

"Symmetry" and Attribution of Profits to Permanent Establishments:
Recent OECD and Treaty Developments and Their Impact on U.S. Taxpayers

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INTRODUCTION

I. Background: the OECD Project on Attribution of Profits to PEs

The publication by the OECD in July 2008 of several related documents marks an important milestone in the modernization of the principles governing the attribution of profits to permanent establishments (“PEs”). This area had long been subject to controversy, and it was identified by the OECD as in need of detailed study as early as 1993. In the late 1990s, several developments led the OECD to undertake a major project that was intended to explore whether the arm’s length principle might be used as a governing standard for attribution of profits to PEs under Article 7 of the OECD Model Treaty and similar bilateral treaties.

This article does not attempt to summarize the OECD’s work concerning the substantive principles that will be used to attribute profits to PEs. That work, which is substantial in scope, might be a better topic for a monograph than a short article. Rather, this article is primarily concerned with recent developments that inform the principles for attribution of profits to PEs. The primary focus here will be on the practical aspects of implementation of the “authorized OECD approach” to attribution of profits, with an emphasis on recent changes to the OECD Model Treaty, changes to the U.S. Model Treaty, and other developments in the area. In this

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context, a brief explanation of the dimensions of the PE problem and a short summary of the conclusions reached by the OECD may provide a useful starting point.

A. Article 7 in Brief

Article 7, which deals with Business Profits, is among the central provisions in any tax treaty. The simplicity of Article 7 belies the complexity that can be involved in applying it in practice.

Article 7(1) of the OECD Model Treaty provides that the profits of an enterprise of a particular state are taxable only in that state unless it carries on business in another state by means of a “permanent establishment.”² In that event, the other state may tax the profits of the enterprise, but only to the extent that such profits are attributable to the permanent establishment (“PE”).³

Article 7(2) of the OECD Model Treaty states that, subject to the provisions of paragraph 3, in each contracting state, the profits attributable to the PE shall be the profits that the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities and dealing independently with the rest of the enterprise.⁴

Article 7(3) of the OECD Model Treaty provides that, in determining the profits of the PE, deductions shall be allowed for all expenses incurred for the benefit of the PE, whether in the state where the PE is located or elsewhere.⁵

The balance of Article 7 deals with specialized situations and provides rules for uniform application of methods one tax year to the next, interaction with other provisions in the Model Treaty, and so on.⁶

² OECD Model Tax Convention on Income and on Capital (2005), Article 7(1).

³ Id.

⁴ Id., Article 7(2).

⁵ Id., Article 7(3).

B. Source of Longstanding Controversy

From its earliest origins, Article 7 was a source of controversy.⁷ Some of the most vexing issues in this area relate not to Article 7 itself, but to the threshold determination that a PE exists, a determination that is made under Article 5.⁸ Various activities, primarily activities of a preparatory or auxiliary nature, do not give rise to a PE.⁹ Even when a PE is found to exist under Article 5(5), there is the possibility that the amount of income attributable to that PE may be immaterial or even zero.¹⁰

One issue that proved controversial was whether the reference in Article 7(2) to a “separate and distinct” enterprise required the PE to be analyzed as a (hypothetically) distinct entity. In this regard, some jurisdictions applied a “functionally separate entity” approach and treated the PE as equivalent to a stand-alone entity in the jurisdiction, which was engaged in business with third parties and with the rest of the enterprise. Others evaluated the PE as engaged in a “relevant business activity,” and viewed the profits attributable to the PE as limited to the profits from that activity. In practice, these approaches could lead to dramatically different attributions of profits to the PE. The potential for double taxation was especially acute if the

⁶ Id., Articles 7(4) through 7(7).

⁷ Michael B. Carroll, Allocation of Business Income: The Draft Convention of the League of Nations, 34 Colum. L. Rev. 473 (1934). That article provided as Appendix the text of the 1933 League of Nations Draft (which was never adopted).

⁸ The Commentary refers to Article 7 as “a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment.” OECD Model Tax Convention on Income and On Capital (2005), Commentary on Article 7, paragraph 1.

⁹ Under most treaties, a fixed place of business does not constitute a permanent establishment if the taxpayer engages in activities of an auxiliary or preparatory character, or if the taxpayer engages in activities through the fixed place of business for a limited time (e.g., construction, installation or building site). OECD Model Tax Convention on Income and On Capital (2005), Article 5(3), 5(4)(e).

¹⁰ Part I of the Report recognizes that, at least in theory, a PE might be found to exist but minimal (or no) income might be attributable to it. But the Report categorically rejects what it terms the “single taxpayer” approach for dependent-agent PEs. The “single taxpayer” approach suggests that if the dependent agent is compensated on an arm’s length basis, no additional profit should be attributable to the PE created as a result of the agent’s activities. The Report concludes that the dependent agent and the PE are separate taxpayers and that the profits attributable to the PE are subject to analysis under the AOA. OECD Report (Part I), paragraphs 271-274.

Source State and the Residence State applied distinct approaches.¹¹ But double taxation could also result despite the fact that both jurisdictions applied the same fundamental approach to attribution of profits.

Most PEs do business both with other parts of the enterprise and with unrelated third parties. A branch or PE customarily maintains records of its transactions with uncontrolled parties, such as suppliers or customers. But for transactions with other parts of the enterprise, the branch may maintain minimal or no documentation. Intercompany contracts, which play a central role in applying the arm's length principle in the associated enterprise context, have little or no meaning in the PE context, since as a legal matter an enterprise cannot transact business with itself. At the same time, however, the Commentary to Article 7 recognized that businesses maintain accounts of their branch operations, and these records could often be relied on, at least as a starting-point, for purposes of evaluating the profits reported by the PE.¹² The purely notional character of these intra-enterprise transactions nonetheless poses a considerable challenge in attributing profits to a PE.

Another set of difficult analytical issues result from the need to determine the capital structure of the PE. The challenges in this area extend beyond the PE context, as countries have adopted debt-equity rules, thin-capitalization rules, and anti-abuse regimes that in many cases apply to both associated enterprises and PEs.¹³ In general, these rules are intended to ensure that the subsidiary (or the PE) obtains a deduction for a reasonable amount of interest, either by

¹¹ This article refers to the State in which the PE is located as the "Source State" and the State in which the Head Office or other part of the enterprise is located as the "Residence State."

¹² OECD Model Tax Convention on Income and on Capital (2005), Commentary on Article 7, paragraphs 12-13 (tax authorities may use the "trading accounts" maintained by the PE to determine the profit attributable to it).

¹³ The OECD has provided guidance concerning financing in the associated enterprises context. *E.g.*, OECD, Transfer Pricing and Multinational Enterprises, Chapter V (Loans) (1979); OECD, Thin Capitalization and Taxation of Entertainers, Artistes and Sportsmen, Issues in International Taxation No. 2 (1987).

applying the arm's length principle or by using various formulary or quasi-formulary approaches that approximate arm's length results in the specific factual setting.¹⁴

In the PE context, the challenges are acute, given that the task is to determine the appropriate capital structure for one part of a single enterprise. Should the total (external) interest expense of the enterprise allocated to the branch? Is the deduction limited to charges for external (third-party) debt financing, and if so, should any markup be permitted on the interest charged? How are external borrowings by the branch taken into account? Should guarantees or other interbranch financing transactions be given effect?

Historically, the OECD used a "direct/indirect" rule that limited these questions primarily to the financial industry. Under this approach, because financing activities were considered not to be directly related to the business activities of a non-financial enterprise, intra-enterprise transactions or dealings in the nature of interest for such enterprises were not taken into account.¹⁵ Conversely, because interest is directly related to the business of banks and other financial institutions, transfers of funds and associated charges in the nature of intra-enterprise interest dealings could be recognized, albeit for the limited purpose of attributing profits to PEs.¹⁶ This rather awkward distinction between financial and non-financial enterprises was retained during the period prior to the OECD project.¹⁷ This distinction was ultimately jettisoned

¹⁴ In the United States, section 163(j), Treas. Reg. § 1.882-5 and the branch interest rules stand out as examples of this type of rule.

¹⁵ OECD Model Tax Convention on Income and on Capital (2005), Commentary on Article 7, paragraph 18.2

¹⁶ Historically, interbranch interest dealings generally had effect only as notional transactions under Article 7; they had no have effect under any other Article of the Treaty. The same approach is retained under the AOA.

¹⁷ The leading study in this area was "The Taxation of Multinational Banking Enterprises," in Transfer Pricing and Multinational Enterprises: Three Taxation Issues, (OECD 1984). Chapter Three of that document dealt at length with branch operations of banking and financial enterprises.

in the final PE reports, although as practical matter the recognition of inter-branch interest dealings outside the financial sector will continue to be limited.¹⁸

Against the backdrop of these difficult theoretical issues, the possibility also exists that the enterprise may be subject to double taxation for more mundane reasons, such as because it is subject to two distinct tax regimes with rules that are not exactly in synch with one another. Assuming that two jurisdictions apply the same basic approach to attribution of profits, and that they see similar dealings between the PE and the rest of the enterprise, double taxation may still result if, for example, the tax accounting rules of the Source State differ from those of the Residence State. Some differences of this type relate to timing of deductions or recognition of income, and such differences tend to offset over time. Others, however, such as an outright ban on a deduction in one State, might yield permanent double taxation. The traditional view was that most differences of this type were not subject to Article 7, a conclusion that was not entirely satisfactory. An aggrieved taxpayer is generally not concerned about the precise reason why double taxation occurs. If the same income is subject to tax in two jurisdictions, the taxpayer sees the rules as ineffective.

C. More Recent Developments

The OECD and others long recognized the connection between the arm's length principle, which is used to evaluate the "conditions" imposed between associated enterprises, and the standard used to attribute profits to a PE.¹⁹ Shortly after the OECD completed the Transfer

¹⁸ A "treasury dealing" between parts of a non-financial enterprise would be recognized only if part of the enterprise performed significant people functions relevant to the economic ownership of assets. See Report (Part I at paragraph 195.

¹⁹ This is the formulation used in Article 9 of the OECD Model Treaty. The "arm's length standard" under U.S. law uses slightly different terminology, but the same underlying approach. See Treas. Reg. § 1.482-1(c).

Pricing Guidelines for Multinational Enterprises and Tax Administrations²⁰ in 1995, it began a project intended to explore the idea of applying the arm's length principle to PEs.²¹

In the late 1990s and early 2000s, several developments occurred that underscored the need for clarification of the basic principles governing attribution of profits to PEs. These developments are discussed briefly below.

