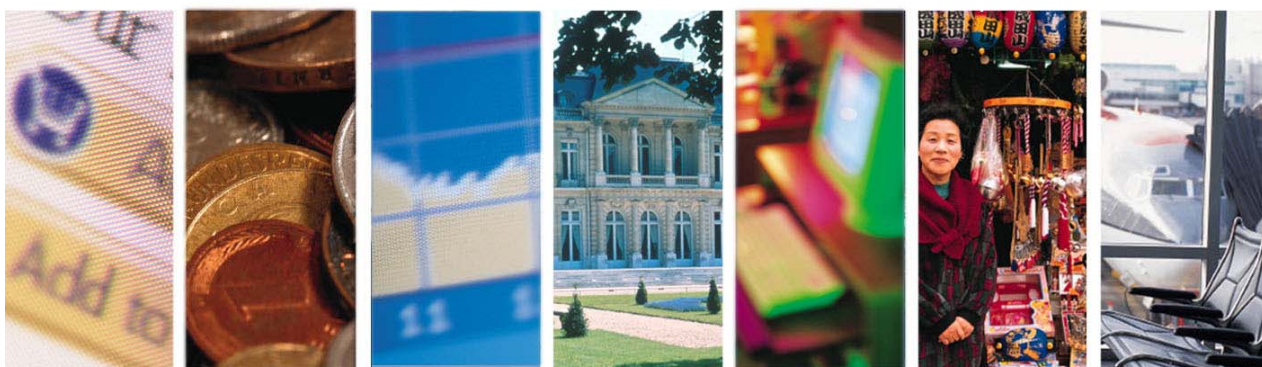




ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention

7 July to 31 December 2008



CENTRE FOR TAX POLICY AND ADMINISTRATION

7 July 2008

**DRAFT NEW ARTICLE 7 OF THE OECD MODEL TAX CONVENTION AND
RELATED COMMENTARY CHANGES**

Public discussion draft

When the Committee of Fiscal Affairs released new versions of Parts I, II and III of its Report on the Attribution of Profits to Permanent Establishments in December 2006, it indicated how the conclusions of that Report would be implemented

In order to provide maximum certainty on how profits should be attributed to permanent establishments, the Committee has decided that the Report's conclusions should be reflected in a new version of Article 7, together with accompanying Commentary, to be used in the negotiation of future treaties and of amendments to existing treaties. In addition, in order to provide improved certainty for the interpretation of existing treaties based on the current text of Article 7, the Committee has decided that revised Commentary for that current text should also be prepared, to take into account those aspects of the Report that do not conflict with the existing Commentary.

The first part of that implementation package, i.e. a draft of the revised Commentary on the current Article 7 of the OECD Model Tax Convention, was released for comments in April 2007, subsequently revised and included in the 2008 update to the Model Tax Convention which was adopted by the Committee at its meeting of 24-25 June 2008, when the Committee also adopted the Report on Attribution of Profits to Permanent Establishments (i.e. the final version of Parts I-IV). The revised Commentary will be included in the new version of the OECD Model Tax Convention that will soon be published; the Report on Attribution of Profits to Permanent Establishments will similarly be published separately.

This discussion draft includes the second part of the implementation package, i.e. a new version of Article 7 with its Commentary together with consequential changes to other parts of the OECD Model Tax Convention. It is expected that once finalised, the new Article and the Commentary changes will be included in the next update to the OECD Model Tax Convention, which is tentatively scheduled for 2010.

The Committee invites interested parties to send their comments on this discussion draft **before 31 December 2008**. Comments should be sent electronically (preferably in Word format) to:

Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
FRANCE
e-mail: jeffrey.owens@oecd.org

Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.

TABLE OF CONTENTS

DISCUSSION DRAFT ON THE NEW ARTICLE 7	3
1. NEW ARTICLE 7	3
2. COMMENTARY ON THE NEW ARTICLE 7	4
I. Preliminary remarks	4
II. Commentary on the provisions of the Article	6
Paragraph 1	6
Paragraph 2	7
Paragraph 3	15
Paragraph 4	23
3. CONSEQUENTIAL CHANGES TO OTHER PARTS OF THE MODEL TAX CONVENTION	24
Introduction	24
Article 5	25
Article 8	25
Paragraph 20	25
Paragraph 21	26
Article 10	26
Article 11	27
Article 12	28
Article 13	29
Article 15	30
Article 21	31
Article 22	32
Article 24	33
Paragraph 20	33
Paragraph 24	34
Article 26	34

DISCUSSION DRAFT ON THE NEW ARTICLE 7

1. NEW ARTICLE 7

1. The following is the draft new Article 7 that the Committee has drafted in order to fully implement the conclusions of the Report on Attribution of Profits to Permanent Establishments.

Article 7

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

[Existing paragraph 1: The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.]

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, 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, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

[Existing paragraph 2: Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.]

[The existing paragraphs 3, 4, 5 and 6 are deleted:]

~~3.— In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.~~

~~4.— Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.~~

~~5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.~~

~~6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.~~

3. Where

- a) in one Contracting State, the amount of “free” capital that is used for determining the interest that is deducted in computing the profits that are attributable to a permanent establishment situated in that State of an enterprise of the other Contracting State is determined using a method of attributing capital to the permanent establishment that is provided by the domestic law of the first-mentioned State and both States agree that the application of that method produces an arm’s length result in conformity with paragraph 2 in that case; and
- b) that method is different from the method provided by the domestic law of the other State and used by that State to attribute capital to the permanent establishment and, as a result of this difference, part of the profits of the enterprise are charged to tax in both Contracting States and, in the absence of this paragraph, Article 23 would not apply to eliminate the double taxation of these profits,

the other State shall, in determining the profits attributable to the permanent establishment for the purposes of Article 23, use the amount of “free” capital derived from the application of the capital attribution approach used by the first-mentioned State. For the purposes of this paragraph, “free” capital means capital that does not give rise to a return in the nature of interest that is deductible in the first-mentioned State.

[New.]

4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

[Identical to paragraph 7 of the existing Article.]

2. COMMENTARY ON THE NEW ARTICLE 7

2. The following is the draft Commentary on the new Article 7. Where a paragraph comes from Parts I-IV of the Report on the Attribution of Profits to Permanent Establishments, from the Commentary as it read before the 2008 update (“pre-2008 Commentary”) or from the revised Commentary included in the 2008 update (“revised Commentary”), this is indicated in square brackets at the end of the paragraph. Paragraphs that are not in the current Commentary or in the revised Commentary on existing Article 7 are in ***bold italics***; where the paragraph is relatively similar to a paragraph of the existing Commentary or of the revised Commentary, the changes are shown in ***bold italics*** for additions and ~~strikethrough~~ for deletions.

