News Analysis: Revenge of the Source Countries?
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In news analysis, Lee Sheppard dissects the OECD’s discussion draft on the attribution of profits to a business’s permanent establishment in a foreign country.

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Some of our readers wonder where the ideas for the intros to these articles come from. Serendipity.

Your correspondent, on arriving in Washington for the February 24-25 International Fiscal Association meeting, was walking from the train station to the hotel, when what should suddenly appear on a theater marquee? An absolutely not-to-be-missed theatrical train wreck -- the road show of The Graduate, with Morgan Fairchild as pop culture's favorite old tart, Mrs. Robinson.

For our cave-dwelling readers, Morgan Fairchild is an aging soap opera actress who has made a specialty of playing old tarts for as long as anyone can remember, most notably two decades ago on Falcon Crest, a prime-time soap opera that starred Ronald Reagan's ex-wife Jane Wyman as the matriarch. Fairchild, who is from Texas, where even women who aren't in show business routinely get implants, has disproportionate surgical enhancement.

Which brings us to the nudity question -- The Graduate having become a vehicle for older actresses, with the promise of dimly lit disrobing of some C-lister as the hook. On this point, our readers' money might be better spent at the local strip club. With the exception of the tentative and nerdy Benjamin -- copying Dustin Hoffman, who was cast against type -- the acting is about as good as it is at the local strip club. La Fairchild struts and preens her way through the production in a series of retro dresses that are pulling at the side seams. She can't act, but she could float.

Nonetheless, the show is enjoyable because the writing is great. The script comes more from the book than from the movie, so that while the play is not as frantic as the movie, some of the social statements are clearer. Benjamin's eventual marriage to Elaine Robinson is shown not as the fulfillment of a love story but as the last-ditch concession to conformity that it is. Benjamin's rebellion against his "grotesque" parents and their materialistic lifestyle consisted entirely of a fling with dad's business partner's alcoholic wife. Some rebellion.

Of course the OECD knows a thing or two about dressing up the old slapper. In the OECD's case, the old boiler in need of powder and paint would be transfer pricing on the separate accounting model. And unlike the producers of the road show of The Graduate, the OECD is not working from good material. Having noticed that taxpayers were taking advantage of separate company accounting by stripping income out of high-tax countries where they need to operate, the OECD has contrived to help beleaguered tax collectors find a hook to tax them. Sort of. When the Italians got a bit too creative in that regard, the OECD slapped them down at the behest of business.

The OECD's latest volley in this effort is a four-part discussion draft on the attribution of profits to a permanent establishment, accompanied by an announcement that the organization has finished testing its working hypothesis on attribution of profits to a PE and is satisfied that it will work. Three parts of the four-part discussion draft have been published, having to do with general considerations, banking, and global trading. (Insurance is forthcoming.)

The OECD recently announced that none of the drafts will go final until the insurance draft and new language to be included in article 7 commentary are completed. The whole mess is supposed to be completed by January 2007.

This article discusses the draft on general considerations (hereinafter the article 7 discussion draft), which when adopted will become commentary of article 7 of the OECD model treaty, as well as recent guidance on article 5. Article 5 says whether a PE exists, and article 7 says how profits are to be attributed to it once it is found to exist. The threshold decision under article 5, as the following discussion will show, is the more important. (Doc 2004-15880 [PDF], 2004 WTD 150-2). For the general considerations draft, see http://www.oecd.org/dataoecd/22/51/33637685.pdf.)

Meanwhile, tax examiners from some source countries have opted to put the OECD’s definition of PE and suggestions for the attribution of profits thereto into administrative practice, much to the consternation of the complaining business people. But the OECD model treaty, the versions that these countries have signed, and the existing and draft interpretations can only get the beleaguered source-country tax administrators so far. At every turn, there is an existing provision or interpretation, usually involving undue respect for legal entities and separate accounting, that blocks the path to allocation of more revenue to source countries.

Permanent Establishment
The concepts of PE and profits attributable to a PE are bedrock principles of tax treaties entered into by OECD member countries. That is because treaties frequently feature the source country ceding its primary right to tax an item of income to the earner's country of residence. That ceding of jurisdiction is usually accomplished by the source country promising to tax only the profits attributable to a PE in that country. A PE can be a fixed place of business, subject to some very generous exceptions, or a dependent agent, subject to interpretation.

In other words, under prevailing treaty practice, metal bashers pay tax and investors do not. This has become an administratively questionable practice in a world where everyone pretends to be a nonresident investor, and metal bashers have become employees’ beneficiary associations.

The practice of the source country ceding tax jurisdiction seemed like a good idea when the world was full of manufacturers, but they are all in Asia now. And some of those Asian countries, like India, take the pragmatic approach and collect tax at the source, instead of ceding jurisdiction in treaties. The world of OECD member countries is full of financial intermediaries, remote sellers, and nonresident investors, all of which are perfectly capable of doing business in a country without maintaining any physical presence there.

The OECD maintains a dichotomy between the taxation of PEs, which are taxed on the basis of activities, and the taxation of subsidiaries, which are taxed on the basis of residence. Indeed, in its revised March 2003 discussion draft on bank PEs, the OECD has said that parity between branch and subsidiary treatment is not intended in all circumstances, because it really believes that the different legal forms have some economic effects. That is nonsense, but business screams when legal forms are not respected and accuses the OECD of treating subsidiaries like branches.

There cannot be a discussion about attribution of profits to a PE under article 7 of the OECD model treaty without an update on the recent expansion of the definition of PE in the form of new article 5 commentary. (For the OECD model treaty with commentary, see the Tax Analysts Web site, http://www.taxanalysts.com. For the OECD model treaty without commentary, see http://www.oecd.org/dataoecd/52/34/1914467.pdf.)

Under paragraph 1 of article 5 of the OECD model treaty, a PE is "a fixed place of business" through which the business of the nonresident enterprise is regularly pursued. In 2003 the OECD expanded the notion of "place of business" to include having space at the disposal of the enterprise. The OECD expanded the concept of "fixed" to bring multiple locations within a country together if they perform complementary functions.

