1

Introduction

1 Outline

The importance of bilateral tax treaties[1] has increased significantly over the last sixty years with the extensive integration of national economies and the growth in the number of enterprises operating internationally. The growth in the tax treaty network has been phenomenal and there are presently over 3,000 tax treaties in force. The primary objective of tax treaties is to support international trade and investment by, inter alia, reducing the risk to business of double taxation, resulting from the overlapping of two countries' jurisdictions to tax. Tax treaties deal with the problem of overlapping tax jurisdictions by allocating taxing rights over items of income or taxpayers between the contracting countries. Tax treaties do not create jurisdiction to tax; rather, they allocate taxing rights between the treaty countries to prevent double taxation.[2] International taxation comprises the interaction between the network of tax treaties and the domestic tax systems of countries. Most tax treaties are based on the Organisation for Economic Co-operation and Development (OECD) *Model Tax Convention on Income and Capital*[3] (OECD Model) and it has become the keystone of the international tax treaty system. Moreover, the United Nations (UN) Model is based on the OECD Model.[4]

A key feature of tax treaties is the allocation of business profits of international enterprises operating globally through permanent establishments under the business profits Article, Article 7 of the OECD Model. This provision became a broadly accepted treaty measure in

[1] In this book bilateral tax treaties are referred to as tax treaties.

[2] The Australian Commissioner of Taxation is of the view that Australia acquires additional tax jurisdiction under its treaties. As a result, transfer pricing adjustments in Australia are issued under both the domestic transfer pricing rules and Article 9 of Australia's treaties. This interpretation is controversial and has not been accepted by a court in Australia.

[3] The current version is the 2010 OECD Model.

[4] United Nations, *United Nations Model Tax Convention Between Developed and Developing Countries* (2001).

the early part of the twentieth century when national economies were relatively independent and closed. Globalization has resulted in international enterprises and multinational enterprise groups operating across national borders as highly integrated businesses. International enterprises operate abroad through permanent establishments in host countries. On the other hand, multinational enterprise groups operate abroad through locally incorporated subsidiaries. International enterprises and multinational enterprise groups may use complex financial techniques and sophisticated tax planning arrangements to exploit the deficiencies in the tax treaty system. Former Article 7 has come under increasing pressure through globalization and there was no consensus interpretation of former Article 7 prior to the publication of the *Report on the Attribution of Profits to Permanent Establishments*[5] (2008 Report) and the adoption by the OECD of the 2008 OECD Model, which incorporated some of the measures from the 2008 Report in the Commentary on former Article 7. A new Article 7 was adopted by the OECD in the 2010 OECD Model which fully implements the principles in the 2008 Report.[6] At the same time, the OECD adopted the 2010 Report which is a revised version of the 2008 Report; the conclusions of the 2010 Report were amended to reflect the drafting and structure of new Article 7. Since 2001, the European Commission has been studying the implementation of formulary apportionment for EU enterprises.[7] The OECD Article 7 reforms and the EU's formulary apportionment proposals are essentially a debate over the relative merits of the arm's length principle as compared with unitary formulary apportionment for allocating the profits of enterprises which operate in more than one country.

The former Article 7[8] of the OECD Model and the new Article 7 are based on the arm's length principle. Under the arm's length principle a permanent establishment of an international enterprise is treated as a separate entity for the purposes of determining the profits that are attributable to the permanent establishment. Transfers of assets and funds between the head office of an international enterprise and its permanent establishment are treated as notional intra-entity transactions – which are called 'dealings' – between arm's length entities. The transfer prices for these notional intra-entity transactions must then conform to the transfer

5 OECD, *Report on the Attribution of Profits to Permanent Establishments* (2008).
6 2010 OECD Model.
7 Commission of the European Communities, *Towards an Internal Market without Tax Obstacles* (2001).
8 2008 OECD Model.

prices for comparable transactions between independent enterprises. The arm's length principle seeks to emulate open market transactions. The OECD initially acknowledged in 2001 that there is no consensus within member countries on the correct interpretation of former Article 7. This conclusion was confirmed by the International Fiscal Association in 2006.[9] This lack of a consensus interpretation and the inconsistent application of former Article 7 may result in either double taxation or under-taxation of the business profits of permanent establishments, and thereby makes former Article 7 ineffective in allocating business profits to permanent establishments.