Multinational businesses reported that tax administrations were concluding that PEs existed more frequently than in the past, and were also concluding that more substantial amounts of profit were attributable to such PEs.²² This phenomenon suggested that tax administrators were paying closer attention to the threshold issue of whether a PE exists, whether via a fixed place of business or through the activities of a dependent agent. During the 1990s and early 2000s, tax administrators increased their level of awareness concerning pricing issues between associated enterprises. It may have simply been a by-product of this analysis that led them to pay closer attention to dealings between various parts of a single enterprise. Such dealings, after all, raise many of the same conceptual issues as transactions between associated enterprises, so the examination tools and the analytical processes involved are similar for both sets of transactions.²³

At the same time, rapid developments in the area of electronic commerce ("E-commerce") called into question whether the existing rules for transfer pricing and attribution of

²⁰ Paragraph 9 of the Preface to the Guidelines noted that "The issues discussed in this Report also arise in the treatment of permanent establishments and will be dealt with subsequently." The same paragraph went on to cite two previous OECD studies in the area.

²¹ At the time, suitability of the arm's length principle as a comprehensive means of attributing of profits under Article 7 was untested, so this approach was referred to as the "Working Hypothesis." When the hypothesis was found to be reliable, the resulting approach became known as the "Authorized OECD Approach" or AOA.

²² National Foreign Trade Council, Toward a U.S. Tax Treaty Policy for the Future (Part I, Executive Summary (November 2004) ("Global businesses are encountering increased examination activity on permanent establishment issues in many countries, typically involving the attribution of substantial profits."))

²³ Cite to EU cases, Philip Morris, others.

profits to PEs were capable of dealing with new business paradigms. Obviously, tax administrators in developed countries were concerned that the new business models might erode the tax bases in their countries. The OECD devoted significant resources to this issue. Studies were undertaken to address, among other questions, whether a computer server might itself constitute a PE and if so how much income was attributable to such a PE under both Article 7.²⁴ Because a server can be readily moved from one jurisdiction to another, the concern was that e-commerce might allow taxpayers to position income in low-tax or no-tax jurisdictions.²⁵ Ultimately, the OECD concluded that the existing rules (including character of income and transfer pricing rules) were capable of handling most issues in e-commerce scenarios.²⁶ But the initial concerns added to the impetus for detailed and uniform rules concerning both the existence of PE (Article 5) and attribution of profits (Article 7).

Another important development in the associated enterprise (controlled transaction) context was the use by taxpayers of so-called stripped risk or limited risk structures, such as commissionaires or toll manufacturers.²⁷ For a multinational enterprise operating in traditional parent-subsidiary form, relocating high risk or “value-chain” activities had the potential to significantly reduce the amount of taxable income in a jurisdiction. Alternatively, the risk associated with certain value-chain activities might be transferred, by means of contractual provisions, to an entity in a low-tax jurisdiction, and this might or might not entail substantial

²⁴ “Fundamental Changes to Business Tax Rules Unnecessary, Says OECD E-Commerce Group,” BNA-Daily Tax Report, 5 DTR G-2, January 9, 2006. The OECD released documents on treaty and transfer pricing aspects of e-commerce in E-Commerce: Transfer Pricing and Business Profits Taxation, OECD Tax Policy Study No. 10 (June 2005).

²⁵ These issues were first explored in a study, Office of Tax Policy, U.S. Department of the Treasury, Selected Tax Policy Implications of Global Electronic Commerce (1996), available at <http://www.treas.gov/offices/tax-policy/library/internet.shtml>.

²⁶ See Note 24, *supra*.

²⁷ E.g., Steven P. Hannes, “Achieving Transfer Pricing Objectives Without Creating a U.S. Business for a Foreign Person,” Tax Notes Today, 2003 TNT 92-57 (May 9, 2003).

changes in the underlying functions. This alternative in some cases allowed taxpayers to reduce the amount of taxable income in a jurisdiction, without making extensive changes to a company's existing operations.

Historically, the presence of a subsidiary in a jurisdiction (particularly one that had been in operation for some time) was viewed as near-certain protection against a determination under Article 5 that a PE of the parent also existed in the jurisdiction.²⁸ Yet, especially as the new limited risk structures became more prevalent, this assumption came under scrutiny.

Coincidentally or not, at the same time as the OECD was attempting, in the attribution of profits project, to define the so-called "key entrepreneurial risk-taking functions" (KERTs)²⁹ of an enterprise (*i.e.*, the functions that, once identified, would result in economic ownership of assets and associated risks in a particular part of a single enterprise), multinational business reported that certain countries were applying similar principles to associated enterprises, particularly in the aftermath of changes in functions or risks. In some cases, tax administrators used KERTs as a means of limiting the impact of business restructuring activities.³⁰ In some cases, tax administrators evidently pointed to KERTs or similar "people" functions to support their conclusion that a PE existed under Article 5 – although this would be a clear misapplication of

²⁸ Under Article 5(7), the existence of an entity in a State that controls, or is controlled by a company that is resident of another Contracting State, "shall not of itself constitute either company a permanent establishment of the other." OECD Model Tax Convention on Income and on Capital (2005), Article 5(7) (emphasis added).

²⁹ For reasons that are not directly relevant here, the KERT concept was eliminated from the Part I of the Report, in favor of a broader formulation: "significant people functions relevant to determining the economic ownership of assets." The KERT concept was retained in Parts II-IV, albeit in a modified role.

³⁰ An excellent description of the issue is contained in Gregg D. Lemein, "Transfer Pricing and Related Tax Aspects of Global Supply Chain Restructurings," *Worldwide Tax Daily*, 2005 WTD 36-13 (Feb. 24, 2005). Later in 2005, the Australian Taxation Office published a document, Attributing Profits to a Dependent Agent Permanent Establishment, NAT 14314-09.2005 (available on ATO website).

the principles under development by the OECD.³¹ Business representatives suggested that, whether inadvertently or by design, the OECD had provided conceptual ammunition for these approaches.³²

Another event that potentially affected a large number of U.S. taxpayers confirmed the need for additional certainty in the area of attributing profits to PEs. In the late 1990s, Mexico informed the United States that it intended to impose tax on PEs of U.S. parent corporations operating in subsidiary form in Mexico under the maquiladora program.³³ Mexico and the United States eventually reached a Competent Authority agreement whereby Mexico declined to impose tax on PEs of the U.S. enterprise, provided that the maquiladora paid tax on a somewhat larger amount of income (*i.e.*, in its capacity as a subsidiary, rather than as a PE of the U.S. corporation) on its operations in Mexico.³⁴ Interestingly, one of the “unwind” events in the U.S.-Mexico Competent Authority agreement was issuance by the OECD of guidance concerning attribution of profits to a PE.³⁵

Another key event in the United States was the litigation in the Court of Federal Claims in National Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008)

³¹ Deputy U.S. International Tax Counsel Patricia Brown was quoted as saying: “people have been focusing on KERT in a way I don’t think was ever intended.” “Officials Discuss Section 482 Projects, APA Review, Permanent Establishment Issues,” BNA-Daily Tax Report, 98 DTR G-4 (May 23, 2005).

³² Carol A. Dunahoo, “Source Country Taxation of Foreign Corporations, Thoughts on Evolving Permanent Establishment Concepts,” BNA –Daily Tax Report, 235-DTR-J-1 (December 7, 2007).

³³ For historical reasons not relevant to taxation, a maquiladora generally does not hold title to its production equipment, its work-in-process, or its finished goods inventory (the U.S. corporation retains tax and economic ownership of the assets). In addition, a maquiladora generally has costs for hourly workers that are low in absolute terms. When a traditional cost-based transfer pricing method was applied to a maquiladora with such a cost structure, it potentially indicated an amount of “arm’s length” income that was very low in relation to the functions actually performed.

³⁴ “New U.S.-Mexico Maquiladora Tax Regime Seen Significantly Raising Tax Markups,” BNA-Daily Tax Report, 213 DTR G-5 (November 4, 1999).

³⁵ OECD, Peer Review of Mexican Transfer Pricing Legislation and Practices (January 2005), available at <http://www.oecd.org/dataoecd/29/16/34244429.pdf>.

(“NatWest”).³⁶ The central issue in that case involved the amount of interest deduction allowed to the U.S. branch of a U.K. bank, under U.S. law and the U.S.-U.K. Treaty. In a series of rulings on motions for partial summary judgment and evidentiary matters, the Court of Federal Claims concluded that, in the context of a claim under the 1975 U.S.-U.K. Treaty, the United States could not apply the interest apportionment rules of Treas. Reg. § 1.882-5.³⁷ Evaluating the intent of the parties as of the time they negotiated the 1975 Treaty, the Court of Federal Claims relied primarily on evidence that was contemporaneous with the negotiation (or the ratification) of the Treaty. However, the trial court also took into account certain post-ratification conduct of the parties and in that context gave some consideration in passing to the OECD’s 2001 and 2003 discussion draft on attribution of profits to a PE.

Assuming that the decision of the Federal Circuit becomes final,³⁸ NatWest stands for the relatively limited proposition that under the 1975 U.S.-U.K. Treaty, the U.S. branch of a foreign bank may rely on the amount of capital reflected in its books and records for purposes of calculating its interest deduction. In NatWest, the bank’s U.S. branch was not required to calculate its interest deduction using an approach analogous to that in Treas. Reg. § 1.882-5, nor was it required to restate its accounts to the “free” capital that it would have needed to operate as a stand-alone operation in the United States. The decision in NatWest may ultimately be of

³⁶ See also National Westminster Bank, PLC v. United States, 44 Fed. Cl. 120 (1999), National Westminster Bank, PLC v. United States, 58 Fed. Cl. 491 (2003), and National Westminster Bank, PLC v. United States, 69 Fed. Cl. 128 (2005). For analysis of the recent opinion by the Court of Appeals for the Federal Circuit, see William W. Chip, “Interpreting Tax Treaties After NatWest,” 37 BNA-Tax Mgmt. Int’l J. 321 (June 13, 2008); Richard L. Reinhold and Catherine A. Harrington, “What NatWest Tells Us About Treaty Interpretation,” Tax Notes Today (Special Report), 2008 TNT 73-52 (April 15, 2008).

³⁷ The Tax Court had ruled that the United States could not apply section 842(b) to determine the income of a U.S. branch of a Canadian life insurance company, as this approach was inconsistent with the U.S.-Canada Tax Treaty. North West Life Assurance Co. of Canada v. Commissioner, 107 T.C. 363 (1996).