Paragraph 4.1 of the commentary on article 5 states: "the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business." But then paragraph 4.2 cautions: "the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise."

How's that again? Paragraph 4.5 contains the infamous "painter" example. For two years, a painter spends three days a week in the office building of its main client, painting. The OECD concludes that the presence of the painter in the office building where he is performing the "most important functions of his business" constitutes a PE of the painter. But if that painter worked successively on a series of unrelated contracts in the same building, he might not have a PE by virtue of having no fixed place of business. Business is apoplectic about this example. (Doc 2004-14257 [PDF], 2004 WTD 134-11 [1].)

Moreover, a computer server, unattended by natural persons, could constitute a PE if it were a fixed place of business and if it performed core functions that went beyond preparatory and auxiliary functions. Paragraph 42.6 of the commentary on article 5 states that "the presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location."

In paragraph 6 of the commentary on article 5, the OECD threw tax planners for a loop by shortening the administrative guideline period for finding the existence of a PE from 12 months to 6 months. Moreover, the OECD gave tax administrators its blessing to combine recurrent shorter periods of time when a place of business in the source country is used, noting that "temporary interruptions of activities do not cause a PE to cease to exist."

The OECD further shocked business by expanding the scope of agency PE. An agent need not be a resident or have a fixed place of business in the source country for a PE to be deemed to exist there on the basis of the agent's authority to make contracts on behalf of the principal. It is the activity of the agent and not the agent's presence that constitutes the PE. Conversely, it makes no difference if a dependent agent has no authority to conclude contracts if it has a fixed place of business.

There is also a new set of factors for determining when an agent is independent. The determination of whether and when an agent has the authority to conclude contracts in the source country depends on the nature of the contracts and the principal's business. There is a lot of law and commentary on the meaning of "dependent" and almost none on the meaning of "agent." Paragraph 38 of the commentary on article 5 of the model treaty asks whether the agent is subject to comprehensive control or detailed instructions, and whether it bears entrepreneurial risk.
Businesses have complained long and loud about the OECD's effort to expand the definition of PE but have not offered any constructive alternatives, perhaps because they benefit from the inefficacy of separate company accounting. They want certainty on whether a PE exists and argue that the OECD proposals reduce certainty by ignoring legal forms. They complaint that the OECD's treatment of dependent agents as PEs would unfairly allocate profit to entities with minimal functions. In short, they want to be able to conduct business in a country without ever being considered to have created a PE.

Business does not want a PE to be deemed to exist if meaningful amounts of income would not be allocated to it. The OECD's business advisory group insists that stripping income out of some countries is "cost-effective" and that international trade would be deleteriously affected if PEs in those countries were deemed to exist. The group further argues that any income attributed to those PEs should be minimal. (Doc 2004-14257 [PDF], 2004 WTD 134-14.)

Forza Italia

In April 2004 the OECD issued a management services discussion draft to clarify the definition of PE under article 5 of the OECD model treaty. Under paragraph 2 of article 5 of the model treaty, a "place of management" can be a fixed place of business that could create a PE. (Doc 2004-8256 [PDF], 2004 WTD 74-2.) For the draft, see http://www.oecd.org/dataoecd/33/9/31483903.pdf.)

The OECD was acting to reverse a case, Ministry of Finance (Tax Office) v. Philip Morris (GmbH), Corte Suprema di Cassazione, No. 7682/02 (25 May 2002), in which the Italian Supreme Court held that a group could have a PE, which could exist by virtue of mere participation in contract negotiations. The case presented an interesting intersection between the idea of a PE as a fixed place of business and as a dependent agent. (For coverage, see Doc 2002-7376 [PDF], 2002 WTD 59-1.) For discussion, see Doc 2002-20001 [PDF], 2002 WTD 169-1 and Doc 2004-9520 [PDF], 2004 WTD 106-13.)

Philip Morris's German subsidiary had no office in Italy. It obtained access to the not inconsiderable Italian cigarette market by selling cigarettes and licensing its trademarks to the Italian government tobacco monopoly, AAMS. It also had a separate contract with a private Italian company, Intertaba, which required the latter to monitor distribution of Philip Morris products by AAMS and do promotional activities. Intertaba's activities were critically important to the Philip Morris business in Italy. The German subsidiary had an indirect shareholding in Intertaba as well. The point of having no subsidiary set up in Italy was to avoid Italian tax on royalties from AAMS. Intertaba was designed not to be a PE by virtue of having its own substantive business.

The Italian tax administrator found a PE for the German subsidiary in Italy based on its relationship with Intertaba. Italy sought to tax the gross proceeds from the subsidiary's dealings with AAMS without allowing any deductions. After two lower courts upheld the taxpayer's position, the Supreme Court reversed and remanded for reconsideration based on a set of five criteria. Those criteria included the idea that a group could have a PE, which could be divined by looking at the common business strategy of the worldwide group.

The Italian Supreme Court further found that the "entrusting of management of business transactions to a 'national structure' . . . causes that structure to take on the status of a PE . . . even if it concerns a certain area of business." Knocking out the favorite business argument that every challenged action is merely "preparatory and auxiliary," the court stated that the "supervision or control of the proper performance of a contract . . . cannot be considered -- in principle -- auxiliary." For that statement the court cited article 5, paragraph 4, of the OECD model, and article 5, paragraph 3(e), of the Italy-Germany tax treaty.

Under paragraph 4 of article 4, there is no fixed place of business PE if the multinational group maintains a warehouse, showroom, purchasing office, or any combination thereof as long as the combination does not rise to the level of a PE. That would be the "preparatory and auxiliary" out, which is leniently interpreted in the commentaries. A taxpayer can have an awful lot of activity and stuff in a source country without having a PE there. The activities and facilities listed in paragraph 4 are automatically deemed to be "preparatory and auxiliary," even when they are permanent.

But that activity cannot rise to the level of management. Paragraph 24 of the commentary on article 5 states: "A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level."