The OECD rules for attributing business profits under former Article 7 to a permanent establishment, prior to 2008, were far less developed than the OECD's transfer pricing rules for associated enterprises of a multinational enterprise group under Article 9 of the OECD Model. In 1994, the OECD announced its intention to include permanent establishments within the scope of the Transfer Pricing Guidelines.[10] The 2008 Report and 2010 Report adapt the Transfer Pricing Guidelines for associated entities to attributing profits to permanent establishments. But this approach is flawed because it is based on a fundamental fiction as a matter of law, and, in reality, there cannot be transactions between parts of one enterprise. An alternative approach is being explored by the European Commission, which is considering comprehensive reforms to remedy the problems of a bilateral tax treaty system and the arm's length principle. The European Commission is looking at moving to unitary formulary apportionment, under which the profits of an international enterprise are allocated between European Union (EU) countries on the basis of an agreed formula. The European Commission's work on formulary apportionment for the EU was motivated in part by the challenges caused by transfer pricing and the arm's length principle in the EU. This proposal requires the implementation of an EU multilateral tax treaty for the taxation of companies. Clearly, reform of the methods of allocating profits to permanent establishments of international enterprises is a controversial issue.

The topic of this book is the allocation of business profits to permanent establishments of international enterprises under Article 7 of the OECD Model. The book studies the OECD principles for the

[9] International Fiscal Association (ed.), *The Attribution of Profits to Permanent Establishments* (2006).
[10] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Discussion Draft of Part I* (1994).

allocation of business profits under the three versions of Article 7 and Commentary:

- the former Article 7 with the accompanying Commentary, called the pre-2008 Commentary in this book;[11]
- the former Article 7 with the accompanying 2008 Commentary,[12] reflecting the principles in the 2008 Report; and
- the new Article 7 and accompanying new Commentary were adopted by the OECD in the 2010 OECD Model,[13] reflecting the principles in the 2010 Report.[14]

As most tax treaties are based on former Article 7, it will take a considerable period of time before the use of new Article 7 is widespread as most treaties are only amended after ten years. But new Article 7 may not be widely adopted by OECD countries and non-OECD countries. This reflects differences within the OECD between Working Party No. 1, which is responsible for tax treaty issues, and Working Party No. 6, which is responsible for the taxation of multinational enterprises. Both Working Party No. 1 and Working Party No. 6 submit their conclusions to the OECD Committee on Fiscal Affairs for adoption as OECD principles. Working Party No. 6 developed the principles in the 2008 Report and the 2010 Report which are based on arm's length economics. The focus of Working Party No. 6 is transfer pricing and it has extended its area of responsibility from developing transfer pricing principles for multinational enterprise groups to applying these principles in attributing profits to permanent establishments of international enterprises. On the other hand, the members of Working Party No. 1 are usually treaty negotiators and they may not be convinced of the practical application of the arm's length principle to permanent establishments. As a consequence, there are doubts about whether treaty negotiators will adopt the new Article 7 when they negotiate new treaties and renegotiate treaties.[15]

[11] The pre-2008 Commentary was last published in the 2005 OECD Model.
[12] 2008 OECD Model. The former version of Article 7 and its Commentary have been reproduced in the 2010 OECD Model at pp. 154–73.
[13] 2010 OECD Model.
[14] OECD, *Report on the Attribution of Profits to Permanent Establishments* (2010).
[15] Five OECD countries recorded reservations on Article 7 in the 2010 OECD Model, reserving their right to use former Article 7. New Zealand reserved the right to use former Article 7 (taking into account its observations and reservations on former Article 7) because it does not agree with the approach reflected in Part I of the 2010 Report and therefore does not endorse the changes that were made to the Commentary on Article 7 in the 2008 OECD Model: 2010 OECD Model, p. 153, para. 95. Chile,

Moreover, the UN has rejected adopting new Article 7 in the UN Model and this is likely to be influential with non-OECD countries.[16]

The book also studies the alternative of implementing a multilateral tax treaty using unitary formulary apportionment to allocate profits to permanent establishments. The key argument is that the arm's length principle, on which Article 7 is based, is inappropriate to use for allocating business profits to permanent establishments of international enterprises, particularly highly integrated international enterprises, such as international banks. The arm's length principle is asserted to be an ineffective measure for allocating business profits to permanent establishments because it does not reflect business reality. Moreover, international enterprises have a common profit motive. Conversely, the relationship between independent entities is governed by legally enforceable contracts. It is contended that there is no single economic basis for allocating profits within highly integrated international enterprises operating globally through permanent establishments. This book examines the alternative approach of unitary formulary apportionment under a multilateral tax treaty, which is contended to be a more effective method for allocating the profits of highly integrated international enterprises. A multilateral tax treaty would provide a global response rather than a bilateral response to a problem arising from the globalization of international business.

International banks are examined in this book as they operate in countries through branches, and branches of international banks are permanent establishments for tax treaty purposes. International banking was one of the first sectors to carry on business internationally through highly integrated branch operations, as they were quickly able to exploit the Internet and developments in communication and business information technologies. International banks are relatively mobile businesses with the flexibility to move out of countries in which after-tax profit targets are not being met. To operate abroad a bank does not need a great deal of investment in plant and equipment. The main entry requirements are prudential regulations specifying the amount of equity capital

Greece, Mexico and Turkey reserved the right to use former Article 7 and they do not endorse the changes made to the Commentary on Article 7 in the 2008 OECD Model: 2010 OECD Model, p. 153, para. 96.