I. Preliminary remarks

1. This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention. It incorporates the basic principle that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of

that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State. [REPLACES PARAGRAPH 1 OF THE PRE-2008 COMMENTARY]

2. *Article 5, which includes the definition of the concept of permanent establishment, is therefore relevant to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. That Article, however, does not itself allocate taxing rights: when an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, it is necessary to determine what, if any, are the profits that the other State may tax. Article 7 provides the answer to that question by determining that the other State may tax the profits that are attributable to the permanent establishment.* [REPLACES PARAGRAPH 1 OF THE PRE-2008 COMMENTARY]

3. *The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm's length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.* [ADAPTED FROM PARAGRAPH 2 OF THE PRE-2008 COMMENTARY]

4. *Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.¹ In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"² and to subsequent changes to the Commentary.* [BASED ON PARAGRAPH 5 OF THE REVISED COMMENTARY]

5. *Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled "Attribution of Profits to Permanent Establishments" (hereinafter referred to as "the Report"). The approach developed in the Report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating*

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1. "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises - Three Taxation Issues*, OECD, Paris, 1984.
 2. *Attribution of Income to Permanent Establishments*, Issues in International Taxation No. 5, OECD, Paris, 1994; reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(13)-1.

the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade. [BASED ON PARAGRAPH 6 OF THE REVISED COMMENTARY]

6. *The Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).* [NEW]

7. *When it approved the Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the Report and the interpretation of Article 7 previously given in this Commentary. For that reason, the Committee decided that a new version of Article 7 should be included in the Model Tax Convention to allow the full incorporation of these principles. The new Article, which was adopted in [2010], therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it.* [ADAPTED FROM PARAGRAPH 7 OF THE REVISED COMMENTARY]

II. Commentary on the provisions of the Article

Paragraph 1

8. *Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (e.g. income derived by an enterprise in respect of personal activities of an entertainer or sportsman).* [NEW]

9. *The first principle underlying paragraph 1, i.e. that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State sets up a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.* [ADAPTED FROM PARAGRAPH 3 OF THE PRE-2008 COMMENTARY]

10. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general “force of attraction” according to which income such as other

business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods or manufactures in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention. [PARAGRAPH 10 OF THE REVISED COMMENTARY, WHICH REPLACED PARAGRAPHS 5-10 OF THE PRE-2008 COMMENTARY]

11. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase “profits that are attributable to the permanent establishment” found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment. [NEW]

12. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10). [PARAGRAPH 10.1 OF THE PRE-2008 COMMENTARY]

Paragraph 2

13. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment 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, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise. [NEW]

14. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9). [NEW]

15. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, that directive paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits. [FIRST PART IS NEW; LAST TWO SENTENCES CORRESPOND TO THE LAST SENTENCE OF PARAGRAPH 11 OF THE REVISED COMMENTARY]

*16. Clearly, however, ~~where~~ ~~an enterprise of a Contracting State of~~ ~~has a permanent establishment in the other Contracting State~~, the ~~enterprise-first~~ State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with *either* Article 23 A *or* 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise. [PARAGRAPH 12 OF THE REVISED COMMENTARY]*

17. As indicated in paragraph 7 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2008. That Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose of the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2. [NEW]

18. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with unrelated enterprises, transactions with related enterprises (with direct application of the 1995 Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (e.g. risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the

risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).
[BASED ON PARAGRAPH 47 OF PART I]

19. Under the first step, a functional and factual analysis is undertaken which will lead to:

- The attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- The identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- The identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- The identification of other functions of the permanent establishment;
- The recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 23; and
- The attribution of capital based on the assets and risks attributed to the permanent establishment. [BASED ON THE LAST PART OF PARAGRAPH 47 OF PART I]

20. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the 1995 Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:

- The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and
- The application by analogy of one of the Guidelines' traditional transaction methods or, where such methods cannot be applied reliably, one of the transactional profit methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise. [BASED ON PARAGRAPH 47 OF PART I]

21. Each of these operations is discussed in greater detail in the Report, in particular as regards the attribution of profits to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (see Part II of the Report, which deals with permanent establishments of banks; Part III, which deals with permanent establishments of enterprises carrying on global trading, and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities). [NEW]

22. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the

enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (e.g. the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to the permanent establishment to reflect what a separate and independent enterprise would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between States R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty. [NEW]

23. *Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:*

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;*
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the taxpayer’s documentation does not practically impede the tax administration from determining an appropriate transfer price; and*
- the dealing presented in the taxpayer’s documentation does not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions.[BASED ON PARAGRAPHS 37 AND 39 OF PART I]*

24. *The opening words of paragraph 2 and the phrase “in each Contracting State” indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide*

relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose. [NEW]

25. *The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7. Assume, for example, that the circumstances of a particular case justify considering that the economic ownership of a building used by the permanent establishment should be attributed to the head office (see paragraph 104 of Part I of the Report). In such a case, paragraph 2 could require the deduction of a notional rent in determining the profits of the permanent establishment. That fiction, however, could not be interpreted as creating income from immovable property for the purposes of Article 6. Indeed, the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise; it merely applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7 and Article 23. Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise. Clearly, however, if interest paid by an enterprise to a different person is paid on indebtedness incurred in connection with a permanent establishment of the enterprise and is borne by that permanent establishment, this real interest payment may, under paragraph 2 of Article 11, be taxed by the State in which the permanent establishment is located. Where, however, a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States from treating any gain from such a transfer as a capital gain to which the rules of that Article will apply (see paragraphs 4, 8 and 10 of the Commentary on Article 13). [NEW]*

26. *Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 is not restricted to the application of Articles 7 and 23 but extends to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent provided for under domestic law). [NEW]*

The Committee has taken note of the fact that the domestic law of very few member countries provides for the taxation at source of notional payments that are recognised for purposes of attributing profits to permanent establishments. Accordingly, the Committee has decided not to make a determination at this time as to whether it is appropriate to supplement paragraph 26 by including in the Commentary the text of an alternative provision that could be used by States wishing to provide for the source taxation of any such notional payments. The

Committee will monitor this issue to determine whether any future change in circumstances warrants a re-examination of that decision.

27. Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses is a matter to be determined by domestic law, subject to other provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 29 and 30 below). [NEW]

28. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses will normally result in a different amount of taxable income in each State even though, for the purposes of the Convention, the amount of profits attributable to the permanent establishment will have been computed on the basis of paragraph 2 in both States (see also paragraphs 39-43 of the Commentary on Article 23). Thus, even though paragraph 2 applies equally to the Contracting State in which the permanent establishment is situated (for the purposes of paragraph 1) and to the other Contracting State (for the purposes of Articles 23 A or 23 B), it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given period of time, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B. [NEW]

29. In taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether these are incurred for the purposes of the taxation of the profits of a permanent establishment situated in a Contracting State or the taxation of the profits of an enterprise of that State. As stated in paragraph 24 of the Commentary on Article 24:

Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises. [NEW]

30. The requirement imposed by paragraph 3 of Article 24 is the same regardless of how expenses incurred by an enterprise for the benefit of a permanent establishment are taken into account for the purposes of paragraph 2 of Article 7. In some cases, it will not be appropriate to consider that a dealing has taken place between different parts of the enterprise. In such cases, expenses incurred by an enterprise for the purposes of the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment (e.g. the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment of a foreign enterprise). In other cases, expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment and an appropriate charge will be deducted in determining the profits attributable to the permanent establishment (e.g. overhead expenses related to administrative functions performed by the head office for the benefit of the permanent establishment. In both cases, paragraph 3 of Article 24 will

require that, as regards the permanent establishment, the expenses be deductible under the same conditions as those applicable to an enterprise of that State. Thus, any expense incurred by the enterprise directly or indirectly for the benefit of the permanent establishment should not, for tax purposes, be treated less favourably than a similar expense incurred by an enterprise of that State. That rule will apply regardless of whether or not, for the purposes of paragraph 2 of this Article 7, the expense is directly attributed to the permanent establishment (first example) or is attributed to another part of the enterprise but reflected in a notional charge to the permanent establishment (second example). [NEW]

31. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7. [PARAGRAPH 23 OF THE REVISED COMMENTARY]

32. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment. [PARAGRAPH 24 OF THE REVISED COMMENTARY]

33. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it. [PARAGRAPH 23 OF THE REVISED COMMENTARY]

34. *Article 7, as it read before [2010], included the following paragraph 3:*

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Whilst that paragraph was originally intended to clarify that paragraph 2 required expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account in determining the profits of the permanent establishment even if these expenses had been incurred outside the State in which the permanent establishment was located, it had sometimes been read as limiting the deduction of expenses that benefited indirectly the permanent establishment to the actual amount of the expenses. [NEW]

35. *This was especially the case of general and administrative expenses, which were expressly mentioned in that paragraph. Under the previous version of paragraph 2, as interpreted in the Commentary, this was generally not a problem since a share of the general and administrative expenses of the enterprise could usually only be allocated to a permanent establishment on a cost-basis.* [NEW]

36. As now worded, however, paragraph 2 requires the recognition and arm's length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (e.g. through the provision of assistance in day-to-day management). The deduction of an arm's length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all relevant expenses of the enterprise, wherever incurred, be taken into account, this being done, depending on the circumstances, through the deduction of all or part of the expenses or through the deduction of an arm's length charge in the case of a dealing between the permanent establishment and another part of the enterprise. [NEW]

37. Article 7, as it read before [2010], also included a provision that allowed the attribution of profits to a permanent establishment to be done on the basis of an apportionment of the total profits of the enterprise to its various parts. That method, however, was only to be applied to the extent that its application had been customary in a Contracting State and that the result was in accordance with the principles of Article 7. For the Committee, methods other than an apportionment of total profits of an enterprise can be applied even in the most difficult cases. The Committee therefore decided to delete that provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle. [NEW]

38. At the same time, the Committee also decided to eliminate another provision that was found in the previous version of the Article and according to which the profits to be attributed to the permanent establishment were to be "determined by the same method year by year unless there is good and sufficient reason to the contrary." That provision, which was intended to ensure continuous and consistent treatment, was appropriate as long as it was accepted that the profits attributable to a permanent establishment could be determined through direct or indirect methods or even on the basis of an apportionment of the total profits of the enterprise to its various parts. The new approach developed by the Committee, however, does not allow for the application of such fundamentally different methods and therefore avoids the need for such a provision. [NEW]

39. A final provision that was deleted from the Article at the same time provided that "[n]o profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." Subparagraph 4 d) of Article 5 recognises that where an enterprise of a Contracting State maintains in the other State a fixed place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justifies taxation in that other State. Where, however, subparagraph 4 d) is not applicable because other activities are carried on by the enterprise through that place of business, which therefore constitutes a permanent establishment, it is appropriate to attribute profits to all the functions performed at that location. Indeed, if the purchasing activities were performed by an independent enterprise, the purchaser would be remunerated on an arm's length basis for its services. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise would require that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the permanent establishment, such an exemption would raise administrative problems. The Committee therefore considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article. [NEW]

Paragraph 3

40. *Since paragraph 2 applies to both Contracting States (see paragraph 24 above), the combination of Articles 7 (which restricts the taxing rights of the State in which the permanent establishment is situated) and 23 (which obliges the other State to provide relief from double taxation) will in most cases ensure that there is no unrelieved double taxation of the profits that are attributable to the permanent establishment. [NEW]*

41. *Indeed, risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State which will ensure the same result for the purposes of Article 7 and Article 23. Insofar as each State agrees that the taxpayer has done so in conformity with paragraph 2 and with its domestic law, it should refrain from adjusting the profits on a different arm's length basis. This is illustrated in the following example. [NEW] [previously paragraph 44]*

42. *Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm's length price of 100 has been used to determine the profits attributable to the permanent establishment. The use of that amount is in conformity with the domestic law of each State and each State agrees that the price used is within an acceptable range of arm's length prices. In this case, both States should refrain from adjusting the profits on the basis that a different arm's length price should have been used; as long as there is agreement that the taxpayer has conformed with paragraph 2 and with the domestic law of each State, the tax administrations of both States cannot substitute their judgment for that of the taxpayer as to what are the most appropriate arm's length conditions. In this example, the fact that the same arm's length price has been used in both States and that both States will recognise that price for the purposes of the application of the Convention will ensure that any double taxation related to that dealing will be eliminated under Articles 23 A or 23 B. [NEW]*

43. *In limited circumstances, however, the fact that paragraph 2 allows different results could result in double taxation. One such case arises with respect to the attribution of "free capital" to a permanent establishment. [NEW]*

44. *As explained in paragraphs 136-183 of Part I of the Report "Attribution of Profits to Permanent Establishments", there are different acceptable approaches for attributing "free" capital to a permanent establishment that are capable of giving an arm's length result. The Committee recognised that the existence of these different acceptable approaches capable of giving an arm's length result could give rise to problems of double taxation. To the extent that the enterprise, in determining the profits attributable to the permanent establishment for the purposes of taxation in each Contracting State, has used the same approach resulting in what both States consider to be an arm's length result, no double taxation will result from the existence of different acceptable approaches. This, however, may not be possible if the domestic law rules of the State where the permanent establishment is located and of the other State require different acceptable approaches for attributing an arm's length amount of "free" capital to the permanent establishment. In such a case, the amount of profits calculated by the State of the permanent*

establishment may be higher than the amount of profits calculated by the other State for the purposes of relief of double taxation. [NEW]

45. *Paragraph 3 deals with this issue, which is especially problematic for financial institutions. It provides that a Contracting State must accept, for the purposes of determining the amount of interest deduction that will be used in computing double taxation relief, the attribution of “free” capital derived from the application of the approach used by the other State in which the permanent establishment of an enterprise of the first State is located if the following two conditions are met. First, the difference in capital attribution between the two States must result from conflicting domestic law choices of capital attribution methods. Second, the States must agree that the State in which the permanent establishment is located has used an authorised approach to the attribution of capital and that that approach produces a result consistent with the arm’s length principle in the particular case. The following example illustrates the application of the paragraph. [NEW]*

46. *Example. An enterprise of State R has incurred a number of loans some of which have directly or indirectly been used for the purposes of its permanent establishment situated in State S. The domestic law of State S requires that for the purposes of determining the profits attributable to a permanent establishment situated in State S, a certain amount of “free” capital be allocated to the permanent establishment; the domestic law of State S goes on to prescribe the use of a capital allocation approach (see paragraphs 155-161 of Part I of the Report) for that purpose. As a result of that approach, 9% of the overall interest paid by the enterprise is considered to be deductible in computing the profits attributable to the permanent establishment. The domestic law of State R similarly prescribes that a certain amount of “free” capital be allocated to the permanent establishment; that domestic law, however, prescribes the use of a thin capitalisation approach for that purpose (see paragraphs 163-168 of Part I of the Report). Based on that approach, 11% of the overall interest paid by the enterprise is considered to be deductible in computing the profits attributable to the permanent establishment. State R agrees that the application of State S’s method produces an arm’s length result that conforms with paragraph 2 in that particular case. In that situation, paragraph 3 will eliminate any double taxation that would otherwise result from the use of different capital allocation methods by requiring State R to follow the method used by State S to determine the amount of “free” capital of the permanent establishment. [NEW]*