Once the situation is beyond paragraph 4, however, there is not necessarily a PE. That is, if a fixed place of business does not make a PE, then there must be a dependent agent. The question becomes whether Intertaba was a dependent agent of Philip Morris's German subsidiary, so that income could be attributed to a dependent agent PE under paragraph 5 of article 5. There's nothing to prevent Intertaba from being a dependent agent, even though it is not controlled by Philip Morris. Under paragraph 5 of article 5 of the OECD model treaty, a dependent agent creates a PE of the nonresident principal when the agent has and habitually exercises the authority to conclude contracts on behalf of the principal.

"Agent," however, is undefined in OECD model treaties. It is left up to local law, and Italy is a civil law country. Under the common law, anyone acting with apparent authority is an agent. Under civil law, it is harder to deem an agent to exist. In practice, once an agency relationship is found, the resulting agent is likely to be a dependent agent. The Italian Supreme Court appears to have concluded that Intertaba was a dependent agent, based on its participation in contract negotiations, and that the German
South Africa, a civil law jurisdiction that was fed up with taxpayer antics, creatively addressed the apparent agency problem by changing its law to broaden the definition of agent and asking for extensive information about the activities of local affiliates. (Doc 2002-16965 [PDF], 2002 WTD 140-2, and Doc 2000-27840, 2000 WTD 210-3.)

The Italian Supreme Court significantly stated that substance and not form should determine whether a PE exists. The court had it right conceptually and economically, but unfortunately the Italian government signed versions of the OECD model treaty.

In its management services discussion draft, the OECD rejected the idea that a group, as opposed to a single corporation, could have a PE. A PE has to be determined on a separate company basis without regard to control relationships. That was the big statement in the discussion draft, and the main reason that the OECD seemingly rushed to the rescue of complaining businesses with this draft. The OECD is adamant that, for better or worse, an "enterprise" is a separate legal entity, not a group or a unitary business.

"Enterprise" is a term used throughout the OECD model and treaties based on it. It has never been explicitly defined but is traditionally interpreted to respect separate legal entities. The interpretation is an important question because, under article 5, a PE belongs to a nonresident "enterprise." Business representatives are having fits about the Italian decision, arguing that a PE has to belong to some separate legal entity. (Doc 2003-22777 [PDF], 2003 WTD 203-12.) The OECD appears to have split the baby by instructing that in some cases the entity to which the PE belongs is the group's parent. (Doc 2004-9743 [PDF], 2004 WTD 90-15.)

The Italian Supreme Court, in Philip Morris, took the economically realistic position that an enterprise is the whole multinational group. Of course a group can have a PE, as a practical matter. Of course a group can be considered to be in a unitary business. The Italians correctly understand that a corporation is a piece of paper. It is an election. There is no reason that a tax administrator should have to accept economically meaningless legal differences in form of organization, or ascribe differences in taxable profit to them.

Well, could "enterprise" be reinterpreted to encompass a group? Certainly other model treaty terms have been reinterpreted, usually at the behest of the Americans, to mean something other than what they have historically connoted. The answer in the case of "enterprise" is no, at least without amendment of the model itself, because a reading of "enterprise" as group would make article 9 of the model treaty, which speaks of groups, redundant. Moreover, the model treaty as a whole does not contemplate taxation of groups.

The OECD model treaty's failure to think in terms of groups is a significant failing, but not one that is curable in a discussion draft. Ironically, as this article's discussion of the IRS's section 482 services regulations will show, the Americans are more inclined to think of an "enterprise" as a group or a unitary business than is the OECD. One American official recently shocked business types by stating that "enterprise" should mean the whole ball of worldwide wax, looking at the functions. This would indicate creeping formulary and profit-split methods, as in the services regulations. (Doc 2004-9743 [PDF], 2004 WTD 90-15.)

The OECD management services discussion draft stated that the provision of services through a fixed place of business does not mean that the nonresident service recipient is carrying on its own business there by virtue of having management services provided to it. The draft insists that the provision of management services is not in furtherance of the service recipient's business, but instead should be considered to be in furtherance of the service provider's business. How's that again? This would mean that Intertaba's premises were not "at the disposal" of the German subsidiary. Thus the latter would have no PE based on a fixed place of business in Italy.

The OECD management services discussion draft further stated that mere participation in contract negotiations does not indicate a power to conclude contracts under paragraph 5 of article 5. The OECD management services discussion draft insists that:

The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise.

So if Intertaba could negotiate on behalf of Philip Morris but had no power to sign off on a deal, Philip Morris would have no dependent agent PE in Italy. That is, of course, sophistry. Styled as a clarification, it appears to contradict existing article 5 commentary. The Italian Supreme Court was correct under the existing commentary.

But the OECD did not give multinational taxpayers everything they wanted. It did not comment on the substance-over-form holding. There is a substance-over-form comment in paragraph 33 of the commentary on article 5. This comment appears to contradict the position of the management services discussion draft. Paragraph 33 states:
A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State," even if the contract is signed by another person in the State in which the enterprise is situated.

Paragraph 32.1 reinforces the idea that a dependent agent need not have sign-off authority:

The phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent.

Why didn't the OECD just badmouth the Philip Morris decision on the narrower basis of the Italian court's failure to allow expenses to offset gross income? Paragraph 3 of article 7 requires allowance of expense deductions to a PE. The OECD seems to have been anxious to placate business. That being said, member countries don't always go along with business-friendly interpretations.

Paragraph 2 of article 5 lists examples of PEs, among which are a place of management, a branch, an office, a factory, a workshop, and a mine. But then paragraph 12 of the commentary to article 5 states that those examples still must separately meet the fixed place of business requirement if they are to be considered PEs. Italy says no to that further requirement. Italy believes that the paragraph 2 examples "can always be regarded as constituting a priori PEs." Consistent with that view, Italy has adopted a statutory definition of PE stating that those examples are always PEs. (For discussion, see Doc 2004-15625 [PDF], 2004 WTD 150-14.)

Italy is not a renegade in this regard, which is why business fretted that other countries would take up the Philip Morris rationale. Australia reserves the right to treat an enterprise as having a PE there when the enterprise carries on designated supervisory activities for more than 12 months, or when a person acting on behalf of the enterprise manufactures or processes goods or merchandise belonging to the enterprise.