16 United Nations, *Report of Experts on International Tax Cooperation in Tax Matters* (2009), p. 9, para. 31. The following non-OECD countries have reserved the right to use former Article 7: Argentina; Brazil; India; Indonesia; Latvia; Malaysia; Romania; Serbia; South Africa; Thailand; and Hong Kong, China: 2010 OECD Model, p. 441, paras. 1–2.

an international bank must have to support its business operations. Branches of international banks are an ideal type of permanent establishment to case study for establishing the flaws of using the arm's length principle to allocate business profits under the former Article 7.

2 Structure

The book compromises twelve chapters. Chapters 2 and 3 examine the structure and effectiveness of the international tax treaty system. It is argued in Chapter 2 that the rules for allocating taxing rights to countries under double tax treaties – based on source, residence and the arm's length principle[17] – have been eroded by globalization.[18] The chapter underscores the gap between the development of the international trade system and the development of the international tax treaty system. In the field of international trade, the response to globalization has been the creation of a multilateral trade treaty – the General Agreement on Tariffs and Trade (GATT) – supplemented in 1995 with the World Trade Organization Agreement, and the creation of a new supervisory body – the World Trade Organization (WTO). But in the international tax treaty system there have not been parallel developments.

Chapter 3 explores the deficiencies of the present international tax treaty system in taxing international enterprises operating abroad through permanent establishments and multinational enterprise groups operating abroad through locally incorporated subsidiaries. It considers flaws, such as the inflexibility of the tax treaty network, and identifies the treaty network as providing significant avoidance opportunities and tax planning opportunities for multinational enterprise groups through transfer pricing.[19] It examines empirical evidence on tax avoidance by international banks. The chapter argues that, as a result of developments in

[17] 'The old rules of the international tax game – separate-entity arm's length principle, permanent establishment, non-discrimination, source, residence, etc. – decreasingly serve to carve up the international tax base in a reasonable and sustainable way, whether in the EU or more generally.' Bird and Wilkie, 'Source- vs. residence-based taxation in the European Union' in Cnossen (ed.) *Taxing Capital Income in the European Union* (2000) 78–109, p. 90.

[18] Warren asserts that international developments, such as GATT, the WTO and corporate tax integration have rendered the existing tax treaty system obsolete. He also argues that there should be an examination of the relationship between the tax treaty system and the international trade system: Warren, 'Income Tax Discrimination Against International Commerce' (2001), p. 169; Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice' (1992), p. 566.

[19] Thuronyi, 'International Tax Cooperation and a Multilateral Treaty' (2001), p. 1641.

communication technology, international enterprises and multinational enterprise groups have become more integrated, and that therefore the allocation of profits using the arm's length principle is becoming more controversial and subject to more challenges.[20]

Chapter 4 provides a history of aspects of the tax work of the League of Nations, focusing on multilateral and bilateral model tax treaties developed by it. The chapter establishes that the League of Nations' preference was to have a multilateral tax treaty, but that the bilateral tax treaty model was proposed as a compromise measure that was acceptable to member countries. The chapter also surveys the development of the permanent establishment concept by the League of Nations.

Chapter 5 establishes the importance of the OECD Model and Commentary in the current tax treaty system. It illustrates the role of the Commentary in providing guidance to tax authorities and courts on the interpretation of Articles of the OECD Model. Chapter 5 claims that the OECD Commentary in force when a treaty is concluded may be used to assist in interpreting provisions of the treaty. It is contended that Commentaries adopted by the OECD subsequent to a tax treaty coming into force may be considered by a court in interpreting the treaty, but that they will have no weight as they were not in existence when the treaty was negotiated. In particular, the 2008 Commentary on Article 7, which reflects many of the sweeping reforms in the 2008 Report, should only be used to interpret the business profits Article of tax treaties concluded after 17 July 2008, the date on which the OECD adopted the 2008 OECD Model.[21] An exception to this assertion is that tax treaties which came into force before 2008 but were negotiated in anticipation of the 2008 Commentary may use the Commentary on former Article 7.[22]

The proposition that the arm's length principle is an ineffective measure for allocating business profits to permanent establishments is established in Chapters 6, 7 and 8. These chapters critically evaluate the OECD rules for attributing business profits to permanent establishments under the pre-2008 Commentary and the 2008 Commentary. Chapters 6 and 7 establish the flaws of using the arm's length principle

[20] Tanzi, *Taxation in an Integrating World* (1995), p. 139; Weiner, *Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level* (1999), p. 42.
[21] 2008 OECD Model.
[22] The US has claimed that its treaties with UK and Japan were negotiated in anticipation of the OECD, *Report on the Attribution of Profits to Permanent Establishments* (2006), which subsequently became the 2008 Report.