³⁸ In NatWest, the U.S. Department of Justice received an extension of time to file a petition for certiorari to the United States Supreme Court. “IRS May Seek High Court Ruling on U.S.-U.K. Treaty Interpretation in National Westminster,” BNA-Daily Tax Report, 139 DTR K-2 (July 21, 2008).

largely historical importance, given that the United States and the United Kingdom in 2001 reached agreement on a new Treaty that adopted an approach very similar to the one that was ultimately agreed to in the AOA.³⁹

II. Implementation of the AOA into the OECD Model Treaty

The “Authorized OECD Approach” or AOA entailed changes to the fundamental principles regarding taxation of PEs. Because these changes were significant in their own right and had potential follow-on effects on other provisions of the Treaty, substantial care was required in adopting the AOA into the OECD Model. A key feature of the implementation exercise was to develop for resolution of double taxation controversies that will inevitably arise as countries adopt the AOA and apply it to actual cases.

A. The “Two-Prong” Approach

Practitioners who are familiar with U.S. treaty policy and procedures might assume that most countries have a similar view of situations that involve changes to the OECD Model Treaty or the underlying Commentary.⁴⁰ That view would be mistaken. In fact, wide divergence exists between the practices of the OECD member states. Some countries have domestic regimes that are closely linked to the OECD Model Treaty and consequently the Commentary. For these countries, changes in the Model or Commentary, if not self-executing, would have a potential impact on day-to-day procedures. The United States and certain other countries accord substantial respect to the OECD Model and related guidance, but view their domestic law provisions, or provisions of bilateral tax treaties, as paramount. Other countries occupy points on the continuum between these two views. The challenge facing the OECD was to develop an

³⁹ The U.S.-U.K. Treaty was signed on July 24, 2001. A protocol amending the treaty was signed on July 19, 2002, and entered into force on March 31, 2003.

⁴⁰ See Hugh J. Ault, “The Role of the OECD Commentaries in the Interpretation of Tax Treaties,” 4 INTERTAX 144-148 (April 1994).

approach for implementation of the AOA that took account of individual country practices but also ensured that the AOA would be adopted within a reasonable period.

In an effort to ensure timely and uniform adoption of the AOA, the OECD adopted what it termed a two-prong approach to implementation. Under the first prong, the OECD would propose changes to the existing Commentary to Article 7. These changes would graft the basic principles of the AOA onto the OECD Model Treaty, to the extent that this could be done without major changes to existing Article 7. This portion of the exercise was recently completed and the results were published in the most recent update to the OECD Model Tax Convention, issued on July 18, 2008.

The second prong of the implementation process was more ambitious. It involved a comprehensive redraft of Article 7 and the Commentary to incorporate the conclusions of the AOA and to provide, to the extent possible, for symmetrical application of the AOA. Discussion Drafts of the proposed Revision to Article 7, and the revised Commentary on Article 7, were released by the OECD on July 7, 2008. This portion of the implementation project is currently underway and scheduled to be completed in 2010, when the changes agreed upon will be adopted in the OECD Model Treaty. Once this second prong is complete, new Article 7, the new Commentary, and the OECD Reports on Attribution of Profits (Parts I-IV) will form a unified set of principles that governs the attribution of profits to PEs. In the interim, and perhaps after 2010, most countries will modify their bilateral treaties or their domestic law provisions (or both), as part of the process of incorporating the AOA.

B. The Attribution of Profits Reports

The complete version of the OECD Report on Attribution of Profits to PEs was approved by the OECD's Committee on Fiscal Affairs on June 24, 2008 and then approved by the OECD

Council for publication on July 17, 2008. The final report includes four parts: Part I (General Considerations), Part II (PEs of Banks); Part III (Global Dealing) and Part IV (Insurance). This final report replaced an interim version of Part I-III that was published in December 2006, and a Discussion Draft of Part IV that was published in August of 2007.⁴¹

In terms of its length, and the scope and the depth of its consideration of technical issues, the final OECD Report (“PE Report”) is substantial. The OECD intends that PE Report will play a role similar to that of Transfer Pricing Guidelines for Multinational Enterprises and for Tax Administrations (“OECD Guidelines”) under Article 9 of the OECD Model. The PE Report will provide highly detailed guidance to taxpayers, in connection with reporting of income, and to tax administrators in relation to potential adjustments to the amount of income attributable to PEs and resolution of disputes with other countries.

C. U.S. Position Regarding AOA Implementation

Since the announcement of agreement on the AOA, the United States has taken the position that the AOA implementation process would have little or no direct impact on U.S. tax practice, either with respect to bilateral treaties or domestic law.⁴² The United States participated actively in the OECD project from the outset, and in fact began adopting concepts similar to the AOA into its bilateral treaties and in the U.S. Model Treaty while the OECD project was still underway. With the exception of treaties with Germany, the United Kingdom, Japan, and Belgium (among those currently in effect), the final pronouncements by the OECD arguably had

⁴¹ Interim drafts of parts of the Report were released for public comment, starting in 2001. As a housekeeping matter, the Final Report still must be revised to conform all references to the text of Article 7 of the OECD Model Treaty, as finally agreed in 2010. See Final Report, July 17, 2008 at 263 (Recommendation of the OECD Council).

⁴² “Treasury Clarifies U.S. Position Regarding Interim OECD PE Profit Allocation Guidance,” BNA-Daily Tax Report, 110 DTR I-1 (June 8, 2007). Treasury issued a statement indicating that, “the ‘overall’ limitation provided for in our foreign tax credit rules . . . makes it unlikely that double taxation of PE income will occur with respect to capital attribution and interest allocation.”

no immediate impact on U.S. practice. And with respect to those treaties, the United States evidently considered that its application of the AOA was governed by the treaties and also limited by domestic rules. Traditionally, the United States does not view post-ratification modifications to the OECD Model Treaty or its Commentary as having ambulatory effect on its bilateral treaties. But the situation here is unique, both because the United States was actively engaged in the paradigm-shift that was taking place at the OECD and because it was at the same time adopting AOA-type principles in treaties with several of its major trading partners.

The U.S. position reflected its view that Article 7 of the U.S. Model Treaty and most of the U.S. bilateral treaties differed in material respects from Article 7 of the OECD Model.⁴³ Prior to 2006, Article 7(3) in the U.S. Model Treaty and in most (but not all) bilateral U.S. treaties required the signatories to grant deductions for allocations of general and administrative expenses and research and development expenses in determining the income of the PE.

The United States was fully engaged in the process of implementing the AOA into the broader framework of the OECD Model Treaty. As discussed below, the United States recently entered a key observation on the revised Commentary to Article 7, which was adopted in the July 18, 2008 update to the OECD Model Tax Convention.⁴⁴ Notwithstanding its view that the OECD Model Treaty has no direct bearing on its existing bilateral treaties, the United States nonetheless has a major stake in the OECD Model, if only because the Model is viewed as highly influential and also serves as a template for many bi-lateral treaties among OECD members as well as other countries.

III. Recent OECD Documents

⁴³ “OECD Profit Attribution Effort May Require Further Pacts Under Existing U.S. Treaties,” BNA-Daily Tax Report, 106 DTR I-1 June 4, 2007) (stating view of IRS and Treasury that if AOA was not contemplated at time of negotiation of treaty, a separate agreement with the treaty partner would be required to apply it).

⁴⁴ This marks the final step in “prong one” of the AOA implementation process.

The OECD recently released several documents that begin the process of integration of the AOA into the framework of the OECD Model Treaty. This section considers those documents in some detail.

A. Revisions to Commentary on Article 7 (2008)

On July 18, 2008, the OECD released the 2008 update of the OECD Model Tax Convention.⁴⁵ This update proposed numerous changes to the Commentary, but only those directly relevant to Article 7 will be discussed here. The reader will recall that, under the two-prong approach agreed upon for implementation of the AOA, the first prong involved modification of the Commentary for existing Article 7. The second prong, which was based on a new Article 7 and Commentary, is addressed in the next section.

1. The Commentary

Most of the changes to the Commentary, consisting of revisions and in some cases new material, are unremarkable in that they incorporate the basic principles of the AOA and otherwise bring the language of the Commentary up to date. The introductory material eliminates certain references in the Commentary that might be considered anachronistic,⁴⁶ and also describes in some detail the process that led up to adoption of the AOA and the revision of the Commentary. Consistent with the initial conception of the PE project⁴⁷ and the two-prong implementation approach, the Commentary recognizes that the OECD Report (Parts I-IV) remains, for the time being, provisional. “The [PE] Report . . . represents internationally agreed

⁴⁵ OECD Model Tax Convention on Income and Capital (2008), released July 18, 2008.

⁴⁶ For example, Paragraph 4 of the Commentary referred to “the launching of rockets and spaceships [and] the presence of many satellites in space with human crews spending longer and longer periods on board.”

⁴⁷ The remit to the implementation group was to suggest changes to the Commentary that would incorporate the AOA, to the extent that this could be done within the parameters of existing Article 7. “OECD Seeks to Include New Commentary on PE in 2008 Update to Model Tax Treaty,” BNA-Daily Tax Report, 241 DTR I-6 (Dec. 17, 2007).

principles and, to the extent that it does not conflict with [the] Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article."⁴⁸ Thus, until the final revisions are adopted in 2010, the PE Report will yield to the revised Commentary, in the event of a conflict between the two.

The substantive provisions of the Commentary confirm that the functionally separate enterprise approach, as further informed by the arm's length principle, is the preferred approach regarding attribution of profits under Article 7. The Commentary also describes the new approach for attribution of capital within a single enterprise and indicates that in the case of a dependent-agent PE, similar principles will apply for attribution of profits. The Commentary also preserves the historical prohibition on internal interest dealings, "subject to the special situation of banks."⁴⁹

The Commentary provides substantially more detailed rules for resolution of double taxation cases that involve PEs. These principles, foreshadowing the rules proposed in the revised raft of Article 7 and the Commentary (as discussed in the next section), are novel in several respects. Prior to the PE project, general consensus existed that the primary, if not sole, purpose of Article 7 was to place limits on the ability of the Source State to impose tax on the income of a PE. The Commentary takes a somewhat broader view and concludes that the phrase "in each Contracting State" in Article 7(2) should be interpreted literally, meaning that both the Source State and the Residence State are equally subject to the Article. This in turn leads to a more extensive obligation on the part of the Residence State to eliminate double taxation under Article 23:

⁴⁸ Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 7 (emphasis added).

⁴⁹ Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 42.