So the OECD wants to beat back the expansive Philip Morris interpretation, but simultaneously wants to stop the cheesier versions of PE avoidance, such as commissionaire setups. This means that multinational groups would be advised to hire really expensive tax advisers to plan with quasi-related partners and should not purchase off-the-peg advice from accounting firms.

Nonetheless, the article 7 discussion draft would empower the source country to potentially tax more of a group's profits than the group might have chosen to assign to the local PE. Taxpayers are fond of using commissionaires in third countries, which basically siphon some of the selling profit away from both the parent and the operating companies. Commissionaires would potentially become PEs of the parent under the discussion draft.

The article 7 discussion draft is premised on the source country already having found a PE, particularly a dependent agent PE, under article 5 of the model treaty. The draft has the limited purpose of telling the source country how to allocate profits to the PE under existing treaties. The draft does not supply additional justification or jurisdiction for a source-country tax administrator to conclude that a PE exists, the crucial threshold decision. Yet, as the Philip Morris case and the unfortunate OECD response to it demonstrate, existing law, treaties, and interpretations are hamstringing source country tax administrators when a nonresident clearly has a presence and is doing a lot of business in the country.

The job of identifying the weaknesses in existing treaties and interpretations falls to the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (OECD TAG), which is about to issue its final report. Electronic commerce was the original impetus for the OECD's beginning to think about tax jurisdiction and nexus questions, but taxpayer creativity with legal relationships among separate entities has provided a more immediate need for rethinking old structures. In the group's forthcoming final report, members disagreed heartily about what the basis for taxing profits of nonresident businesses should be. (For a previous report, see http://www.oecd.org/dataoecd/46/29/1923350.pdf.)

Historically, the multinational agreement reflected in the OECD model treaty has been not to allow the source country to tax nonresident business profits on the basis of the supplying of goods or services in response to demand in a market in the source country. Moreover, the technical advisory group's forthcoming report will reject market as a basis of tax jurisdiction. Of course that rejection greases the wheels of commerce; a tax is a cost, and being able to sell without tax lowers costs. But a tax is also a social responsibility, and that longstanding consensus is looking more foolish by the day.

The Chimera

Once a PE has been deemed to exist, the OECD considers it to be a separate, freestanding enterprise, and tries to allocate profits to it using separate company accounting. Article 7 of the OECD model treaty states that the profits to be attributed to a PE are
"the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

The idea of treating a PE as a separate enterprise is, of course, ludicrous, since the whole point of being a multinational enterprise is not to have to pay arm's-length prices to affiliates, whether they are vertically integrated or part of a keiretsu-style network. But separate accounting is the American-imposed international standard. It has provided remunerative employment for many of our readers, including economists, and has given multinationals ample opportunity to minimize tax everywhere.

The idea that a PE can be described as a hypothetical freestanding company reached its apogee in February 2001 when the OECD put forward the "working hypothesis," which has become the authorized OECD approach. The OECD is taking a flawed banking model, complete with attribution of risk and capital, on the road to apply it to all types of enterprises, regardless of whether it is suitable to describe what they do. Commentators have argued that this will perversely increase the potential for income stripping rather than reduce it. They further argue that an attempt to ascribe source on the basis of risk could ultimately endanger source principles. (For discussion, see Doc 2004-22744 [PDF], 2005 WTD 26-14.)

In the authorized OECD approach, the OECD would assign profits based on the functions performed by the PE, assuming that arm's-length prices can be derived for them. As a practical matter, the functional analysis is a nose-count of the people, an attempt to find a market price for their tasks, plus allocation of some of the group's equity capital to the PE. What happens when the PE is a people-free computer server? No entrepreneurial risk is to be attributed to it.

The OECD chose to recognize intercompany transactions, which prior interpretations of the OECD model wisely ignored. The drafters recognize that many intercompany transactions are phony, so they would ignore those, while trying to ascribe commercial terms to legitimate intercompany transactions that are undocumented, as is frequently the case. Each intercompany transaction is to be tested for economic substance to determine whether it is worthy of recognition. Internal guarantees and interest payments would generally be ignored. Taxpayers may be tempted to extensively document those intercompany transactions they want recognized and not to memorialize those they want ignored. (For discussion, see Doc 2001-23928 [PDF], 2001 TNT 180-4.)

The OECD plans to cement the authorized OECD approach in a final version of amendments to the commentaries to article 7 of the OECD treaty. Thus the authorized OECD approach would become the preferred method of allocating profits to PEs, and the arm's-length results derived would cap the profits that a country could attribute to a PE.

It should be noted that paragraph 4 of article 7 of the OECD model treaty not only does not prevent countries from using formulary apportionment to attribute profits to a PE, but also explicitly grandfather those that did. The drafters of the authorized OECD approach, however, did not want the baggage of past practice to get in the way of their flight of separate-accounting fantasy. The discussion draft states that paragraph 4 is limited to grandfathering the practices of countries already using formulary apportionment, and cautions that formulary apportionment is not to be used to attribute profits to a PE. (Paragraphs 295-300.)

The IRS has already adopted much of the authorized OECD approach in the proposed section 482 services regulations. The proposed regulations ask whether a "specific benefit" has been provided when one affiliate renders a service to another. The regulations ask whether there has been "a reasonably identifiable increment of economic or commercial value" to the service recipient. That is a significant expansion of the reach of the current regulation, which asks whether a third-party service provider would charge for the services, not whether the recipient would be willing to pay for them. (For the regulations, see 2003 WTD 179-17, 2003 TNT 178-21, or Doc 2003-20158 [PDF].)

The proposed regulations would formalize seven traditionally used methods of transfer pricing that are consistent with the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Among the methods are comparable and residual profit-split methods, to be used when the services have a high value or cannot be segregated from other transactions. When there are no comparable transactions, the residual profit-split method would be invoked as a default method. The OECD guidelines are unremittingly hostile to profit-split methods, basically saying that profit-split methods should be invoked only when all else has failed.