under Article 7 to allocate business profits to permanent establishments. Chapter 6 critically analyses the interpretation of Article 7 of the OECD Model and establishes that it is being interpreted inconsistently in member countries under the pre-2008 Commentary. It also considers the 2008 Commentary on Article 7 which reflects the 'authorized OECD approach' in the 2008 Report. Chapter 7 considers the OECD rules on the taxation of branches of international banks with a focus on the allocation of interest expenses within international banks under the pre-2008 Commentary. The OECD acknowledged the need for reform of this area because there is a lack of consistency in the interpretation of the business profits Articles by member countries.

Chapter 8 critically considers the 2008 Commentary which seeks to apply the Transfer Pricing Guidelines for associated entities to notional transactions between a branch and other branches or the head office of an international bank. This chapter asserts that the authorized OECD approach is flawed because the OECD's Transfer Pricing Guidelines for associated enterprises under Article 9 of the OECD Model cannot be adapted effectively to notional intra-bank transactions to attribute profits to branches of international banks. Article 9 of the OECD Model deals with adjusting the profits of an associated enterprise which arise from intra-group transactions that are not on arm's length terms. In the case of international banks operating through branches, there are no actual transactions that may be used for transfer pricing purposes, as intra-bank dealings are only notional transactions. Moreover, the measures in the 2008 Report are complex, impose significant compliance costs on international enterprises operating abroad through permanent establishments and tax authorities, and are based on a number of questionable assumptions. But support for the arm's length principle in the OECD is being challenged by the EU's unitary taxation reform proposals. Moreover, many EU countries are also OECD countries.

Chapter 9 examines the measures in the 2008 Report on business restructuring involving permanent establishments. While business restructuring is a vital activity for international enterprises to maintain their international competitiveness, business restructuring raises complex issues, particularly where it involves intangible assets. The chapter focuses on business restructures involving intangible property transferred to and from a permanent establishment under the authorized OECD approach. The chapter also considers the five transfer pricing methods – the three traditional transaction methods and the two transactional profit methods – which must be applied under the authorized OECD approach.

Under the former Transfer Pricing Guidelines, the transactional profits methods (the profit split method and the transactional net margin method) could only be used in so-called exceptional circumstances when the traditional transaction methods are inapplicable. The chapter claims that the transactional net margin method has for a significant time been the most commonly used method because the traditional transaction methods are usually inapplicable. In 2010, the OECD adopted the 2010 Transfer Pricing Guidelines which gave the transactional profit methods equal status with the traditional transaction methods; this reform reflected the significant time lag between practice and the Transfer Pricing Guidelines that had developed.[23]

Chapter 10 considers new Article 7 which fully implements the authorized OECD approach in the 2010 Report. New Article 7 is designed to provide the basis for the business profits Article of new tax treaties and renegotiated tax treaties. If new Article 7 is used in tax treaties it may provide for more consistency in the interpretation of the provision, but it is uncertain whether new Article 7 will be widely adopted by OECD countries and non-OECD countries. Moreover, it is likely to involve high compliance costs for international enterprises and administrative costs for tax authorities because of theoretical economic approach to the allocation of profits to permanent establishments which does not reflect business practice.

Chapter 11 considers the relative merits of implementing a multilateral tax treaty and focuses on the proposals being studied by the EU as key potential reforms. It is argued that the best method for allocating profits under a multilateral tax treaty would be a unitary method that reflects the integrated international operations of international enterprises. The arm's length principle cannot be applied effectively to allocate profits to permanent establishments because the dealings between a permanent establishment and the rest of an enterprise are fictional transactions. Permanent establishments do not operate as separate enterprises as they are parts of highly integrated businesses. Chapter 11 concludes by arguing that a unitary formulary apportionment method is a viable alternative to allocating the profits of international enterprises under a multilateral tax treaty.

This book is a critical analysis of the normative and practical aspects of the attribution of profits to permanent establishments. The debate over the arm's length principle and formulary apportionment has been

[23] 2010 Transfer Pricing Guidelines.

well documented in the literature. Until the announcement of the European Commission studies, formulary apportionment was the weakest line of argument in this international tax law debate. But the challenges to the international tax treaty system posed by globalization and developments in the EU have given new strength to formulary apportionment. However, the considerable degree of international cooperation required to negotiate a multilateral tax treaty and to develop a formula cannot be overstated. Even if unitary formulary apportionment and a multilateral tax treaty do not eventuate in the EU, formulary apportionment methods are likely to be accepted as conforming with an extended notion of the arm's length principle. This book is a contribution to the debate on the relative merits of the arm's length principle and formulary apportionment.