Clearly . . . the Contracting State of the enterprise has an interest in the directive of [Article 7,] 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 Article 23, eliminate double taxation on the profits attributable to the permanent establishment.⁵⁰

As part of the AOA implementation process, all references in the prior draft of the PE Report to the symmetry issue were deleted.⁵¹ So, to that extent, the original views of the Report concerning symmetry are of limited historical interest. But it is worth noting that, with one minor exception, the 2004 Discussion Draft of the Report made no reference to the use of Article 23 to resolve instances of double taxation.⁵² The increased emphasis on Article 23 is therefore a product of the implementation work, rather than the substantive evaluation of Article 7 that took place in previous years.

The expanded role of Article 23 is manifest in the Commentary's treatment of situations where the Source State and the Residence State apply different methods of capital allocation. The inability of OECD member states to agree, in the course of the PE project on a single method of capital allocation ultimately resulted in the final Report adopting two "authorized" or acceptable approaches to capital allocation: (1) the economic capital allocation method and (2) the thin capitalization method. The Commentary provides that, in event of a conflict between the methods applied by the respective states, the Residence State, "in determining the amount of the interest deduction that will be used in computing double taxation relief," will accept the attribution of capital that results under the source state's capital attribution method, assuming

⁵⁰ Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 12 (emphasis added).

⁵¹ These paragraphs were contained in the Discussion Draft of Part I released in August 2004.

⁵² The August 2004 Discussion Draft contemplated that Article 23 would apply to address double taxation that resulted solely because the Source State and the Residence State different methods of capital attribution. See Discussion Draft (Part I) dated August 2, 2004 at paragraphs 30-48.

that it is one of the authorized methods and that it produces an arm's length result.⁵³ The paragraph provides that similar relief might also be obtained under Article 25 or under domestic law, rather than by application of Article 7 and Article 23.

2. Reaction by the United States

The United States, as well as Germany and Japan, entered an observation on the above paragraph:

Germany, Japan and the United States, whilst agreeing to the practical solution described in paragraph 48, wish to clarify how this agreement will be implemented. Neither Germany, nor Japan, nor the United States can automatically accept for all purposes all calculations by the State in which the permanent establishment is located. In cases involving Germany or Japan, the second condition described in paragraph 48 has to be satisfied through a mutual agreement procedure under Article 25. In the case of Japan and the United States, a taxpayer who seeks to obtain additional foreign tax credit limitation must do so through a mutual agreement procedure in which the taxpayer would have to prove to the Japanese or the United States competent authority, as the case may be, that double taxation of the permanent establishment profits which resulted from the conflicting domestic law choices of capital attribution methods has been left unrelieved after applying mechanisms under their respective domestic tax law such as utilisation of foreign tax credit limitation created by other transactions.⁵⁴

The observation indicates that these countries will not automatically accept an attribution of income to a PE (even resulting from one of the authorized capital attribution methods) unless the taxpayer initiates a Mutual Agreement Procedure and shows that actual double taxation has occurred.⁵⁵ For its part, the United States has expressed concerns that the procedure described in the Commentary, if applied in the context of the U.S. foreign tax credit rules, could lead to unanticipated results. First, a taxpayer could conceivably obtain "relief" when the income of a foreign PE was increased as a result of the foreign state's applying a capital attribution method

⁵³ Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 48.

⁵⁴ Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 73.

⁵⁵ Sweden also made an observation on the symmetry concept. Sweden noted that because it did not consider that the authorized methods of capital attribution would necessarily reach an arm's length result, double taxation would likely be involved, and this would make resort to Mutual Agreement Procedures necessary. Id. at paragraph 71.

different from that applied by the United States, although the taxpayer obtained a foreign tax credit for the full amount of additional tax imposed by the Source State as a result of the adjustment.⁵⁶ Second, until the AOA is fully integrated into the bilateral treaty network, the potential for mismatches is especially acute, because the United States does not recognize interest dealings within a single enterprise.⁵⁷ Finally, the United States may consider that the critical determination of whether the Source State's attribution of capital produces an arm's length result should be made by Competent Authority personnel, perhaps because they are more likely to have the specialized expertise needed to apply the new conceptual framework described in the AOA.

3. Practical Impact of the New Commentary

As a practical matter, these changes to the Commentary are not likely to have a direct impact on U.S. practice, either now or in the near future. As noted above, the United States has taken the position that OECD pronouncements concerning the AOA are potentially relevant only with respect to a limited number of U.S. bilateral treaties that already incorporate similar concepts, *i.e.*, that provide for application of the arm's length principle, and contemplate a risk-weighted allocation of "free" capital to the PE as a functionally separate enterprise. Statements of disagreement with some aspects of the implementation process, underscored by the recent observation on paragraph 48 of the new Commentary, indicate that the United States will continue to apply traditional principles to cases involving attribution of profits to PEs, in both the inbound and outbound context.

⁵⁶ We refer to an "adjustment" of the foreign PE's income But the same result may obtain where the taxpayer takes inconsistent reporting positions, pursuant to the requirements of foreign law.

⁵⁷ Treas. Reg. § 1.882-5(c)(2)(iii) provides that "a transaction of any type between separate offices or branches of the same taxpayer does not create an asset or a liability." In other words, interbranch transactions have no for purposes of interest allocation under the provision.

In terms of the final implementation of the AOA, the new Commentary is at best an intermediate step – one that will be in effect only for several years. The more significant portion of the exercise, discussed in the next section, involves redrafting Article 7 from the ground up and the formulation of what amounts to a new Commentary for that Article.

B. Discussion Draft: New Article 7 and Commentary

On July 7, 2008, the OECD issued a discussion draft of a new Article 7 and associated Commentary.⁵⁸ This document also identified several changes to other provisions of the OECD Model Treaty that would be necessary as a consequence of the revisions to Article 7. As compared to the revised Commentary on existing Article 7, which was more limited in scope, this exercise sought to implement fully the conclusions of the PE Report into the OECD Model Tax Convention and the associated Commentary. Public comments are invited on the draft documents until December 31, 2008.

1. New Article 7

The proposal for a new Article 7 is a streamlined version of the Article that it would replace. Paragraph 1 is essentially unchanged from the existing draft.⁵⁹ Paragraph 2 indicates that the profits of the PE are determined on a functionally separate enterprise basis, by reference to the functions performed, assets used, and risks assumed by the enterprise through the PE and through other parts of the enterprise – the central principle of the AOA.⁶⁰ One noteworthy if

⁵⁸ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention (July 7, 2008).

⁵⁹ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Article 7(1).

⁶⁰ Id., Article 7(2).

anticipated provision states the profits of the PE, so determined, are controlling not only for purposes of Article 7 but also for purposes of Articles 23A or 23B.⁶¹

The Draft eliminates paragraphs three through six of existing Article 7. In their place, a new paragraph 3 provides a rule that applies in situations where different amounts of profit are attributed on account of the use of different capital attribution methods by the two States.⁶² Relief under this provision is granted only if both states agree that the application of the capital attribution method produces an arm's length result. If the attribution of profits to the PE produces a result for which Article 23 would not, in the absence of the paragraph, eliminate double taxation, then the Residence State must use the amount of free capital attributed under the Host State's method, and must give relief under Article 23. Although it perhaps could be expressed in simpler terms and is hardly an example of elegant drafting, the apparent intent of this provision is to address, and to require relief under Article 23 for, situations for which a remedy is not otherwise available under Article 23.⁶³

Paragraph 4 of the Article reproduces Article 7(7) of the existing Convention, which deals with situations where profits of the PE include items of income that are addressed by other provisions of the Convention.⁶⁴

2. Commentary on the New Article 7

The Draft Commentary on Article 7 is the OECD's first attempt to summarize all the operative components of the AOA in concise form.⁶⁵ As compared to the revised Commentary

⁶¹ Id.

⁶² Id., Article 7(3).

⁶³ The symmetry paragraphs contained in the 2004 Discussion Draft of the PE Report (paragraphs 36-40) proposed a similar approach. As indicated below, it is unclear whether a U.S. taxpayer that obtained a foreign tax credit sufficient to relieve double taxation from a PE adjustment, i.e., without regard to this provision, would be eligible for relief under the provision.

⁶⁴ Id., Article 7(4).

on existing Article 7, this document goes into considerably more detail and touches on several issues not covered in the above document. Examples include the following:

- Application of the AOA in “three-State” scenarios that implicate adjustments under Article 9 in addition to Article 7 (Paragraph 22);
- The role of taxpayer documentation and the standard for recognition of dealings in the PE context (Paragraph 23);
- General prohibition against secondary tax impacts from notional dealings under the AOA (Paragraph 24); and
- Implications of shifting from allocation of at-cost charges for most or all activities to a new paradigm that requires charges to be based on the arm’s length principle (Paragraph 36).

Consistent with the primary focus of this article on the practical rules regarding interaction between tax administrations, these substantive provisions will not be discussed in detail.

The Draft Commentary identifies several types of double taxation issues that are most likely to arise under Article 7, and for each category provides approaches that should be used to eliminate double taxation. Many of those approaches, either directly or by implication, assign priority to either the Source State or the Residence State concerning particular applications of Article 7. Given that assignment of priority among tax jurisdictions historically ranks among the most critical issues in the Article 7 context, these rules reflect difficult policy choices by the OECD and are matters on which the United States and other OECD member states may ultimately adopt different conclusions.

a. The General Rule

New Article 7(2), rather than the Commentary, contains the primary substantive rule concerning relief from double taxation. The same standard concerning attribution of income to a PE under Article 7 has now been imposed on Article 23, albeit without any changes to the latter

⁶⁵ Id., Commentary on new Article 7

article. The Commentary on Article 7(2) makes it clear that, in practice, the provision favors the adjustment of PE income made by the Source State:

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 23A and 23B by the other Contracting State.⁶⁶

Re-stated in more simplistic terms, this paragraph indicates that the Residence State should grant relief when the Source State modifies the attribution of the PE’s profits, subject to the condition that the Source State acted in accordance with the Convention.

This approach substantially increased the complexity of the analysis under Article 7. Historically, the Source State examined the amount of profit reported by the PE, including the basis on which the reporting of profits was made, and the Source State either made an adjustment to the amount of profits or it did not. If the Source State adjusted the profit attributable to the PE, that adjustment, or more properly the profits of the PE after adjustment by the Source State, would be evaluated by reference to Article 7.⁶⁷ The issue of relief from double taxation that might result from the Source State adjustment was not specifically mentioned in either the Article or the Commentary.⁶⁸ Presumably, if requested, the Residence State would attempt to reduce or eliminate double taxation, either by granting a credit or exemption or perhaps by convincing the Source State that the initial amount of profit attributed to the PE (prior to the

⁶⁶ *Id.*, Commentary on new Article 7, paragraph 24.