Thus the proposed regulations would have the practical effect of pushing taxpayers toward a cost-plus method of pricing services rendered to related companies, unless those services involved embedded transfers of intangibles. The proposed regulations would require taxpayers to break out transfers of intangibles bundled into a provision of services to related companies, and then treat those transfers separately under reg. section 1.482-4. Those would be the sort of loosey-goosey intangibles that taxpayers persuaded courts to allow them to amortize before the enactment of section 197.

Taxpayers nonetheless gripe that this would have IRS examiners looking for hidden intangibles. (Doc 2004-431 [PDF], 2004 WTD 8-11.) Europeans have shown some hostility to the proposed regulations in the belief that the United States is using them to allocate more profit to U.S. parents. (Doc 2004-5435 [PDF], 2004 WTD 51-8.)

The functional analysis has a logical appeal, but it would still allow taxpayers to disaggregate their activities and then argue with
the tax administrators about how much profit should be allocated where. An alternative mentioned by the OECD article 7 discussion draft is the "relevant business activity" approach, which would define a PE's activities more broadly than the taxpayer might.

The relevant business activity approach would ask how much of the multinational group's total profit from the business in question was earned by a particular PE. And the group's total profit from that business would be the ceiling on how much profit could be attributed to a PE. Thus the implementation of this approach depends crucially on the breadth of the definition of the relevant business activity. Well, gee, wasn't the relevant business activity in the Philip Morris case the sale and marketing of cigarettes? Weren't all of the participants engaged in that same relevant business activity?

The relevant business activity approach would mean that the PE's profitability would rise or fall with that of its group for the business in question. The PE would be getting a cut of the synergistic and fortuitous profit earned by the larger business of which it is a part, or not, if there was no profit. The drafters of the discussion draft argue that while an overall enterprise loss would affect a PE under a relevant business activity approach, that would not be the case under their preferred "functionally separate entity" approach. Business people blanche at the thought that a PE could be deemed profitable while the group posted an overall loss.

Under the functional approach, in contrast, the PE would be compensated only for a circumscribed function. There would be no "force of attraction" pulling the profits or losses of the larger business toward the PE. That is, a PE that distributed a money-losing product would nonetheless have to be paid enough to earn a profit if the pricing of its function was arm's length, and could even be deemed to have earned that profit before the product was resold. Both the relevant business activity and functionally separate entity approaches are in use in OECD member countries, which are not bound by any OECD or treaty definition of profit in their application of their domestic law to PEs.

The proponents of the functionally separate entity approach also believe that describing a hypothetical freestanding entity, complete with attributed assets and capitalization, is simpler than figuring out whether the larger worldwide business of which the PE is a part made a profit during the relevant accounting period. The tax administrator is expected to make an economic analysis of the entrepreneurial risk assumed by a PE. The drafters generously admit that there is no single arm's-length amount of capital to be attributed to a PE, which should enjoy the same credit rating as the whole group ("an observable condition").

How does a tax administrator attribute entrepreneurial risk to an entity that by definition has no specific share of the group's risk? If the PE's warehouse burns down, doesn't the parent then just argue with its outside insurer? Or since the parent is probably self-insured and reinsured by an outside provider, will the tax administrator attribute enough capital to the PE to cover the loss of the warehouse and its contents? Does sufficient capital to support the functions of a commissionaire include the ability to cover the loss of an entire inventory? If some functions are performed outside the country on behalf of the PE, how does the tax administrator find out enough about them to ascribe them to the beneficiary?

As previously discussed in these pages, the OECD would ascribe enough capital to a bank PE to make it a hypothetical freestanding bank, even if it is more capital than a regulator might require. Capital is supposed to follow risk. But nonbank PEs do not make loans and may not assume much risk in their limited functions. The drafters wondered whether fast-food merchants would have to reserve against being sued for causing obesity. Again, trying to take the banking model on the road, the OECD would ascribe to nonbanks enough capital to purchase their assets, or replace them, or even value them at book. What if the nonbank doesn't own outright the assets it uses? Then the economic owner must be deduced and rental payments ascribed if the PE is not the economic owner.

Of course there is no need to allocate any equity capital at all to a PE, as the OECD acknowledges, but the OECD wants to allocate equity capital to PEs. Wouldn't be within the arm's-length principle, apparently, if the thing had no equity. Equity capital would be allocated proportionally according to the assets and risks allocated to the PE. The OECD seems to be under the impression that PEs that hold valuable proprietary intangibles had some role in developing them.

For banks, capital would be allocated according to risk only. The diplomatic notes accompanying the new U.S.-Japan treaty enshrine that approach to capital allocation. Paragraph 2 of the American diplomatic note accompanying the treaty states:

> With respect to financial institutions other than insurance companies, a Contracting State may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them.

A PE could also have some debt capitalization. The OECD might decide the debt/equity ratio by using the ratio for the worldwide enterprise, or by trying to deduce an appropriate market ratio for a separate company performing the PE's function, or by applying the source country's thin capitalization rules. There is no member consensus on a method of allocation of attributed capital between debt and equity. But allocation between the two could result in some deductions being denied for interest that the PE pays. The allocation of some equity capital would be required even if the PE is entirely funded by third-party borrowing.
What if the larger worldwide enterprise is thinly capitalized? Indeed, what if it owes so much money to its retirees that it would have no equity capital if a realistic balance sheet and rating agencies told the unvarnished truth? Here the OECD wonders why some nonbank multinationals get away with being highly leveraged while others do not. The drafters admit that their desire to ascribe some equity capital to a PE may result in its deemed capitalization being out of kilter with the actual capitalization of its highly leveraged group. The OECD has a project on thin capitalization.

Then the OECD goes tripping down the primrose path toward allowing internal interest deductions, principally for financial intermediaries, which demand that internal interest costs be recognized. Existing OECD commentary on article 7 of the model treaty permits recognition of internal interest costs only for financial intermediaries. The draft would expand the circumstances in which internal interest cost would be recognized for nonbank enterprises; this is called "treasury dealings." The notion is that internal treasury functions should be rewarded, perhaps even with a markup for on-lending of funds borrowed from outside lenders.