47. *The agreement referred to in subparagraph a) of paragraph 3 may be made either with or without the mutual agreement procedure. On the one hand, a Contracting State may choose to accept the calculation of capital attribution by the other Contracting State where the permanent establishment is situated without the need to consult that other State. On the other hand, a Contracting State may prefer to make that agreement in the context of a mutual agreement procedure so as to be able to verify that the capital attribution method used by the other State produces arm’s length results. [NEW]*

48. *Paragraph 3 only applies with respect to differences in the determination of the profits attributed to a permanent establishment that result in the same part of the profits being attributed to different parts of the enterprise in conformity with the Article. As already explained (see paragraph 27 above), Article 7 does not deal with the computation of taxable income but, instead, with the attribution of profits for the purpose of the allocation of taxing rights between the two Contracting States. The Article therefore only serves to allocate revenues and expenses for the purposes of allocating taxing rights and does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law. Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable income on which tax will be levied in each State for a given taxable period may be*

different given differences in domestic law rules, e.g. for the recognition of income and the deduction of expenses. Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3. [NEW]

49. Also, paragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State's tax under the domestic law of that other State and in accordance with Article 23 A or 23 B. [NEW]

50. Paragraph 3 should not be understood to suggest that treaties without that paragraph provide no solution to cases of double taxation arising from conflicting applications of Article 7. Indeed, whenever the taxpayer considers that the actions of one or both Contracting States in respect of the taxation of its permanent establishment's profits result or will result in taxation not in accordance with the Convention, it is entitled to present its case to the competent authority of the Contracting State of which it is resident under paragraph 1 of Article 25. The taxpayer will also have potential access to arbitration under paragraph 5 of Article 25. Moreover, Article 23 already provides for a certain degree of entitlement to double taxation relief from the residence State where the permanent establishment State has taxed in accordance with Article 7. Finally, even where both States are taxing in accordance with the Convention but double taxation nevertheless remains, paragraph 3 of Article 25 authorises the competent authorities, in their discretion, to consult together for the elimination of such double taxation. Accordingly, paragraph 3 should be understood as providing supplemental protection against double taxation, beyond that available under the Convention, for a somewhat circumscribed but potentially important type of case. [NEW]

51. Contracting States may, however, also wish to address bilaterally other important cases where double taxation could arise from conflicting applications of Article 7. As already indicated, to the extent that the taxpayer has used in each Contracting State the same conditions, including the price, with respect to a particular dealing between the permanent establishment and another part of the enterprise and both Contracting States agree that these conditions reflect what independent enterprises would have done and therefore conform with paragraph 2 and with the domestic law of each State, neither State should seek to substitute other arm's length conditions for the ones used by that taxpayer. The same holds true for any arm's length approach or method that the taxpayer has used in both States to attribute profits to the permanent establishment. [NEW]

52. There are two situations, however, where double taxation could result from the fact that the Contracting States, in determining the profits attributable to the permanent establishment, have adopted different arm's length approaches or conditions that conform with paragraph 2. The first situation is where a Contracting State considers that the taxpayer has not used an approach or conditions that conform with paragraph 2 and accordingly adjusts the profits attributable to the permanent establishment. The second situation is where the domestic law of one or both Contracting States requires the taxpayer to use different approaches that, whilst conforming with paragraph 2, result in different amounts of profits being attributed to the permanent establishment (whilst paragraph 3 deals specifically with such cases in relation to the attribution of "free" capital to a permanent establishment, there may be other similar cases). [NEW]

53. *Where the taxpayer has not used conditions or methods that conform to paragraph 2, each State is entitled to make an adjustment in order to ensure that the profits have been attributed to the permanent establishment in conformity with paragraph 2. If that is the case, a different amount of profits may be attributed to the permanent establishment in each State with a risk of double taxation. Where one State has made an adjustment in conformity with paragraph 2, that paragraph certainly authorises the other State to make a reciprocal adjustment so as to avoid such double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. This problem could be addressed bilaterally by an additional paragraph, drafted along the following lines, that would provide a corresponding adjustment mechanism similar to the one provided for in paragraph 2 of Article 9 to deal with the comparable situation that could arise following the adjustment of the profits of an associated enterprise:*

Where, in accordance with this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other. For the purposes of this paragraph, where the profits that are attributable to the permanent establishment are determined in one State through the use of a method that is provided by the domestic law of that State and that results in profits that are different from those attributed to the permanent establishment in the other State, the first-mentioned State shall be deemed to have adjusted the profits attributable to the permanent establishment. [NEW]

54. *By virtue of its last sentence, this additional paragraph would also address cases of double taxation that result from the fact that, in conformity with Article 7, the profits attributable to the permanent establishment have been determined differently by each Contracting State because of the application of domestic law rules of either or both Contracting States. That sentence only applies to the extent that paragraph 3 has not already eliminated the difference in the determination of these profits or the resulting double taxation (paragraph 3 prevents a different determination of the profits that would otherwise result from different domestic rules dealing with the attribution of “free” capital to the permanent establishment). The additional paragraph would therefore also cover cases where the taxpayer is required by the domestic law rules of either or both States (other than rules dealing with the determination of “free” capital) to attribute in each State different amounts of profits to the permanent establishment. The last sentence of the additional paragraph deems each State to have adjusted the profits attributable to the permanent establishment, thereby imposing a reciprocal obligation on the other State to make an appropriate adjustment. Since the obligation imposed by the additional paragraph only exists to the extent necessary to eliminate double taxation, the obligation of one State will be extinguished by the other State making an appropriate adjustment. If neither State is willing to do so, the additional paragraph will allow the taxpayer to use the mutual agreement procedure to require the two States to eliminate any double taxation since failure by these States to do so would result in taxation not in accordance with the Convention, thereby triggering the application of paragraph 1 of Article 25 and, if necessary, of the arbitration provision of paragraph 5 of Article 25. [NEW]*

55. *The following two examples illustrate how this additional paragraph would apply. [NEW]*

56. *Example 1. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm's length price of 90 has been used to determine the profits attributable to the permanent establishment. State S accepts the amount used by the taxpayer but State R considers that the amount is below the range of arm's length prices required by both its domestic law and paragraph 2. It considers that the appropriate arm's length price that should have been used is 110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of the exemption (Article 23 A) or the credit (Article 23 B) claimed by the taxpayer with respect to the profits attributable to the permanent establishment. In that situation, since the same dealing will have received a price of 90 in State S and 110 in State R, profits of 20 may be subject to double taxation. The additional paragraph put forward in paragraph 53 above will address that situation by requiring State S, to the extent that there is indeed double taxation, to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States. If State S, however, does not agree that the adjustment by State R was warranted by paragraph 2, it will not consider that it has to make the adjustment. In such a case, the issue of whether State S should make the adjustment under the additional paragraph (if the adjustment by State R is justified under paragraph 2) or whether State R should refrain from making the initial adjustment (if it is not justified under paragraph 2) will be solved under a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25 (since it involves the question of whether the actions of one or both of the Contracting States have resulted or will result for the taxpayer in taxation not in accordance with the Convention).*