⁶⁷ Another, less common, type of adjustment would involve the Residence State reducing the amount of profits that the Enterprise attributed to the PE – for example to correct for the PE being “thickly capitalized” on account of a domestic law requirement in the Source State. Such an adjustment by the Residence State, would also be governed by the standard in Article 7. See Report (Part I) at paragraph 201 (Residence State may reduce profit reported by the PE to amount that reflects an arm’s length allocation of free capital to the PE).

⁶⁸ See generally OECD, Model Tax Convention on Income and on Capital (2005), Article 7 and Commentary. The 2005 Commentary on Article 7 dealt almost exclusively with substantive issues pertaining to the attribution of profits, *i.e.*, issues similar to those now addressed in detail in the final Report (Parts I-IV).

adjustment by the Source State) was in fact correct. In general, this process would take place either under Article 23 or in a Mutual Agreement Procedure under Article 25.

This approach carries over some of the same terminology (“in each State”) from existing Article 7, but states more emphatically that both States are subject to the same standard, insofar as attribution of income to the PE is concerned. This is the basic formulation of the rule, and as such it states the principle in its most general terms. Particular double-taxation scenarios are addressed by more specific rules, to follow. The primary double taxation scenarios addressed are as follows: (1) general inconsistencies in domestic rules regarding the amount, timing, or permissibility of deductions, recognition of income, etc.; (2) differences regarding methods for attribution of capital; and (3) what might collectively be called “transfer pricing” disputes, *i.e.*, differences that relate to the factual and functional analysis of the PE, the nature of the dealings between the PE and the rest of the enterprise, and the construction and application of a range of arm’s length results.

b. General Inconsistencies Between Domestic Rules

Paragraphs 27 through 29 of the new Commentary address the situation in which differences in domestic tax law not directly related to the attribution of profits (*e.g.*, pertaining to depreciation or timing of deductions) result in or contribute to economic double taxation between a PE and the rest of the enterprise.⁶⁹ For example, a U.S. taxpayer might be subject to limitations concerning deductibility of charitable contributions, or the expenses of business-related meals. A host of similar rules of general application (*i.e.*, not targeted at PEs) presumably exists in other jurisdictions. When these domestic rules interact with the analysis used to attribute profits under

⁶⁹ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Commentary on the New Article 7, paragraph 27.

Article 7, double taxation may result, which may be either transient (timing differences that resolve over several tax periods) or permanent (denial of a deduction in one jurisdiction that is available in the other).

In general, Part I of the Report treats the deductibility of items under domestic law as a matter outside the scope of Article 7.⁷⁰ Likewise, the new Commentary concludes that domestic rules pertaining to the deductibility of expenses are not subject to Article 7.⁷¹ However, the new Commentary also takes this opportunity to engage in discussion of the non-discrimination provision of Article 24(3) of the Convention. It concludes that a Contracting State may not impose a condition on deductibility of expenses that, either by design or in practical application, prejudices PEs of enterprises located in another State.⁷²

The desirability of this rule, and the cautionary statements regarding nondiscrimination, is beyond debate. Where a Contracting State might be inclined to adopt (or already might have adopted) a measure that discriminates against PEs of foreign enterprises, the Commentary clarifies that such a practice would violate the State's non-discrimination commitment. In the European Union, treaty non-discrimination rules have been the subject of recent litigation.⁷³ But this provision could conceivably provide a basis for a challenging almost any rule that treats a PE in a different manner than a domestic enterprise. In any event, this language marks a significant

⁷⁰ Report (Part I) at paragraph 54: "It will be noted from the discussion of Article 7(2) that the authorised OECD approach does not mandate an attribution of profit (see paragraph 13 above). Furthermore, the authorised OECD approach only determines which expenses should be attributed to the PE. It does not go on to determine whether those expenses, once attributed, are deductible when computing the profit of the PE. That will be determined under the domestic law of the host country." (Emphasis added). It is noteworthy that this paragraph was retained in the final Report, whereas all other references to "symmetry" were eliminated.

⁷¹ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Commentary on the New Article 7, paragraph 28.

⁷² *Id.*, paragraph 30.

⁷³ See discussion *infra*, Section IV. See Mary C. Bennett, The David R. Tillinghast Lecture, Nondiscrimination in International Tax Law: A Concept in Search of a Principle, 59 Tax. L. Rev. 439 (Summer 2006).

change from the historical approach, which treated issues of deductibility under domestic law as outside the ambit of Article 7.⁷⁴

c. Differences in Methods for Attribution of Capital

In the years leading up to the AOA, a recurring source of controversy was the fact that jurisdictions apply various methods of attributing capital to a PE. Where the Source State and the Residence State apply different methods of capital allocation, the results are often different amounts of equity capital, different amounts of interest expense, and, ultimately, different amounts of income attributable to the PE. Common methods applied are: (1) risk-weighted capital or economic capital allocation methods, which apportion the equity capital of the enterprise based on the relative risk of the assets held by specific parts of the enterprise;⁷⁵ and (2) thin-capitalization, which attributes an amount of equity capital to the PE sufficient to place it within a range of arm's length capital amounts for entities that engage in similar activities and bear similar risks. Some countries also apply a third approach, "quasi-thin capital," which attributes equity capital to the PE based on broad industry classifications.

The Final Report classified the economic capital allocation and thin capitalization approaches as acceptable methods of capital attribution, and also recognized that quasi-thin capitalization might in some cases be used as a safe harbor approach, although it is not an authorized method. But, this carefully-crafted compromise increased the likelihood that

⁷⁴ The "symmetry" language in the 2004 Discussion Draft of the Report (Part I) stated in paragraph 47: [T]here may also be more permanent differences between the way the host country and the home country define profits, for example the host country may not give a deduction for entertaining expenses where the home country does. In these circumstances the difference will not of course disappear over time. However, such differences between countries' rules for calculating profits are outside the scope of tax treaties, and in particular outside the scope of Articles 7 and 9. Accordingly, the issue of taxation not in accordance with the treaty does not arise from such differences and there is no requirement for countries to resolve such differences.

⁷⁵ For example, a financial-services PE that holds a portfolio of low-risk Government bonds would require less equity capital than a similar PE that holds a portfolio of mortgage-backed securities.

inconsistent amounts of profits might be attributed to PEs. Developing an effective and practical solution to this problem was perhaps the highest priority charge to the implementation group.⁷⁶

The first proposal to resolve inconsistencies that might result from application of distinct capital allocation methods was contained in the 2004 Discussion Draft of Part I.⁷⁷ Under this proposal, where the Source State and the Residence State applied different “authorized” methods of capital allocation and different amounts of PE income resulted, the Residence State would generally grant relief from double taxation, provided that it concluded that the result reached by the Source State was consistent with an arm’s length result.⁷⁸ The proposal recognized that States might be able to implement relief under this provision under a summary procedure, *i.e.*, without a Mutual Agreement procedure.⁷⁹ Importantly, any relief that would be granted was “subject to domestic limitations.”⁸⁰ Although the meaning of this term is subject to debate, one obvious interpretation is that any relief granted is subject to all domestic rules in the Source State, including foreign tax credit limitation, exhaustion of foreign remedies, and so on.⁸¹

The proposal for a new Article 7 addresses this issue in a new paragraph 3.⁸² In its broad outlines, Article 7(3) has a rule similar to that proposed in the 2004 Discussion Draft of the Report. The qualifying events are: (1) in attributing profits to the PE, the Source State uses an authorized method of capital attribution that differs from the method applied by the Residence

⁷⁶ The issue was highlighted in the preliminary Note on the release of the Report (Parts I-III) in December 2006. See Report, December 2006, at 4, paragraph 13 (“large majority of countries” agree on an approach for resolution of this issue; a “few countries may not accept [the] broad consensus.”)

⁷⁷ 2004 Discussion Draft (Part I) at paragraph 37.

⁷⁸ Id.

⁷⁹ Id., paragraph 39.

⁸⁰ Id., paragraph 38.

⁸¹ The United States took this position when it entered an observation on a similar provision in the revised Commentary on existing Article 7. See Commentary on Article 7 of the OECD Model Tax Convention (2008), paragraph 73.

⁸² OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Article 7(3).

State of the enterprise; (2) the use of this method by the Source State results in part of the profits of the PE being subject to tax in both States; and (3) the double taxation is not otherwise relieved under Article 23.⁸³ Where these basic requirements are met:

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 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.⁸⁴

Overall, new Article 7(3) reflects a reasonable compromise that that resolves perhaps the most controversial issue in the PE project. Application of the rule entails a number of complex considerations, some of which are addressed in the draft Commentary,⁸⁵ while others are reserved for the Report itself.⁸⁶ The basic conclusion reflects recognition on the part of OECD member states of the potential for double taxation due to inconsistency in methods of capital attribution.

This approach, to what will likely be the most prevalent type of double taxation, particularly the detailed discussion contained in the Draft Commentary, is very flexible. For example, the Commentary gives room for countries to agree to address double taxation in this context by means of either summary procedures or Mutual Agreement procedures.⁸⁷ In addition, Article 7(3) by its terms applies only to the extent that Article 23 does not otherwise relieve double taxation. This would appear to support the United States’ view that if a U.S. taxpayer is able to obtain a foreign tax credit for tax on additional profits attributed to a foreign PE, this

⁸³ Id.

⁸⁴ Id., Article 7(3)(b)

⁸⁵ Id., Commentary at paragraphs 44-50.

⁸⁶ One issue, addressed in detail in the Report, is whether the Source State may apply its home market characterization rules (for example, debt vs. equity) in evaluating the capital structure of the enterprise. See Final Report (Part II), “Annex -- BIS Ratio Approaches.”

⁸⁷ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Commentary at paragraph 47.

provision is inapplicable.⁸⁸ Although this mechanism has more flexibility than the initial proposal in the implementation package,⁸⁹ it remains to be seen whether the United States or other countries will have reservations concerning the approach that has been proposed, as they did with respect to the revised Commentary on the same point.⁹⁰

d. Transfer Pricing Type Disputes

The basic goal of the PE Attribution project, as it was originally conceived, was to consider applying of the arm's length principle, insofar as practical, for purposes of attributing profits to a PE. Successful completion of the project presents both opportunities and risks. On one hand, the full endorsement of the functionally separate entity approach, together with incorporation of the arm's length principle and the pricing methods provided for in the Transfer Pricing Guidelines, have the potential to significantly narrow the points of controversy. On the other hand, the new paradigm, which borrows heavily from Article 9 concepts and transfer pricing approaches, may give rise to new controversies similar to those in the Article 9 context. In the final analysis, these controversies may be more challenging than their counterparts under Article 9.