The Mythical Profits

The madness continues when the OECD draft discusses attribution of profits to a PE, which is hypothesized to be dealing with its parent as though it were wholly independent of it. Attribution of profits would require the application of the OECD's transfer pricing guidelines. The OECD recognizes that this would require a comparison of dealings between the PE and its parent with actual transactions between unrelated parties. In other words, *pommes* would have to be compared with *oranges*.

The discussion at the IFA meeting showed that the OECD discussion draft works better when applied to bank branches than to other types of enterprises. Indeed, the OECD seems to be trying to fit other types of enterprises into its financial model. At the IFA meeting, Gary Sprague of Baker & McKenzie discussed several examples of the application of the recently adopted and proposed PE commentaries.

In his first example, the group sells its products around the world under the X brand. The group's parent owns the worldwide rights to the X brand. A subsidiary, organized in the source country, manufactures and sells products under the X brand in the source country. The subsidiary asked the parent to send some of its employees to oversee its operations. In the process, the parent noticed quality control problems at the subsidiary. The latter will compensate the parent for the use of its employees, who will hang around for seven months.

The question is whether the presence of the parent employees creates a PE of the parent in the source country. Are the subsidiary's premises at the disposal of the parent? The OECD would say yes, according to Sprague, if the parent's employees had office space, but he and other practitioners would argue that more facts were necessary about the responsibilities of the parent employees.

Is the business of the parent being carried on in the source country? Sprague thought it significant that the subsidiary had put in the request for the parent employees, rather than the parent imposing its quality checkers on the subsidiary. It is, however, a bad fact that the parent initiated further inspection. The question, as Sprague saw it, is which legal entity's business is being advanced by the presence of the parent's employees. (The group's business, obviously, but the OECD is still hung up on separate legal entities.) As a planner, Sprague would rather that the parent seconded its employees to the subsidiary, but that would be unpleasant for the employees.

Well, what if the source country finds a PE here? How much of the parent's profits can be attributed to it? The OECD, Sprague noted, would not be satisfied with the subsidiary simply compensating the parent for the employees' salaries, even if that were the market price of the services provided. The OECD is looking for an extra profit from the employees' activities. Moreover, under the discussion draft, once a source country deems a PE to exist, the taxpayer's country of residence has to accept that and accept the concomitant allocation of capital and income to it.

The OECD previously revised its transfer pricing guidelines so that entities cannot provide services to each other at cost. There must be a profit, unless it is an unjustified administrative burden to compute one. But there is no profit attribution guidance extant, so business worries that the PE would become an excuse to tax all of the group's profits in the source country, as in *Philip Morris*. The OECD's answer is that the regular rules will apply, and there is no presumption that a dependent agent will have any profits attributed to it.

Sprague's second example was a common distribution subsidiary that was reorganized so that income is stripped out of the source country, where it is necessary for the group to operate. The parent conducted no business directly in the region in which the full-service distribution subsidiary, and its sister distribution subsidiaries for each country, operated. The distribution subsidiaries were reorganized so that all goods for sale would be drop-shipped from the parent's country of residence. Under the reorganization, the parent will manage marketing for the region and will indemnify the subsidiaries against loss. Nonetheless, the parent will sell directly to each subsidiary.

Is the reorganization successful in stripping income from the subsidiaries by virtue of legally placing risk with the parent? Not if the OECD can help it. The OECD takes a dim view of risk-stripping. The discussion draft saltily points out that "it is worth recalling that under the authorized OECD approach it is not possible within a single enterprise to strip risks from the key entrepreneurial risk-
taking functions that give rise to those risks."

Where is the business risk in this arrangement? Is it with the parent back in its country of residence, or is it with the PE of the parent that is deemed to exist alongside the subsidiaries in the source countries?

The OECD would not kick risk and responsibility that have been legally stripped from the subsidiaries back to the subsidiaries, which would seem to be the more straightforward approach. Why? Because the risk was never with the subsidiary in the first place. Rather, the OECD approach would create two taxpayers for the source country to go after. As the discussion draft notes:

> In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities -- the dependent agent enterprise (which is a resident of the host country) and the dependent agent PE (which is a PE of a non-resident enterprise).

Are the subsidiaries themselves dependent agents of the parent? If so, then would the parent have a dependent agent PE alongside each of the distributor subsidiaries?

According to paragraph 40 of the existing commentary on article 5, a subsidiary is not generally considered a PE of its parent, but rather an independent legal entity, even if the parent manages its business. A subsidiary is evaluated for dependent agent or PE status as though it were an unrelated corporation. The fact that one member of a group maintains a PE in a country should not create any inference that another member of the group has a PE there. (Doc 2004-11972 [PDF], 2004 WTD 110-10.[8])

What if the parent used a commissionaire arrangement? In civil law, commissionaire is an entity that sells in its own name for the account of another. It enters into contracts with customers, usually with set prices or pricing guidelines. Commissionaire is a different legal relationship than agent or distributor, because commercial risks are in the hands of the principal. A commissionaire has no inventory on its books. Is there a difference between a stripped-risk distributor and a commissionaire under article 5? The OECD is studying commissionaires.

The article 7 discussion draft, in paragraph 280, posits a situation in which a dependent agent never takes title to goods it sells on behalf of a nonresident enterprise, so that the latter assumes the inventory risk. Hence an arm's length fee paid to the dependent agent would include no compensation for risk. The question becomes whether that risk and compensation for it should be attributed to a dependent agent PE. That is a question of facts and circumstances.

If, as happens often, a full-service distributor that bore inventory risk was "reorganized" to strip it of inventory ownership and associated risk, making it a dependent agent, but the functions performed by the reorganized distributor did not change, then inventory risk and associated profit should be attributed to a dependent agent PE. Thus the draft alludes to commissionaires, assuming the answer to the question whether they should be considered dependent agents under the source country’s domestic law.

Yet the OECD won't allow tax administrators to follow the Philip Morris decision, which featured an agent participating in contract negotiations. The OECD finds that level of authority insufficient for a dependent agent PE to arise. How, then, are tax administrators going to be able to attack commissionaires, which act on behalf of their principals with even less authority or risk than the dependent agent in Italy had?