[NEW]

57. *Example 2: An enterprise of State R has incurred a number of loans some of which have directly or indirectly been used for the purposes of its permanent establishment situated in State S. Both States agree that the taxpayer's determination of the "free" capital that should be attributed to the permanent establishment is in conformity with paragraph 2 and neither State has domestic rules that require the taxpayer to allocate a different amount of "free" capital to the permanent establishment. The domestic law of State S, however, requires the use of a tracing approach to allocate part of the interest paid by the enterprise to the amount of debt needed to fund the activities of the permanent establishment. The domestic law of State R, on the other hand, requires the use of a fungibility approach for that purpose. Since the various loans carry different rates of interest, these different approaches will result in different amounts of interest being attributed to the permanent establishment even if the same overall amount of debt is attributed to the permanent establishment in the two States. Each State agrees that the application of either approach provided for under their respective domestic laws produces an arm's length result that conforms with paragraph 2 in that particular case (see paragraphs 189-191 of Part I of the Report). As a result of these different approaches, 25% of the overall interest paid by the enterprise is considered by State S to be deductible in computing the profits attributable to the permanent establishment whilst State R considers that 30% of the overall interest paid by the enterprise is deductible in computing the profits attributable to that permanent establishment. Since the difference is not attributable to different domestic rules concerning the allocation of "free" capital, paragraph 3 does not apply. In that particular case, the last part of the additional paragraph put forward in paragraph 53 above will deem each State to have adjusted the profits attributable to the permanent establishment, thereby imposing a reciprocal obligation on the other*

State to make an appropriate adjustment. Since that obligation only exists to the extent necessary to eliminate double taxation, the obligation of one State will be extinguished by the other State making an appropriate adjustment. If neither State is willing to do so, the additional paragraph will allow the taxpayer to use the mutual agreement procedure to require the two States to eliminate any double taxation since failure by these States to do so would result in taxation not in accordance with the Convention, thereby triggering the application of paragraph 1 of Article 25 (if necessary, the arbitration provision of paragraph 5 of Article 25 will be available to ensure that this requirement is satisfied). [NEW]

58. *Like paragraph 3, the additional paragraph put forward in paragraph 53 above addresses the concern that this Convention might not provide adequate protection against double taxation in situations where the two Contracting States take conflicting positions both of which are in conformity with the requirements of Article 7. As shown in the above examples, in addition to cases where the two States' domestic laws prescribe conflicting positions that each conform to the arm's length rule of paragraph 2, this category of situation could include cases where the two States arrive at conflicting attributions of profit to a permanent establishment because they are each determining the price of a dealing between the permanent establishment and another part of the enterprise of which it is a part by reference to different points within a mutually recognised arm's length range. In such situations, the concern is that both States could be considered to be taxing "in accordance with" the Convention, with the result that no provision of the Convention would provide an assured resolution of the resulting double taxation. [NEW]*

59. *The additional paragraph put forward in paragraph 53 above shares the main features of paragraph 2 of Article 9. First, it applies to each State with respect to an adjustment made (or deemed to have been made) by the other State. It therefore applies reciprocally whether the initial adjustment has been made by the State where the permanent establishment is situated or by the other State. Also, it does not apply unless there is an adjustment by one of the States. If the difference in the profits attributed to the permanent establishment in each State results exclusively from the taxpayer having used different arm's length methods or prices in each State (without being required to do so by the domestic law of either or both States), neither State is required to make an adjustment. [NEW]*

60. *As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under the additional paragraph simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The adjustment is due only if the other State considers that the adjusted profits conform with paragraph 2 (and paragraph 3, where applicable). In other words, the additional paragraph may not be invoked and should not be applied where the profits attributable to the permanent establishment are adjusted to a level that is different from what they would have been if they had been correctly computed in accordance with the directives of Article 7. Regardless of which State makes the primary adjustment, the other State is obliged to make an appropriate corresponding adjustment only if it considers that the adjusted profits correctly reflect what the profits would have been if the permanent establishment's dealings had been transactions at arm's length and thus that the primary adjustment is justified both in principle and as regards the amount. In that sense, this paragraph would require that other State to defer to the first State's primary adjustment where it agreed that the taxpayer had taken a non-arm's length position and the first State's primary adjustment had been made to a point within a range recognised as arm's length by both States; it would not allow that other State to refuse to give a corresponding adjustment solely on the grounds that it would have preferred the primary adjustment to have been made to another point in that arm's length range. [FIRST THREE SENTENCES BASED ON PARAGRAPH 6 OF THE COMMENTARY ON ARTICLE 9]*

61. *The additional paragraph does not specify the method by which a corresponding adjustment is to be made. Where the initial adjustment is made (or deemed to have been made) by the State in which the permanent establishment is situated, the adjustment provided for by the additional paragraph could be granted in the other State through the adjustment of the amount of income that must be exempted under Article 23 A or of the credit that must be granted under Article 23 B. Where the initial adjustment is made (or deemed to have been made) by that other State, the adjustment provided for by the additional paragraph could be made by the State in which the permanent establishment is situated by re-opening the assessment of the enterprise of the other State in order to reduce the taxable income by an appropriate amount. [BASED ON PARAGRAPH 7 OF THE COMMENTARY ON ARTICLE 9]*

62. *The issue of so-called “secondary adjustments”, which is discussed in paragraph 8 of the Commentary on Article 9, does not arise in the case of an adjustment under the additional paragraph. As indicated in paragraph 25 above, the determination of the profits attributable to a permanent establishment is only relevant for the purposes of Articles 7 and 23 and does not affect the application of other Articles of the Convention. [NEW]*

63. *Like paragraph 2 of Article 9, the additional paragraph leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text of either paragraph 2 of Article 9 or the additional paragraph ~~the Articles~~ but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 28, 29 and 30 of the Commentary on Article 25). [BASED ON PARAGRAPH 10 OF THE COMMENTARY ON ARTICLE 9]*

64. *If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the examples in paragraphs 56 and 57 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation or if the domestic law of one or both States requires the taxpayer to use different arm’s length prices or methods in each State and neither State grants the corresponding adjustment needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment (or the deemed adjustment) by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention. [THE FIRST PART OF THIS PARAGRAPH IS BASED ON PARAGRAPH 11 OF THE COMMENTARY ON ARTICLE 9]*

65. *The additional paragraph only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment. Assume, for instance, that the State where the permanent establishment is situated adjusts the profits that the taxpayer attributed to the permanent establishment to reflect the fact that the notional price of a dealing between the permanent establishment and the rest of the enterprise did not conform with the arm’s length*

principle. Assume that the other State also agrees that the price used by the taxpayer was not at arm's length. In that case, the combined application of paragraph 2 and of Articles 23 A or 23 B will require that other State to attribute to the permanent establishment, for the purposes of providing relief of double taxation, adjusted profits that would reflect an arm's length price. In such a case, the additional paragraph will only be relevant to the extent that different arm's length prices would be used by each State. [NEW]