Conceptually, the rules for resolution of such disputes appear to be patterned on the rules under Article 9 of the OECD Model Tax Convention. The Article 9 paradigm reflects that the

⁸⁸ See BNA-Daily Tax Report, June 8, 2007, "Permanent Establishment: Treasury Clarifies U.S. Position Regarding Interim OECD PE Profit Allocation Guidance." The official cited in the article noted that a U.S. taxpayer might obtain a credit for additional foreign tax imposed by the PE jurisdiction, simply by operation of the U.S. foreign tax credit regime. It is not clear that this is the type of relief referenced in the OECD draft. At a minimum, before seeking relief under Article 23 or Article 25, a U.S. taxpayer should probably show actual economic double taxation on account of a Source State adjustment, i.e., taxation not relieved by U.S. foreign tax credit.

⁸⁹ The 2006 Draft of the Report indicated that countries had agreed to resolve double taxation that resulted from application of different capital attribution methods by having the Residence State "accept, for purposes of giving double taxation relief, the quantum of the interest deduction derived from application of [the Source State's] approach in determining the permanent establishment profits. OECD, Draft Report, December 2006 at 4 (emphasis added). The Final Report released on July 17, 2008 did not contain a similar statement.

⁹⁰ See Note ____, supra.

arm's length principle contemplates a range of arm's length results or prices, rather than a single result. Under Article 9, if the taxpayer reports income based on prices or results from transactions with an associated enterprise that are within an arm's length range, then in general no adjustment should be made.⁹¹ If one State adjusts the income of an associated enterprise, the result may be double taxation, insofar as the income from the transaction has already been taxed in another jurisdiction.

Article 9 provides the general approach that is used to reduce or eliminate double taxation in the event of an adjustment to the "conditions" prevailing between associated enterprises (*i.e.*, a transfer pricing adjustment).⁹² Generally speaking, the State other than the one that adjusted the income of the associated enterprise must consider making a corresponding reduction of income, applying the arm's length principle in order to eliminate economic double taxation to which the associated enterprise would otherwise be subject.⁹³ But this State does so only if to the extent that it agrees that the income or results of the transaction between the associated enterprises, after adjustment by the other State, correspond to the arm's length principle.⁹⁴

One can safely predict that disputes will arise concerning a wide range of "transfer pricing type" issues under the approach in the final PE Reports. What are the specific terms of the dealings between the PE and the rest of the enterprise? Are the activities performed by the enterprise in its home office in the nature of stewardship (no charge), at-cost services, or services for which an arm's length mark-up is due under the arm's length standard? In other words, in

⁹¹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paragraph 1.48 ("If the relevant conditions of the controlled transactions (*e.g.*, price or margin) are within the arm's length range, no adjustment should be made.").

⁹² OECD Model Tax Treaty (July 2005), Article 9 Commentary, paragraph 5.

⁹³ *Id.*, paragraph 7.

⁹⁴ *Id.*, paragraph 6. If there is a dispute between the States concerning the amount and character of the adjustment of income, the Mutual Agreement procedure of Article 25 should be implemented. *See id.* at paragraph 11. In Mutual Agreement proceedings that relate to Article 9 matters, the Transfer Pricing Guidelines provide the basis for resolution of issues. OECD *Transfer Pricing Guidelines*, Preface, paragraph 17.

the PE context, countries and taxpayers alike will confront issues similar to those involved in transfer pricing between associated enterprises, but these issues will have an increased “degree of difficulty,” if only because the analysis described in the final PE Reports is both novel and potentially very complex.

The approach in the draft Commentary with respect to elimination of double taxation is fundamentally similar to the approach under Article 9. That is, if an enterprise determined the amount of profits attributable to the PE on a consistent basis in both in the Source State and the Residence State, and if the amount of profits reported by the taxpayer corresponds to the Source State’s domestic law and is consistent with an arm’s length result, then no adjustment should be made by either State.⁹⁵ Putting aside the special situation (discussed above) where distinct capital attribution methods result in different amounts of PE income being reported in the two States, the rule is that if a Source State makes an adjustment to the PE’s income, the Residence State should defer to the State that made the adjustment, and grant relief to the taxpayer accordingly.⁹⁶ The Commentary provides an additional paragraph that may be included in bilateral treaties, at the option of the parties.⁹⁷ This first version of this paragraph, which is modeled on paragraph 2 of Article 9, provides a mechanism whereby the affected State is obliged to make a corresponding adjustment, but only if it agrees with the adjustment made by the initiating State.⁹⁸ This provision would provide some preference, but not conclusive effect, to the initial adjustment.

⁹⁵ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Commentary at paragraphs 42, 51.

⁹⁶ Id., paragraph 53.

⁹⁷ Id.

⁹⁸ Cf., OECD Model Tax Treaty (2005), Article 9(2). Although the concept is the same, the mechanism is quite different. In the single enterprise/PE context, it is not possible to modify the “terms” of dealings within the

The Commentary also provides an alternative version of the paragraph discussed above. This more neutral alternative would require virtually all disputed Article 7 cases in this general category to be resolved (if at all) by Mutual Agreement procedures.⁹⁹ The distinction between this alternative approach and the formulation described above are subtle. The paragraph 67 formulation does not create an obligation on the part of the affected State to grant relief. It does, however, require the States to consult in an effort to reach agreement, and if they are unable to do so they will both be in violation of their obligation under the Treaty.¹⁰⁰

The draft Commentary provides detailed but ultimately ambiguous guidance, consisting of two alternative paragraphs and examples that indicate how specific cases would be resolved.¹⁰¹ Given that the document is published in draft form, and will likely be revised, it is probably not worthwhile to discuss all the ramifications of these rules. In one respect, however, the rules are noteworthy, and this is their treatment of the situation where double taxation results, although both the Source State and the Residence State have acted “in accordance with the Convention.”¹⁰² In such cases, various rules direct the parties first to Article 23, then to Mutual Agreement Procedures under Article 25, and finally and if necessary, to arbitration under Article 25. The rules maintain neutrality as between the Source State and the Residence State, in terms of which State’s adjustment takes priority. But they also impose a rigorous discipline on the

enterprise, since those dealings, as compared to transactions between associated enterprises within the scope of Article 9, are notional constructs that exist only for purposes of attribution of profits under Article 7.

⁹⁹ OECD, Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention, Commentary at paragraph 67.

¹⁰⁰ *Id.*, paragraph 68.

¹⁰¹ *Id.*, paragraphs 56, 57

¹⁰² The scenario is familiar to transfer pricing practitioners. Under Article 9, State A makes adjustments to the prices charged on transactions between two controlled enterprises, and these adjustments place the State A taxpayer within the arm’s length range of results, as constructed by State A. In a Mutual Agreement Procedure, State B constructs the arm’s length range in a different manner than State A, or it proposes that the adjustment be made to a different point in the arm’s length range. In such cases, the risk of unrelieved economic double taxation is present.

States to pursue alternate remedies, including arbitration, in an attempt to eliminate double taxation.

On balance, these rules are perhaps best viewed as a work in progress. The Article 9 rules on which they are based are themselves imperfect in that they do not eliminate double taxation in all cases, notwithstanding the advent of more extensive arbitration provisions in recent years. The complexity of the substantive rules that have recently been adopted under Article 7 suggests that the double tax controversies in this area will, if anything, be equally as challenging as those under Article 9.

3. Practical Impact of the Documents

Because these documents were released on preliminary form and are subject to discussion and comment, their impact at present is minimal. The amendment of the Commentary to existing Article 7, which was much more limited in scope, gave rise to observations from the United States and several other countries. The changes reflected in this second prong of the implementation process are much more extensive. It will be interesting to see whether the proposed revisions survive in their present form, and if so whether the United States or other OECD members find it necessary to enter reservations on the Article, or observations on the Commentary.

IV. Impact of the AOA on U.S. Tax Practice

Having discussed the OECD's project to provide more uniform principles regarding attribution of profits to PEs, as well as the two-prong approach for implementation of the AOA, the final portion of this article makes several brief observations concerning the potential impact of the AOA on U.S. tax practice. The substantive rules put forward in the OECD Report will be

influential, as taxpayers adopt reporting positions under the U.S. treaties that incorporate the AOA or close counterparts thereof. The more interesting issues, at least in the short to medium term, will probably not involve the substantive rules for attribution of profits, although those rules will generate controversy. Rather, the critical issues involve practical matters such as the interaction between treaty- and Code-based rules and the procedures that will be used eliminating double taxation in cases where the United States or its treaty partner adjusts the amount of profit attributable to the PE.

A. Original Goals of PE Project Cede to Process Issues

This article previously alluded to the comprehensive scope of the OECD's work concerning attribution of profits. The final Reports (General Principles, Banking, Global Dealing, and Insurance) may not provide actual rules and illustrative examples, such as those with which U.S. practitioners are accustomed. However, the Reports do provide statements of principle that in some areas contain substantial detail. Admittedly, on certain issues that have been disputed for many years, the Report offers pragmatic solutions¹⁰³ and in other cases the Report provides broad principles in lieu of a specific rule.¹⁰⁴ In the final analysis, however, this is not a shortcoming in the PE Reports. Rather, it results from the willingness to address fundamental issues that go to the core of defining the respective tax jurisdiction of the Source and Residence State.

Consensus on a number of these core issues was elusive, not least of them the guidelines for symmetrical application of the AOA. The OECD concluded that this issue required study by experts in interpretation and drafting of tax treaties, individuals who had not been directly

¹⁰³ Cite to paragraph on fixed assets. Cite to Cudd Pressure. Other examples include: ownership of intangibles (paragraph); reimbursement of activities at cost or at cost-plus (paragraph).

¹⁰⁴ Cite to paragraphs on intangible property, cost vs. cost plus markup.

involved in the development of the AOA. The focus of the OECD work thus shifted from theoretical principles (as contained in the Reports, which were largely completed as of December 2006) to drafting considerations (integrating the AOA into Article 7 and the Commentary), including practical issues (procedures to address double taxation).

