bound by the contracts of Dell AS.

The Court of Appeal held that Dell Ireland had a PE in Norway under article 5(5) of the Ireland-Norway Income and Capital Tax Treaty (2000), highlighting that a "functional-realistic" approach should be endorsed in interpreting the phrase "authority to conclude contracts in the name of the enterprise". The Supreme Court, however, quashed the decision of the Court of Appeal, making reference to technical and practical considerations. It concluded that if the argument put forth by the tax authorities (i.e. that a functional realistic approach should be taken, on a case-by-case basis, in determining whether the commissionaire binds the principal) were accepted, it would be very difficult to apply article 5(5) in practice.[112] Consequently, the Supreme Court held that Dell Ireland did not have a PE in Norway.

7.1.7. **Nortel** *(2014): PE status and the application of a proportionate approach to computing income attributable to a PE*

The taxpayer company was tax resident in the United States ("Nortel US"), and belonged to Nortel Group (headquartered in Canada), a leading supplier of telecommunication hardware and software products. A group company in India ("Nortel India") had entered into a contract with an Indian customer for the supply of hardware, but had immediately assigned that contract to Nortel US. For that purpose, Nortel US had purchased the hardware from a Canadian group company incurring gross losses of 65% and 48% for the 2002 and 2003 tax years.

Nortel Canada did not have its own infrastructure or technological capability to execute the contract and, therefore, the tax authorities concluded that it was merely a "paper company" that was set up for the sole purpose of evading Indian taxes. As per the tax authorities, the contract was of a composite nature (i.e. including the installation, testing and commissioning of the hardware). The tax authorities observed that the taxpayer company discharged its contractual obligations through Nortel India. On that basis, the tax authorities concluded that the premises of Nortel India amounted to a fixed place PE in India of Nortel US. In addition, the tax authorities computed the income taxable in India on a proportionate basis, allowing for a deduction of head office expenses at a rate of 5% of turnover (i.e. the contract value).

The CIT(A) opined that all the expenses related to the PE had to be allowed as a deduction (i.e. 50% of Nortel US' net income from the contract should be attributable to the PE and the remaining 50% of net income should be attributable to activities outside India).

The ITAT held that Nortel US was merely a shadow company and, therefore, had a PE in India.[113] In addition, due to unaudited financial statements that lacked credibility, the ITAT approved the computation of income attributable to the PE on a proportionate basis.

7.1.8. **Uge** *(2006): Re-characterization of a company as a PE for VAT purposes*

Uge, a company resident in Panama, was assessed for VAT purposes on the basis that it had a PE in Italy and, therefore, was liable to pay VAT on the supply of goods (deemed to be) made in the Italian territory. The Italian tax authorities based the assessment on the following elements: (1) bank accounts in Italy pertaining to the Panamanian company, (2) amounts credited to the Panamanian company's bank account, (3) the identity of directors and shareholders of the Italian and Panamanian companies, (4) participation of the Italian company in the negotiation of contracts for the Panamanian company and (5) the fact that the Panamanian company's books and records were kept at the premises of the Italian company.

The Supreme Court rejected the taxpayer's appeal and stated that: (1) in the absence of a PE definition in the domestic law, the definition of a PE must be based on article 5 of the OECD Model and the definition of "centre of activities" in the Sixth VAT Directive (77/388);[114] (2) a separate legal entity may be re-characterized as a PE of a foreign taxpayer when the former is entrusted with the management of the business of the latter, since this cannot be considered as an activity of a preparatory or auxiliary character; (3) evidence of the fact that an Italian company is carrying on business on behalf of a Panamanian company should be based on substance and, therefore, should be concluded not only following the interpretation in article 5 of the OECD Model, but also following the actual fact that the persons acting for the Italian company were also acting for the Panamanian company and were, to a large extent, involved in concluding transactions and/or agreements even though they lacked a factual power of representation.[115]

on Income and on Capital (22 Nov. 2000), Treaties IBFD.

112. NO: SC, 2 Dec. 2011, Case no. HR-2011-02245-A, (sak no. 2011/ 755), *Dell Products v. Tax East*, Tax Treaty Case Law IBFD.

113. IN: ITAT Delhi, 13 June 2014, ITA Nos. 1119 to 1121/Del/ 2010, *Nortel Networks India International Inc. v. DDIT*, Tax Treaty Case Law IBFD.

114. EU Sixth VAT Directive: Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, EU Law IBFD.

115. IT: SC, 25 Jan. 2006, Case no. 17206, Tax Treaty Case Law IBFD.

7.2. Tax policy and development

In section 3. of Part 1 of this article,[116] reference was made to the OECD's multilateral instrument to modify bilateral tax treaties published in 2014.[117] The major point of discussion in this regard is a static versus dynamic interpretation of existing tax treaties. As the rudiments of existing tax treaties will be updated according to the language of the new article 7, a question still arises as to whether countries should allow taxpayers leeway in respect of a dynamic interpretation. There will be some countries left that adhere to a static interpretation, but the object and purpose of the multilateral instrument – as per Action Point 15 of the G20/OECD BEPS project – is to catch all bilateral treaties under the umbrella of economic substance and/or SPFs–based concepts instead of more formula-based ratios. As is to be expected, economic layers regarding articles 1, 5 and 9, as well as article 7, are deemed to be incorporated into bilateral tax treaties, as the one-size-fits-all spirit of Action Point 15 inevitably will pierce the veil of old and new treaties equally.

8. Final Remarks

This article has addressed how the interpretation of article 7 has evolved over time. It also highlighted that implementation of the 2010 Report, in terms of a revision of the text of article 7 of existing bilateral tax treaties, has taken a long time.

More recently, BEPS Action Point 15 has suggested accelerating this conversion process by applying a dynamic approach to the interpretation of article 7 based on the underlying assumption that the 2010 Report will be adhered to.

The major challenges in applying the 2010 Report are as follows:
– the application of new concepts like KERT/SPFs and "control over risk" due to a difference in their interpretation in various countries;
– complexities of a two-step approach, leading to questions on how to allocate the proper "people functions", risks and adequate capital to the branch operations;
– the timing, as a taxpayer or a tax authority, for applying all the steps/concepts suggested by the 2010 Report to today's practice of profit attribution between head offices and branches.

The lowering of the PE threshold (article 5) after the BEPS project will increase the need for OECD 2010 Report steps and concepts to be applied in a consistent and transparent manner.

116. S. Huibregtse, L. Verdoner, I. Valutyte & R. Offemanns, *Status of Implementation of the Authorized OECD Approach Into Domestic Tax Law and Tax Treaties* – Part 1, 55 Eur. Taxn. 8 (2015), Journals IBFD.
117. OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties (OECD Publishing 2014), available at http://www.oecd.org/tax/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-9789264219250-en.htm.