66. Since the additional paragraph only applies to the extent necessary to eliminate double taxation, it cannot apply to the situation covered by paragraph 3, i.e. where the difference in the profits attributed to the permanent establishment in each State results from the domestic law rules of the State where the permanent establishment is located and of the other State requiring different acceptable approaches for attributing an arm's length amount of "free" capital to the permanent establishment. In that case, the application of paragraph 3 will eliminate the difference and there will be no double taxation to eliminate. [NEW]

67. Some States may prefer that the cases covered by the additional paragraph be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to either State's preferred position as to the appropriate arm's length price or method. These States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over what is the most appropriate arm's length price or method. States that share that view may prefer to use the following alternative version of the additional paragraph:

Where, in accordance with this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement. For the purposes of this paragraph, where the profits that are attributable to the permanent establishment are determined in one State through the use of a method that is provided by the domestic law of that State and that results in profits that are different from those attributed to the permanent establishment in the other State, the first-mentioned State shall be deemed to have adjusted the profits attributable to the permanent establishment. [NEW]

68. This alternative version is intended to ensure that the State being asked to give a corresponding adjustment would always be able to require that to be done through the mutual agreement procedure. This version differs significantly from the one included in paragraph 53 above e-in that it does not create a legal obligation on that State to agree to give a corresponding adjustment, even where it considers the adjustment made by the other State to have been made to a certain point in a mutually recognised arm's length range, if it would prefer a result at another point in that range. The provision would always give the possibility for a State to negotiate with the other State over what is the most appropriate arm's length price or method. Where the State in question does not unilaterally agree to make the corresponding adjustment, this version of the additional paragraph would ensure that the taxpayer has the right to access the mutual agreement procedure to have the case resolved. Moreover, where the mutual agreement procedure is triggered in such a case, the provision imposes a reciprocal legal obligation on the Contracting States to eliminate the double taxation by mutual agreement even though it does not provide a substantive standard to govern which State has the obligation to compromise its position to

achieve that mutual agreement. If the two Contracting States do not reach an agreement to eliminate the double taxation, they will both be in violation of their treaty obligation. The obligation to eliminate such cases of double taxation by mutual agreement is therefore stronger than the standard of paragraph 2 of Article 25, which merely requires the competent authorities to “endeavour” to resolve a case by mutual agreement. [NEW]

69. *If Contracting States agree bilaterally to include an additional paragraph along the lines of what is provided in paragraphs 53 or 68 above, the comments made in paragraphs 48, 49 and 50 as regards paragraph 3 will also apply with respect to that additional provision. [NEW]*

Paragraph 4

70. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries. [PARAGRAPH 32 OF THE PRE-2008 COMMENTARY]

71. *Absent paragraph 4, this interpretation of the term "profits", however, may give **could have given** rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are ~~treated~~ **dealt with** separately in other Articles of the Convention, e.g. dividends, ~~it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article~~ the question would have arisen as to which Article should apply to these categories of income, e.g. in the case of dividends, this Article or Article 10. [PARAGRAPH 33 OF THE PRE-2008 COMMENTARY]*

72. To the extent that ~~an~~ **the** application of this Article and ~~of the relevant other~~ **the special Article concerned** would result in the same tax treatment, there is little practical significance to this question. *Also, other Articles of the Convention deal specifically with this question with respect to some types of income (e.g. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 17 and paragraph 2 of Article 21).* Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21). [PARAGRAPH 34 OF THE PRE-2008 COMMENTARY]

73. *The question, however, could arise with respect to other types of income and it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to specific categories of income will have priority over Article 7.* It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from this rule that this Article 7 will be applicable to business profits which do not belong to categories of income covered by these **other** special Articles, and, in addition, to dividends, interest etc. **income** which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article 7 (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as income within Articles 7 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other. *This rule does not, however, govern the manner in which the income will be classified for the purposes of domestic law; thus, if a Contracting State may tax an item of income pursuant to other Articles of this Convention, that State may, for its own domestic tax purposes, characterise such income as it wishes*

(i.e. as business profits or as a specific category of income) provided that the tax treatment of that item of income is in accordance with the provisions of the Convention. ~~It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.~~ [PARAGRAPH 35 OF THE PRE-2008 COMMENTARY]

74. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term “profits” with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term “profits” includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits. [PARAGRAPH 36 OF THE PRE-2008 COMMENTARY]

75. *Finally, it should be noted that two categories of profits that were previously covered by other Articles of the Convention are now covered by Article 7.* ~~First, It should also be noted that,~~ whilst the definition of "royalties" in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial, or scientific equipment", the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers ~~to be~~ appropriate given the nature of such income. [PARAGRAPH 37 OF THE PRE-2008 COMMENTARY]

76. *Second, b*Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but *Article 14* ~~it~~ used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as use in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition, *in Article 3*, of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character. [PARAGRAPH 2.1 OF THE PRE-2008 COMMENTARY]

3. CONSEQUENTIAL CHANGES TO OTHER PARTS OF THE MODEL TAX CONVENTION

Introduction

3. Replace paragraph 27 of the Introduction by the following:

27. The Model Convention seeks, wherever possible, to specify for each situation a single rule. On certain points, however, it was thought necessary to leave in the Convention a certain degree of flexibility, compatible with the efficient implementation of the Model Convention. Member countries therefore enjoy a certain latitude, for example, with regard to fixing the rate of tax at source on dividends and interest *and*, the choice of method for eliminating double taxation ~~and, subject to certain conditions, the allocation of profits to a permanent establishment by apportionment of the total profits of the enterprise~~. Moreover, for some cases, alternative or additional provisions are mentioned in the Commentaries.

Article 5

4. Replace paragraph 16 of the Commentary on Article 5 by the following:

16. The paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed *through that office or workshop, taking into account the assets used and the* ~~and~~ risks assumed through that office or workshop, are attributed to the permanent establishment. This could include profits attributable to functions performed ~~and risks assumed~~ in relation to the various construction sites but only to the extent that these functions ~~and risks~~ are properly attributable to the office.

Explanation

5. The above changes clarify that profits are attributed based on the functions performed through the permanent establishment and that it is only to the extent that risks follow the functions that profits may be attributed to risks.

Article 8

Paragraph 20

6. Replace paragraph 20 of the Commentary on Article 8 by the following:

20. Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be ~~attributed to~~ *taxed in the State where the permanent establishment is situated*. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, ~~the permanent establishment's expenditure in respect of the operation of the ships, boats or aircraft should be attributed not to the permanent establishment~~

~~but to the enterprise itself, since none of the profit obtained through the carrying benefits the permanent establishment. ***even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State where the place of effective management of the enterprise is situated. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.***~~

Explanation

7. The Committee concluded that the last two sentences of paragraph 20 needed to be changed because these sentences were based on the view that Article 8 has the effect of modifying the rules of Article 7 on attribution of profits (and, therefore, the expenses deducted in computing these profits), whereas Article 8 merely provides that the part of the profits that relates to international transport functions is only taxable in the State where the place of effective management of the enterprise is situated.