In the United States, substantial thought had been given to similar issues, even before the final adoption of the AOA by the OECD. The following sections describe the basic compliance environment that will be faced by U.S. PEs and U.S. enterprises with foreign PEs. The final section identifies a few key issues that are likely to be important as the AOA becomes more fully integrated into U.S. practice in the coming years.

B. U.S. Practice

This section considers whether application of the arm's length principle under the AOA has an effect on: (1) the attribution of profits by the United States to a PE owned by a foreign entity; and (2) the relief granted in connection with a foreign revenue authority adjustment to the income of a PE owned by a U.S. entity. In the interest of brevity, the basic rules in these areas are provided only in outline form, as some familiarity with them is presumed.

1. Inbound (U.S. taxation of U.S. trade or business)

At present, the United States applies distinct sets of rules to determine the taxable income of an entity engaged in a trade or business in the United States, depending on whether the entity with the U.S. trade or business (1) qualifies for treaty benefits and has claimed such benefits, or (2) elects to be analyzed under the Code and the regulations.

Briefly, a foreign-owned enterprise that engages in a U.S. trade or business and that does not qualify for (or does not claim) benefits under an applicable treaty is subject to net basis tax with respect to its effectively connected income in the United States. Under the Code, a force of

attraction principle may render certain other income of the enterprise subject to net-basis taxation in the United States. Conversely, other rules, if applicable, provide for exclusions that reduce the amount of effectively connected income that is subject to U.S. tax. To determine the amount of interest deduction to which the PE is entitled, the United States has traditionally applied Treas. Reg. § 1.882-5, which provides for a multi-step allocation of the interest expense of the enterprise, on one of several alternative bases. A range of other statutory and regulatory requirements (branch profits, branch interest, etc.) also applies both to branches and to enterprises that engage in a trade or business in the United States.

If a foreign enterprise that has a U.S. trade or business makes a valid claim for treaty benefits with respect to the PE in the United States,¹⁰⁵ specific rules in the Code and the regulations may apply in a modified manner or may be displaced altogether. For example, most U.S. treaties limit the force of attraction principle that otherwise applies under the Code. In some cases, a particular treaty might also contain provide that application of the principles of Treas. Reg. 1.882-5 is permissible, but not required.

Several U.S. treaties currently in force provide for analytical approaches that are quite similar to the AOA (among U.S. treaties currently in force, treaties with Germany, Belgium, U.K, and Japan). Assuming that a taxpayer presents a valid claim for benefits under one of these treaties, is the United States subject to the full range of guidance in the OECD Reports and the implementation project? The answer, which may not be entirely satisfactory, is that at present no guidance directly addresses this scenario.¹⁰⁶ Although section 482, the provision in U.S. law that

¹⁰⁵ As explained below, there are significant issues concerning the so-called consistency requirement, which requires a taxpayer to select either the Code or the Treaty, but prohibits cherry-picking. See Rev. Rul. 84-17, 1984-1 C.B. 308.

¹⁰⁶ The IRS has been updating various compliance documents to reflect the potential that approaches other than Treas. Reg. § 1.882-5 might apply for purposes of allocating interest to a trade or business in the United States.

contains the arm's length standard, by its terms deals with "organizations, trades or businesses," the provision has be viewed as limited to transactions between associated enterprises, or controlled taxpayers, and does not apply to parts of a single enterprise.¹⁰⁷ Extending section 482 or the associated regulations to interbranch transactions would be a significant step and presumably would not be undertaken by Treasury and the IRS without a complete understanding of its potential consequences.

Another approach would be to allow the guidance in the OECD Reports to inform the attribution of profits under U.S. treaties that incorporate similar principles, including treaties that are concluded in the future. This alternative presents several significant problems. Among other things, it would elevate a document that was concluded in a multilateral context to the level of substantive guidance under U.S. domestic law. The implementation framework intends that the status of the PE Reports will be equivalent to that of the OECD Transfer Pricing Guidelines, but the Guidelines do not constitute substantive guidance in the U.S. domestic context.¹⁰⁸ In recent months, U.S. officials, although not referring to the PE area in particular, have suggested that guidance on specific treaty provisions might be appropriate.¹⁰⁹ The attribution of profits under the AOA-type treaties might be one area in which published guidance would be worthwhile. In the interim, the solution appears to consist of applications of the arm's length principle or arm's

See, e.g., Form 1120-F, Schedule I, Interest Expense Allocation under Regulations Section 1.882-5 (2007, General Instructions.

¹⁰⁷ I.R.C. § 482.

¹⁰⁸ See IRS General Legal Advice Memorandum, AM-2007-07 (March 15, 2007) (Issue number 5) (U.S. Competent Authority should use the Transfer Pricing Guidelines to resolve Mutual Agreement procedures, but IRS Exam and IRS Appeals should apply the U.S. regulations).

¹⁰⁹ "Treasury Considering Generic Treaty-Related Guidance, Official Says," 2008 TNT 83-2, Tax Notes Today, April 28, 2008 (statements of Associate Chief Counsel (International) Steven A. Musher); "More Generic Treaty Guidance Likely in Next Business Plan, IRS Official Says," 2008 TNT 92-32, Tax Notes Today, May 12, 2008..

length standard, informed by the section 482 regulations as well as by ad hoc guidance on specific issues.¹¹⁰

2. Outbound (foreign taxation of PE of U.S. entity)

In the outbound context, the primary consideration often involves whether the U.S. taxpayer can obtain effective foreign tax credit relief in connection with additional tax imposed on a foreign PE by a foreign revenue authority. As in the inbound context, the foreign jurisdiction's ability to tax the income of the foreign branch or PE may be limited by an applicable tax treaty. In addition, if a treaty is applicable, the United States may have a greater obligation to grant relief under Article 23 or Article 25, subject to domestic law limitations, such as the foreign tax credit limitation.

U.S. taxpayers are subject to net-basis U.S. tax on their worldwide income, which includes profits earned by a foreign branch or permanent establishment. Expenses of a U.S. enterprise, including items such as interest expense, are allocated and apportioned to various classes of income.¹¹¹

In the single-enterprise context, a U.S. taxpayer can claim a foreign tax credit for income taxes imposed by a foreign revenue authority, subject to the limitation in section 904. The limitation depends on a variety of factors, including the source and character of the income that subject to tax, the rate of tax imposed, and so on. Carry-forwards and carry-backs of unused foreign tax credits are permitted. The allocation and apportionment of deductions to various classes of income, as well as the sourcing and characterization of income, may limit the ability of

¹¹⁰ See discussion infra concerning the interaction between the AOA and domestic rules such as Treas. Reg. § 1.882-5.

¹¹¹ Treas. Reg. § 1.861-8.

a U.S. taxpayer to obtain a foreign tax credit in the event that a foreign revenue authority increases the amount of income attributable to a PE in its jurisdiction.

The amount of income attributed to a foreign PE or foreign branch under the U.S. rules might not, and in many cases likely will not, correspond to the amount of profit attributable to the PE under the AOA. If one of the jurisdictions that was signatory to a treaty with AOA-type provisions attributed additional profits to the PE of a U.S. enterprise, the United States would in theory be required to grant relief to avoid double taxation, provided that the other country acted in accord with its treaty obligations. That is, the United States would attempt to eliminate economic double taxation, either by giving the U.S. taxpayer a credit under Article 23 for the additional tax imposed by the foreign jurisdiction, or by negotiating with the foreign Competent Authority under Article 25 in an attempt to resolve the matter.

The rules that have been proposed for implementation of the AOA alter the above rules in one significant respect. Depending on the specific reason for the foreign revenue authority's adjustment, the proposed rules (e.g., proposed Commentary on existing Article 7) require the United States to grant a foreign tax credit for the additional tax imposed by the foreign revenue authority.

The United States rejects the view that the AOA imposes an independent obligation to grant relief under Article 23 in the event of an adjustment by a foreign revenue authority under the AOA. The United States' position is that, notwithstanding the increase in the foreign tax imposed on the PE, the net effect may not be to subject the U.S. taxpayer to economic double taxation. That is, assuming the U.S. taxpayer has foreign tax credits (or carryovers or carrybacks) for it to obtain a foreign tax credit for the additional foreign tax imposed on the PE, then in theory at least, no double taxation has occurred on account of the foreign jurisdiction's

increase of the PE's taxable income.¹¹² Conversely, if a limitation on the availability of the foreign tax credit prevents the taxpayer from obtaining a tax credit, this would be as a result of U.S. domestic rules, which should not be affected by the AOA or by the directives that implement the AOA.

3. New role envisioned for APA and Competent Authority

On May 21, 2008, the IRS modified the Advance Pricing Agreement (“APA”) Revenue Procedure¹¹³ to provide that the applications would be accepted for resolution of any issues under tax treaties to which transfer pricing principles are relevant, including attribution of profits to a PE under a treaty.¹¹⁴ The incoming Director of the APA Program stated that the new procedure was limited to treaties such as those with Japan and the United Kingdom, and other treaties that applied the AOA for purposes of attribution of profits to a PE.¹¹⁵ Before the modification of the APA Revenue Procedure, the only basis for taxpayers (in the Large and Mid-Size Business Division (“LMSB”)) to obtain a prospective ruling in this regard was to seek a Prefiling Agreement with the IRS/LMSB.¹¹⁶

As indicated above, when it entered an observation on paragraph 48 of the new Commentary to Article 7, the United States indicated that if attribution of profits to a PE leads is

¹¹² Article 23 in most U.S. tax treaties permits, exclusively for purposes of avoiding double taxation, a re-sourcing of items of income to the jurisdiction in question. See U.S. Model Income Tax Treaty (2006), Art. 23(4)(c). Presumably, the United States would apply such re-sourcing provisions for purposes of granting relief from an foreign-initiated adjustment of PE income under the AOA.

¹¹³ Rev. Proc. 2006-9, 2006-1 C.B. 278

¹¹⁴ Rev. Proc. 2008-31, 2008-23 I.R.B. 1 (May 21, 2008).

¹¹⁵ “New Director Shares Goals and Expectations for APA Program,” Tax Notes Today, 2008 TNT 105-4 (May 30, 2008).

¹¹⁶ Rev. Proc. 2007-17, 2007-4 I.R.B. 368 (Dec. 26, 2006). Section 3.06(5) of the Revenue Procedure provides that existence of PE and attribution of profits to PE constitute permissible subject matter for Prefiling Agreement, provided that the Associate Chief Counsel (International) agrees that consideration is in the best interests of tax administration. In view of the expansion of the APA Revenue Procedure to include these cases, the Associate Chief Counsel (International) might conclude that an APA is the exclusive means of obtaining prospective relief for this class of cases.

a matter of disagreement with a treaty partner,¹¹⁷ the preferred approach is to resort to Mutual Agreement procedures pursuant to Article 25.¹¹⁸ By expanding the scope of the APA Revenue Procedure to include attribution of profits cases that involve application of the arm's length principle, the IRS has provided a practical means of resolving cases in this area on a prospective basis.