The point of the article 7 discussion draft exercise is to allow source country tax administrators to go beyond transfer pricing to impute more profit to the source country than the legal arrangements would call for. How much income would be attributable to a PE of the parent in this situation? That would depend on how much inventory risk and credit risk and other types of risk would be attributed to the PE. Sprague mused that if the parent compensated the distribution subsidiaries sufficiently at arm's length, no extra income could be attributed to a PE of the parent.

The article 7 discussion draft says no to this "single taxpayer" theory, a bit of a misnomer. The draft makes clear that the parent's legal responsibility for the business risk does not preclude location of that risk in the source country, stating:

> Although it is agreed that the risks are legally borne by the non-resident enterprise, the difference between the two approaches is that under the "single taxpayer" approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the authorized OECD approach would attribute those risks to the dependent agent PE for tax purposes if, and only if, the dependent agent performed the key entrepreneurial risk-taking functions in respect of those risks.

The article 7 discussion draft is intended to prevent the "single taxpayer" result. "The host country's taxing rights are not
necessarily exhausted by ensuring an arm's length compensation to the dependent agent enterprise," the discussion draft intones. If the business risk is found to be in the source country, it cannot be with the distribution subsidiary, which cannot be compensated for it. Risk would have to be attributed to a dependent agent PE alongside the subsidiary, along with sufficient assets and capital of the parent to bear that risk.

Then profit would be attributed to the dependent agent PE based on the functions it performs. The tax administrator would want to ask whether negotiating and risk management functions are being performed by the dependent agent PE. The PE would be able to deduct the cost of services it performs for the dependent agent subsidiary. Would there be any profits left for the source country to tax? That depends on the facts and circumstances. The discussion draft states:

There is no presumption that a dependent agent PE will have profits attributed to it. In some circumstances, the functional and factual analysis may determine that the amounts to be attributed to the dependent agent PE is a negligible profit, nil or a loss.

The third example, presented at the IFA meeting by Robert Sparks of Delphi Corp., the beleaguered auto parts maker, involved a U.S. company hired by a Canadian company to provide services in Canada for a period of time sufficient to give the U.S. company a PE in Canada. To do the work, the U.S. company will have to move equipment to Canada for the period of the service contract. The fair market value of the equipment roughly equals its acquisition cost, while its tax basis is about half that amount. The U.S. company will take back the equipment for use in other locations at the end of the Canadian contract, and will send its own employees to maintain it.

The musical question is how should Canada (and the United States) treat the transfer of the equipment? Is it a sale? A lease? The answer would determine not just any potential gain or deemed rental income to the U.S. company, but also whether the Canadian PE would be able to deduct rent or depreciation and interest. Thus if asset were deemed sold to a PE, the seller's residence country would need to recognize and tax the transfer, then deem an immediate reacquisition since the seller still owns the thing. (Or, more likely, a bank in the residence country owns the thing.) The article 7 discussion draft acknowledges that sometimes "symmetry" will not be possible.

The example was based on Cudd Pressure Control Inc. v. The Queen, [1995] C.T.C. 2382, Doc 95-21395, 95 TNI 214-20, affirmed, [1999] D.T.C. 6630, Doc 98-31581, 98 TNI 206-19, in which the U.S. taxpayer argued that its Canadian PE should be allowed to deduct notional rent on an offshore drilling rig provided to it by the taxpayer for eight months. No rent was paid. The Canadian tax authorities offered to treat the transfer as a sale and allow a deduction for deemed depreciation. The Canadian government won the case on the ground that Canadian law does not permit notional deductions, and that the PE should be considered to have owned the equipment. The courts were not keen on shifting rental income from Canada to the United States, and one concurring appellate judge noted that the notional rent was not included in the U.S. taxpayer's income. (For coverage, see 95 TNI 185-3, Doc 98-32226, and 98 TNI 211-8.)

Can a taxpayer plan into the discussion draft by documenting the transfer of an asset, to maintain control of the situation? The discussion draft has this to say about that:

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

If the transfer of the equipment to a PE has to be treated in some way, could the taxpayer control the situation by documenting the transfer in a way that suits it? Can a taxpayer plan for the consequences of the inevitable PE here? Taxpayers have tried to, as Sprague put it, "convert" a PE case into a plain vanilla transfer pricing case by documenting their deals in a certain way, and planning henceforth will have to involve documentation. But the documents will not necessarily be believed. The point of the OECD discussion draft is that source countries should be allocated more income and get more revenue than taxpayers' documents would require. The OECD is looking for that extra value added.

**Nowhere Income**

Treaties are historically concerned with double taxation. Double taxation is not the problem at the moment. The problem is nontaxation, anywhere, variously called "nowhere income" in the United States and "white income" in Europe (since it shows up on no reports made to governments). The OECD article 7 discussion draft states that it is desirable to avoid "less than single" taxation as well as double taxation. (The French translation is even better: "une imposition insuffisante.")

The article 7 discussion draft may be, as the title of this article points out, the revenge of the source countries, which are generally
at a disadvantage under the general pattern of treaties that cede practical source-country jurisdiction over flows in favor of unenforceable residence-country jurisdiction over residents. In short, instead of just letting every country collect a nonnegotiable tax at source, we prefer to have residence countries chase their citizens around the world to try to get a piece of those citizens’ earnings outside their borders.

The OECD rejection of the Philip Morris reasoning and its insistence that controlled entities can act independently of their parents are huge roadblocks to arriving at income allocation reality. The OECD model treaty refuses to recognize that groups of controlled corporations have no legal or practical constraints on their tax planning. There is no alternative business reality for them to guide tax administrators. Group members are acting as one. The OECD TAG recognized that a multinational group is capable of producing profits that would not exist between unrelated entities, so that it is impossible to allocate those profits among group members.

No doubt the OECD feels constrained by the separate accounting foolishness, but PE is not a separate company concept. It is a nexus concept designed to step in when separate entities and their formal relationships do not give a complete answer. Separate entity, for that matter, is not a principle. It is an outmoded rule of convenience that is convenient only for tax planners.