Paragraph 21

8. Replace paragraph 21 of the Commentary on Article 8 by the following:

21. Where ships or aircraft are operated in international traffic, the application of the Article to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise; ***thus, even if such profits could be attributed to the permanent establishment under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated (a result that is confirmed by paragraph 6 of Article 7).*** ~~(for example, ships or aircraft put into service by the permanent establishment or figuring on the balance sheet of the permanent establishment).~~

Explanation

9. The Committee decided to replace the example included in the last part of the paragraph as that example suggested that merely having assets put in service through a permanent establishment or figure in a balance sheet prepared for a permanent establishment would be enough to attribute to the permanent establishment the profits derived from the use of these assets.

Article 10

10. Replace paragraph 32 of the Commentary on Article 10 by the following:

32. It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, ***also as explained below***, that the requirement that a shareholding be "effectively connected" to such a location ~~requires that the shareholding be genuinely connected to that business~~ ***requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes.***

32.1 A holding in respect of which dividends are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the “economic” ownership of the holding is allocated to that permanent establishment under the principles developed in the Committee’s report entitled “Attribution of Profits to Permanent Establishments”³ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the “economic” ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and the potential exposure to gains or losses from the appreciation or depreciation of the holding).

32.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a holding is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee’s report with respect to whether the income on or gain from that holding is taken into account in determining the permanent establishment’s yield on the amount of investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise’s reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

Explanation

11. Paragraph 4 of Article 10 refers to a shareholding “effectively connected with” a permanent establishment and paragraph 31 of the Commentary on that Article refers to holdings “forming part of the assets of the permanent establishment”. The Committee concluded that the meaning of these phrases, which are also used in other Articles and elsewhere in the Commentary, should be aligned with the principles developed to allocate the ownership of assets for the purposes of paragraph 2 of Article 7. It also concluded that paragraph 32 of the Commentary on Article 10 should be amended to clarify that shareholdings cannot be considered to be effectively connected with a permanent establishment or to form part of the business property of that permanent establishment unless the economic ownership of these shareholdings is allocated to that permanent establishment under these principles and that merely recording the shareholdings on the balance sheet of a permanent establishment would not be enough. Finally, paragraph 32.2 has been added to indicate that the determination of whether a shareholding is effectively connected with the permanent establishment of an enterprise carrying on insurance activities should be made in light of the specific guidance provided for in Part IV with respect to whether the income on or gain from that shareholding is taken into account in determining the permanent establishment’s yield on the amount of investment assets attributed to it.

Article 11

12. Replace paragraph 25 of the Commentary on Article 11 by the following:

25. It has been suggested that the paragraph could give rise to abuses through the transfer of loans to permanent establishments set up solely for that purpose in countries that offer preferential treatment to interest income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and,

3. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

~~also~~ ***explained below***, that the requirement that a debt-claim be “effectively connected” to such a location ~~requires that the debt claim be genuinely connected to that business~~ ***requires more than merely recording the debt-claims in the books of the permanent establishment for accounting purposes.***

25.1 A debt-claim in respect of which interest is paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the “economic” ownership of the debt-claim is allocated to that permanent establishment under the principles developed in the Committee’s report entitled “Attribution of Profits to Permanent Establishments”⁴ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the “economic” ownership of a debt-claim means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the interest attributable to the ownership of the debt-claim and the potential exposure to gains or losses from the appreciation or depreciation of the debt-claim).

25.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a debt-claim is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee’s report with respect to whether the income on or gain from that debt-claim is taken into account in determining the permanent establishment’s yield on the amount of investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise’s reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

Explanation

13. The reasons for this change are similar to those underlying the changes to paragraph 32 of the Commentary on Article 10 (see above).

Article 12

14. Replace paragraph 21 of the Commentary on Article 12 by the following:

21. It has been suggested that the paragraph could give rise to abuses through the transfer of rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to royalty income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, ~~also~~ ***explained below***, that the requirement that a right or property be “effectively connected” to such a location ~~requires that the debt claim be genuinely connected to that business~~ ***requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes.***

21.1 A right or property in respect of which royalties are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the “economic” ownership of that right or property is allocated to that permanent establishment

4. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

under the principles developed in the Committee’s report entitled “Attribution of Profits to Permanent Establishments”⁵ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the “economic” ownership of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the royalties attributable to the ownership of the right or property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property).

21.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a right or property is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee’s report with respect to whether the income on or gain from that right or property is taken into account in determining the permanent establishment’s yield on the amount of investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise’s reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

Explanation

15. The reasons for this change are similar to those underlying the changes to paragraph 32 of the Commentary on Article 10 (see above).

Article 13

16. Add the following paragraphs 27.1 and 27.2 to the Commentary on Article 13:

27.1 For the purposes of the paragraph, property will form part of the business property of a permanent establishment if the “economic” ownership of the property is allocated to that permanent establishment under the principles developed in the Committee’s report entitled “Attribution of Profits to Permanent Establishments”⁶ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the “economic” ownership of property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to any income attributable to the ownership of that property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that property). The mere fact that the property has been recorded, for accounting purposes, on a balance sheet prepared for the permanent establishment will therefore not be sufficient to conclude that it is effectively connected with that permanent establishment.

27.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether property will form part of the business property of the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee’s report with respect to whether the income on or gain from that property is taken into account in determining the permanent establishment’s yield on the amount of

5. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

6. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that form part of the business property of the permanent establishment.

Explanation

17. As indicated in the explanation on paragraph 32 of the Commentary on Article 10 (see above), the Committee has concluded that the meaning of the phrase "forming part of the business property of a permanent establishment" should be aligned with the principles developed to allocate the ownership of assets for the purposes of paragraph 2 of Article 7. It was also agreed to clarify that property cannot be considered to form part of the business property of a permanent establishment unless the economic ownership of the property is allocated to that permanent establishment under these principles and that merely recording the property on the balance sheet of a permanent establishment would not be enough. Finally, paragraph 27.2 has been added to indicate that the determination of whether property forms part of the property of the permanent establishment of an enterprise carrying on insurance activities should be made in light of the specific guidance provided for in Part IV with respect to whether the income or gain from that property is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it.

Article 15

18. Replace paragraph 7 of the Commentary on Article 15 by the following:

7. Under the third condition, if the employer has a permanent establishment in the State in which the employment is exercised, the exemption is given on condition that the remuneration is not borne by that permanent establishment. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph c) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised.

7.1 ~~In this regard, it must be noted that~~ The fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available *with respect to* ~~for~~ that remuneration *should be taken into account in determining the profits attributable to the permanent establishment* ~~would be allocated to the permanent establishment.~~ That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

7.2 *For the purpose of determining the profits attributable to a permanent establishment pursuant to paragraph 2 of Article 7, the remuneration paid to an employee of an enterprise of a Contracting State for employment services rendered in the other State for the benefit of a permanent establishment of the enterprise situated in that other State may, given the*

circumstances, either give rise to a direct deduction or give rise to the deduction of a notional charge, e.g. for notional services rendered to the permanent establishment by another part of the enterprise. In both cases, the remuneration of the employee is borne by the permanent establishment: since the notional charge required by the legal fiction of the separate and independent enterprise that is applicable under paragraph 2 of Article 7 is merely a mechanism provided for by that paragraph for the sole purpose of determining the profits attributable to the permanent establishment, it does not affect the reality that that remuneration paid by the employer is borne by the employer's permanent establishment.