C. Critical Treaty Issues

Implementation of the AOA is proceeding in incremental steps. One practitioner has suggested that at present there are in effect two separate regimes that exist side by side: (1) the longstanding Code-based rules, with a modest overlay for pre-AOA tax treaty provisions that may have limited those rules in some respects; and (2) the new treaties that implement the arm's length principle and thus have the potential to displace the treaty based rules in their entirety in favor of an application of the AOA. In an environment characterized, for the time being at least, by complex and uncertain interactions between Code- and treaty-based rules, it is not surprising that serious treaty policy issues are being raised. We focus on two of these, in order to give some sense of the dimensions of the problem.

1. Consistency

Historically, the United States has applied a general consistency rule concerning the election to claim the benefits of a treaty, as opposed to taxation under the Code. For example, in an early case involving the treaty with Poland the IRS concluded that a U.S. taxpayer could not apply the provisions of the U.S.-Poland Treaty for business profits attributable in part to a PE, while electing the provisions of the Code for a business loss that was not attributable to the

¹¹⁷ Presumably, this would apply to both the inbound and outbound scenarios discussed above.

¹¹⁸ Note ____, supra.

PE.¹¹⁹ The taxpayer was required to apply either the Code or the provisions of the Treaty, but could not apply the provisions of both in a selective manner that resulted in decreased tax liability.

The same principle was reflected in the 1996 U.S. Model Tax Convention¹²⁰ and was described in the Technical Explanation as follows:

It follows that under the principle of paragraph 2 a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax.¹²¹

The treaties with United Kingdom and Japan adopted the concept that the income of the PE could be interpreted in accordance with the arm's length principle, but the TEs both Treaties also cite the general consistency principle. In particular, the TEs state that risk weighting of assets might be too difficult, so some taxpayers may elect to apply the approach in Treas. Reg. § 1.882-5 in lieu of risk weighting.¹²² In hindsight, this language in the TEs may have created a chimerical method, based in part on Treas. Reg. § 1.882-5 and in part based on the arm's length standard and recognition of interbranch transactions, but without any means of resolving inconsistencies between the two, much less with any explanation of the interaction with Art. 1(2), which provides that the Treaties do not restrict any benefit provided under U.S. domestic law.¹²³

¹¹⁹ Rev. Rul. 84-17, 1984-1 C.B. 308, amplifying Rev. Rul. 81-78, 1981-1 C.B. 604.

¹²⁰ U.S. Model Income Tax Convention, Article 1(2) (1996).

¹²¹ Treasury Department Technical Explanation of the U.S. Model Income Tax Convention (Sept. 20, 1996), Art. 7(2). The TE went on to describe the facts and holding of Rev. Rul. 84-17, 1984-1 C.B. 308.

¹²² E.g., Technical Explanation for U.S.-Japan Treaty, Art. 7(3).

¹²³ See also Notice 2005-53, 2005-2 C.B. 263. The Notice indicated that Treas. Reg. § 1.882-5 no longer provided the "exclusive rules for determining the interest expense of a PE under a U.S. tax treaty, and described the approach under the treaties with Japan and the United Kingdom.

When Treasury and the IRS issued final regulations under Treas. Reg. § 1.882-5, the Treasury Decision indicated that the interaction between the regulations and various treaty-based rules that applied the arm's length principle was under study:

The Treasury Department and the IRS are continuing to consider the specific application of [the] consistency principle including the application of §1.882-5, the interaction of §1.882-5 with other U.S. income tax treaties (particularly those being renegotiated in whole or in part), and the application of the branch profits tax under alternative rules for determining interest expense attributable to business profits.¹²⁴

The Technical Explanation of the 2006 U.S. Model Treaty provided a general example of a taxpayer that had extensive foreign-source royalty income attributable to a U.S. branch that would be excluded under section 864(c).¹²⁵ The TE indicated that the taxpayer could elect to apply whichever approach – Article 7 or section 864 – that leads to the lesser amount of U.S. tax, but the taxpayer must act consistently and in accordance with the TE for Article 1(2).¹²⁶ The TE went on to provide a similar example for a financial institution:

In the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules.... Under the consistency rule . . . a financial institution that conducts different lines of business through its U.S. permanent establishment may not choose to apply the rules of the Code with respect to some lines of business and Article 7 of the Convention with respect to others. If it chooses to use the rules of Article 7 to allocate its income from its trading book, it may not then use U.S. domestic rules to allocate income from its loan portfolio.¹²⁷

¹²⁴ T.D. 9281, Tax Treatment of Foreign Corporations Operating in the United States Through Branches, 2006-2 C.B. 517, 519.

¹²⁵ Treasury Department Technical Explanation of the U.S. Model Income Tax Convention (Nov. 15, 1996), Art. 7(2).

¹²⁶ Id.

¹²⁷ Id.

Commentators objected strongly to the above language in the TE of the Model Treaty, and to similar language in the TEs for various treaties that incorporated AOA-type concepts.¹²⁸

The U.S. position on this issue appears to be evolving. The most recent treaties that contain AOA-type language, including several that are being considered by the Senate, do not contain the “anti-mix-and-match” language.¹²⁹ U.S. officials have indicated that the consistency rules in the various treaties would not prevent a foreign bank from applying different methods of capital allocation to various parts of a foreign banking operation.¹³⁰

2. Nondiscrimination

In recent years, the role of the nondiscrimination article of income tax treaties has been the subject of substantial attention by scholars and practitioners.¹³¹ The broader implications of the nondiscrimination article on treaty practice are beyond the scope of this article. But the nondiscrimination principle may have a direct impact on the process of implementing the AOA into U.S. practice.

The non-discrimination article in most treaties prevents the signatories from applying measures that have the effect treating non-nationals on a less favorable basis than nationals of the Contracting State. The provision contains a prohibition that applies specifically to permanent establishments, of which the following provision in the U.S. Model Treaty is representative:

¹²⁸ “Institute of International Bankers Comments to Treasury on Consistency Between Income Tax Treaties, U.S. Domestic Law,” BNA-Daily Tax Report, 191 CTR I-2, October 3, 2007.

¹²⁹ E.g., Treasury Department Technical Explanation of the September 21, 2007 Protocol to the U.S.-Canada Treaty, explanation of Article 4 of the Protocol (which replaces Article 7(2) of the Treaty); Treasury Department, Technical Explanation of the Convention Between the United States and Iceland, July 10, 2008, available on BNA TaxCore.

¹³⁰ “Different Rules Allowed for Global Dealing Versus Lending, IRS Official Tells Bankers,” BNA-Daily Tax Report, March 5, 2008. Statement of Steven A. Musher, Associate Chief Counsel (International) concerning interaction between Global Dealing proposed. Deputy Assistant Secretary for International Tax Affairs Michael Mundaca indicated that Treasury was still working through issues associated within interaction between treaties and U.S. tax rules.

¹³¹ M.C. Bennett, supra Note ____; see also International Fiscal Association, 93a Cahiers de Droit Fiscal International, Non-Discrimination at the Crossroads of International Taxation (2008).

The taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that state carrying on similar activities.¹³²

The TE for this provision gives examples of situations in which U.S. law places different requirements on PEs of foreign enterprises the overall result of which does not contravene the nondiscrimination provision.¹³³

The nondiscrimination provision in bilateral tax treaties, and similar concepts incorporated in the freedom of establishment provision in Article 43 of the European Community Treaty have been the subject of numerous opinions in the EU.¹³⁴ United States courts have addressed this provision on only a few occasions. One of the summary judgment rulings in NatWest, for example, concluded that the nondiscrimination provision prevented the approach whereby a so-called “under-capitalized” branch was be required to treat a portion of its borrowings from the rest of the enterprise as an infusion of equity capital.¹³⁵ The court concluded that it was erroneous and discriminatory to apply a “corporate yardstick” to evaluate the amount of capital required by a U.S. branch.¹³⁶

At this early stage, it is not possible to identify specific nondiscrimination arguments that might be raised, other than to predict such arguments will surely be raised as the AOA is more widely applied under U.S. law. One area in which the AOA might be viewed as imposing

¹³² U.S. Model Income Tax Treaty (2006), Art. 24(2).

¹³³ Treasury Department Technical Explanation of U.S. Model Income Tax Convention (Nov. 15, 2006), Art. 24(2).

¹³⁴ Most recently, in Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn, ECJ No. C-414/06 (May 15, 2008), the European Court of Justice ruled, under Article 43 of the European Community Treaty, that Germany’s denial of the losses incurred by a foreign PE was permissible. “ECJ Rebuffs Advocate General Ruling, Upholds Germany’s Cross-Border Rules,” BNA-Daily Tax Report, July 9, 2008 ggs

¹³⁵ NatWest, 58 Fed. Cl. 491, ___ (2003).

¹³⁶ The issue of equivalent or disparate treatment as between PEs and stand-alone subsidiaries, in this particular context, is a red herring. The issue under Article 24(3) is whether a state applies discriminatory treatment to a PE, based on its nationality. See Final Report (Part 1) at paragraphs 133-134 (general rule precluding non-recognition of guarantees within a single-enterprise is not discriminatory against PEs because it reflects fundamental factual difference between PE and stand-alone subsidiary).

significant additional burdens is in the area of documentation of interbranch dealings. Under the AOA, recognition of dealings between parts of the enterprise is critical to application of the arm's length principle, and the Reports acknowledge that the burdens on taxpayers in this regard might actually be more onerous than in the associated enterprise context.¹³⁷ Thus, whereas a part of a national enterprise might satisfy its tax reporting requirements by means of fairly routine bookkeeping entries, the PE of a foreign national would in theory be required to prepare and maintain detailed documentation that describe its dealings with other parts of the enterprise. Although distinct informational requirements applicable to foreign PEs are not necessarily discriminatory,¹³⁸ the requirement imposed on PEs by the AOA might be subject to challenge on nondiscrimination grounds.

¹³⁷ See Final Report (Part I) at paragraph 37: "This . . . 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 recognize the dealing"

¹³⁸ For example, the TE for the U.S. Model Treaty (2006) refers to different information-reporting requirements applicable to foreign PEs.