The OECD needs to get away from the idea that group members or controlled affiliates of whatever stripe ever act independently of one another, regardless of the effect on article 9 of the model. The OECD should acknowledge that a group can have a PE. If article 9 is rendered obsolete, then so be it.

On the dependent agent question, the management services discussion draft appears to have been a hasty response to Philip Morris to placate unhappy businesses. It should be withdrawn forthwith. It contradicts existing article 5 commentary about the agent’s ability to negotiate contracts, and takes an absurd position on the use of local premises. Although agent is still undefined, and subject to the peculiarities of local law, this draft would draw the scope of an agency relationship so narrowly that groups could have agents contracting on their behalf everywhere without owing tax anywhere. They need only say that a signoff from headquarters is necessary to conclude a contract.

The OECD should also eliminate the article 5 commentary that states that a subsidiary is not automatically a PE. Of course it is, as a practical matter. It is a dependent agent. A subsidiary is a large presence in a country that clearly demonstrates the importance of its activities to the group that bothered to establish it. If the group could have accomplished the same functions through an unrelated and independent agent, it would have. But it would have had to share profits with a truly independent agent.

On the fixed place of business point, a better approach might be to rethink paragraph 4 of article 5, which allows groups to sell into a country and have considerable presence there without being deemed to have a PE there. Why shouldn’t a group be taxable in a country where it has measurable sales and a sizeable physical presence? The OECD should remove paragraph 4 from the model and encourage members to remove paragraph 4 from their treaties.

Paragraph 4 is a Quill rule for international taxation, only worse, because it allows huge physical presence not to constitute a PE, and there is no force of attraction rule. (That's Quill Corp. v. North Dakota, 504 U.S. 298 (1992).) Even when the taxpayer has enough warehouses, displays, et cetera in a source country to constitute a PE in combination, the current result is an unproductive argument with the local tax administrator about whether the combination does rise to the level of a PE.

To its credit, the OECD TAG considered getting rid of those paragraph 4 exceptions, as well as the mere selling exception of paragraph 5 of article 7. Government representatives on the group fretted about deliberate fragmentation of functions over different locations to take advantage of the exceptions. The group rejected elimination of all the exceptions.

The group alternatively considered elimination of the storage, display, and supply exceptions of paragraph 4. Something about having a boatload of inventory stashed in a country would seem to indicate that income could be attributable to the facility holding the stuff. Government representatives worried about disaggregation of activities, while business representatives argued that very little profit could be attributed to warehouses. The group agreed that the existing article 5 commentary should be straightened out instead. It was duly noted that the U.N. model treaty, used by many poorer countries, lacks a delivery exception. (For the U.N. model treaty, see http://www.taxanalysts.com.)

The group also considered subjecting all of the current paragraph 4 exceptions to a "preparatory and auxiliary" standard; at the moment, they are automatically presumed to be so. The group rejected elimination of the exceptions, in the name of international commerce, but thought a "preparatory and auxiliary" overlay to be "a reasonable line to draw."

On the one hand, that change would just move the argument to a different level, as the group acknowledged. On the other hand, it might prevent another Philip Morris arrangement in that the activities and facilities could not be permanent. At some point, a taxpayer with a bunch of facilities in a country would have to become subject to local taxation.

**Force of Attraction**

Moreover, even in a perfect world of source taxation with no ceding of jurisdiction, the definition of PE would not merely continue
to be important but may even increase in importance.

The OECD TAG considered and rejected a base erosion rule, similar to that found in some American treaties, as an addition to the PE concept to prevent income stripping. This rule would ask whether a nonresident received a payment from a source-country payer that the latter was allowed to deduct under local law. The source country would withhold tax on the payment. The payer would be given the alternative of filing a return as though it were a PE. An alternative the group considered was a low, final withholding on deductible payments, no arguments.

No-arguments withholding at source is where the world will have to go, with the Americans kicking and screaming in resistance. The OECD TAG, despite rejecting the rule, noted that it would be a great simplification that would eliminate the need for messy source and character rules.

The OECD TAG also considered and rejected formulary apportionment as a replacement for separate accounting, while tacitly admitting that the latter is breaking down. (No surprise there; half of the members of the group are business representatives.) The group noted that the key elements of the system would have to be uniform across countries; Europe is working on that. Moreover, there would still have to be some sort of nexus or PE concept to give a source-country jurisdiction to tax.

The group fretted that formulary apportionment would produce arbitrary results, and that a group's overall loss would feed through to countries where it might be operating profitably, and vice versa. But the group did admit that uniform formulary apportionment would dramatically reduce administrative and compliance costs. The group further admitted that formulary apportionment would be more certain and simpler than separate accounting. If intragroup payments were ignored, there would not need to be withholding.

John Cullinane of Deloitte & Touche sees residence and PE as perpetually conflicting bases for assertion of tax jurisdiction. Residence for business taxpayers is a highly artificial construct, Cullinane argues, so that countries will eventually have to organize their tax systems to tax on the basis of PE. Cullinane would tax global businesses on the basis of the presence or absence of a PE in the source country. (Doc 2004-4443 [PDF], 2004 WTD 42-5.)

The concept of attaching everything that comes in to a local PE is called "force of attraction" in treaty parlance. The OECD TAG rejected a force of attraction rule that would attribute electronic commerce profits to a PE. The U.N. model treaty has a limited force of attraction rule in paragraph 1 of article 7. Italy should have signed the U.N. model, which states in pertinent part:

The profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

H. David Rosenbloom of Caplin & Drysdale would replace subpart F with a high-tax kick-out regime that would allow business profits attributable to a PE in the source country to go untaxed in the United States, provided the source country imposed an adequate comparable income tax, regardless of rate. Business profits not attributable to a PE would be currently taxed to the U.S. shareholder, regardless of having been taxed by the source country. Controlled foreign entities would be treated as passthroughs. Basically, all controlled foreign income would be currently taxed unless it qualified for the business profits/PE exemption. That would put a lot of pressure on the definition of PE. (Rosenbloom, "From the Bottom Up: Taxing the Income of Foreign Controlled Corporations," XXVI Brooklyn Journal of International Law 1525 (2001).)