Explanation

19. Paragraph 1 of Article 15 establishes the general rule that income from employment may be taxed in the State where the employment is actually exercised. Paragraph 2 contains, however, an exception for short-term employment that only applies, among other conditions, as long as the remuneration is not “borne by” a permanent establishment situated in that State.

20. The Report on Attribution of Profits to Permanent Establishments provide for a greater recognition of internal dealings in the area of services provided between different parts of the enterprise than what is currently allowed by the Commentary on Article 7. This raises the question of whether the remuneration for the employment services of employees of the enterprise who work for short periods of time for the benefit of a permanent establishment should be considered to be borne by the permanent establishment.

21. Assume, for example, that an employee of the head office of a bank resident in State R is asked to work for 130 days at a branch of the bank situated in State S. Assume further that it is appropriate, in accordance with the fiction of paragraph 2 of Article 7 as interpreted in the WP6 conclusions, to deduct, in determining the profits attributable to the permanent establishment, an amount representing the arm's length value of the services notionally rendered by the head office to the permanent establishment through the activities of the employee. In that case, for the purposes of subparagraphs 2c) of Article 15, should the remuneration of the employee be considered to have been “borne by” the permanent establishment?

22. The above-proposed change reflects the Committee's conclusion that in such a case, since the fiction of paragraph 2 of Article 7 does not apply for the purposes of Article 15, the remuneration of the employee should be considered to be borne by the permanent establishment for the purposes of paragraph 2 of that Article.

Article 21

23. Add new paragraphs 5.1 and 5.2 and replace paragraph 6 of the Commentary on Article 21 as follows:

5.1 *For the purposes of the paragraph, a right or property in respect of which income is paid will be effectively connected with a permanent establishment if the “economic” ownership of that right or property is allocated to that permanent establishment under the principles developed in the Committee's report entitled “Attribution of Profits to Permanent Establishments”⁷ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the “economic” ownership of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the income attributable to the ownership of the right or property, the right to any available*

7. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property).

5.2 *In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a right or property is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that right or property is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.*

6. Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases where the arrangements were primarily made for the purpose of taking advantage of this provision. *Also, the requirement that a right or property be "effectively connected" with such a location requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes.*

Explanation

24. The reasons for this change are similar to those underlying the changes to paragraph 32 of the Commentary on Article 10 (see above).

Article 22

25. Add the following paragraphs 3.1 and 3.2 to the Commentary on Article 22:

3.1 *For the purposes of paragraph 2, property will form part of the business property of a permanent establishment if the "economic" ownership of the property is allocated to that permanent establishment under the principles developed in the Committee's report entitled "Attribution of Profits to Permanent Establishments"⁸ (see in particular paragraphs 101 to 128 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to any income attributable to the ownership of that property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that property). The mere fact that the property has been recorded, for accounting purposes, on a balance sheet prepared for the permanent establishment will therefore not be sufficient to conclude that it is effectively connected with that permanent establishment.*

8. *Attribution of Profits to Permanent Establishments, Paris, OECD, 2008.*

3.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether property will form part of the business property of the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee’s report with respect to whether the income on or gain from that property is taken into account in determining the permanent establishment’s yield on the amount of investment assets attributed to it (see in particular paragraphs 165-170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise’s reasonable and consistent application of that guidance for purposes of identifying the specific assets that form part of the business property of the permanent establishment.

Explanation

26. The reasons for these additions are similar to those underlying the addition of paragraphs 27.1 and 27.2 of the Commentary on Article 13 (see above).

Article 24

Paragraph 20

27. Replace paragraph 20 of the Commentary on Article 24 by the following:

20. It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied. ***For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 which provides that the profits attributable to the permanent establishment are those that a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions would have been expected to make. Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7 cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.***

Explanation

28. The argument was apparently put forward by some commentators that paragraph 3 of the Article 24, since it requires that the taxation of a permanent establishment in a State “shall not be less favourably levied” than the taxation of enterprises of that State, could require the deduction of a notional payment in determining the profits attributable to a permanent establishment because, without such a deduction, the permanent establishment would receive less favourable treatment since it cannot deduct what is economically equivalent to a payment made by a local enterprise. Conversely, it was also argued that paragraph 3 of Article 24 could be read to prevent a permanent establishment from being taxed on notional payments considered to be received from its head office (or another part of the enterprise) since a local enterprise is only taxed on real payments and not on notional payments.

29. The Committee concluded, however, that “notional payments” are simply an accounting artifice limited to the application of the fiction enacted by paragraph 2 of Article 7 for the purposes of attributing profits to a permanent establishment. For the purposes of paragraph 3 of Article 24, there are no “payments” between a permanent establishment and the rest of the enterprise but merely an attribution of business profits. The fact that such special accounting artifice applies only with respect to permanent establishments and not with respect to local enterprises, whether by virtue of the paragraph 2 of Article 7 only or by virtue of that treaty provision and the domestic law of a Contracting State, should not be considered to be in violation of paragraph 3. To the extent that that artifice is mandated by the treaty itself, it should not constitute a violation of Article 24 when that Article is interpreted in the context of the whole treaty, as required by Article 31(1) of the *Vienna Convention on the Law of Treaties*. Also, the purpose of the accounting artifice of assuming a “notional payment” is to attribute to the permanent establishment the profits that a local enterprise carrying on similar activities would have earned. Since paragraph 3 requires that the taxation of the permanent establishment be not less favourable than that of a resident enterprise carrying on similar activities, it is based on the same principle as paragraph 2 of Article 7 and what is required by the latter paragraph should therefore be acceptable for purposes of paragraph 3.

30. The Committee therefore concluded that paragraph 3 of Article 24 is generally not relevant to the issue of notional payments and decided to clarify the Commentary accordingly.

Paragraph 24

31. Replace subparagraph 24 a) of the Commentary on Article 24 by the following

24. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

- a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits ~~in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise~~. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises (*see also paragraph 29 of the Commentary on Article 7*).

Explanation

32. The existing Commentary on Article 7 generally recommends that a share of the general administrative expenses of an enterprise should be allocated to a permanent establishment on a cost-basis (see paragraph 17.7 of the Commentary on Article 7). The Report on Attribution of Profits to Permanent Establishments, however, generally considers that where management services are performed by the head office for the benefit of a permanent establishment, a charge for notional services should be recognised. The above-proposed change eliminates from the Commentary on Article 24 the reference to the approach underlying the current Commentary.

Article 26

33. Replace subparagraph 7 c) of the Commentary on Article 26 by the following:

7. Application of the Convention

...

- c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated *enterprises* ~~companies~~ in different States or *the proper determination of the profits attributable to a permanent establishment situated in one*

~~*State of an enterprise of the other State* the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23 A and 23 B).~~

Explanation

34. The Committee considers that the new formulation better reflects the approach underlying the Report on Attribution of Profits to Permanent Establishments and that a reference to “associated enterprises” is more accurate than the current reference to “associated companies”.