

PE Attribution Amnesia at the OECD

© Richard Vann: Not to be quoted without permission

The 2016 OECD discussion drafts produced as part of the G20/OECD Base Erosion and Profit Shifting (BEPS) project on international tax rules involving permanent establishments (PEs)¹ are concerning: they often ignore the last 30 years of OECD work in this area, apparently misconceive the issues and produce probably unworkable proposals. One obvious question is why would this OECD amnesia happen. Possible answers are that the OECD is still working in silos which do not communicate with each other (in this case Working Party 6 (WP6) on Taxation of Multinational Enterprises and Working Party 11 (WP11) on Aggressive Tax Planning),² that the turnover of OECD Secretariat staff particularly in the WP6 transfer pricing area means there is no OECD institutional memory, or that the OECD has realised the problems created by its 1998-2010 PE attribution work³ and is now second-guessing it but without admitting the problems and pushing it from a transfer pricing and mismatch perspective to its “logical” conclusion.

This paper is part of a larger BEPS project but here only the technical tax law consequences of one issue in the PE Drafts are tackled. The paper argues that the PE Drafts proposals imply much more extensive changes to domestic tax law and tax treaties than appears on the surface, which amount to a dramatic restructuring of some basic elements of international tax rules. It also questions whether the outcomes are practically feasible.

Fearful symmetry

The particular focus is on what Brian Arnold refers to as “fearful symmetry”,⁴ that is, to what extent do the international tax rules relating to PEs require symmetrical tax treatment in the PE country and head office or other-PE country of PE dealings which do not amount to transactions that are recognised by the legal system generally. The term “dealings” is used here to describe intra-entity events recognised for tax purposes under the separate entity arm’s length principle in article 7(2) of the OECD Model in relation to the taxation of business profits:⁵

¹ OECD, Public Discussion Draft: BEPS ACTION 7 Additional Guidance on the Attribution of Profits to Permanent Establishments (2016 – PE Attribution Draft), OECD, Public Discussion Draft: BEPS ACTION 2 Branch Mismatch Structures (2016 – PE Mismatch Draft) – together the PE Drafts.

² WP11 is acknowledged as the body responsible for the PE Mismatch Draft. WP6 is not referred to at all in the PE Attribution Draft and it may be that the work is a combined effort of WP6 and WP11, as occurred in the final stages of the OECD work on attribution of profits to PE in the period 1998-2010, see note 3 below.

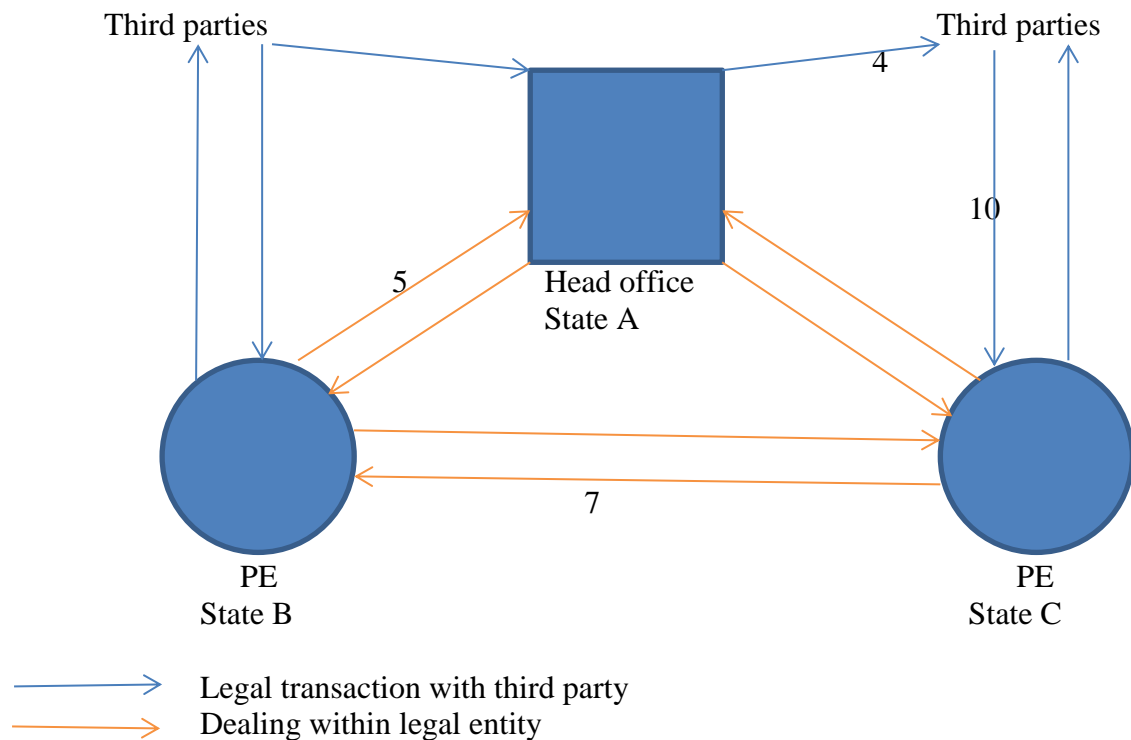
³ OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (2010 Attribution Report) available at <http://www.oecd.org/ctp/transfer-pricing/45689524.pdf>. There was an earlier Report in 2008 (hence the 2010 in the title) and multiple earlier drafts of the four parts going back to 1998 (and a draft in 1997 when global trading, which is Part III of the 2010 Attribution Report, was part of a different OECD project). At the same time as this report was released, the OECD released a new article 7 and Commentary, see note 5 below.

⁴ Arnold, Fearful Symmetry: The Attribution of Profits “in Each Contracting State” (2007) Bulletin for International Taxation 312, drawing on the poem by William Blake, The Tyger.

⁵ OECD, Model Tax Convention on Income and on Capital (2014 Full Version published in 2015 – OECD Model) M-22; this is the version adopted in 2010 which has only been clearly accepted in the short period of its existence by a minority of generally large OECD countries (eg, Germany, Japan,

For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The nature of this issue can be illustrated diagrammatically as follows:



The direction of the arrows indicates the flows of income (rather than the flow of goods and services) with each of the head office and the PEs making sales (inflow) and purchases (outflow)
 The numbers are for a simple example below; it is assumed that the numbers represent appropriate arm's length prices, but they have been chosen mainly to leave different profits at each stage for exposition

Netherlands, UK, US) and has been rejected by the UN Tax Cooperation Committee, see UN, Model Double Taxation Convention between Developed and Developing Countries (2011) 139-140. So the former OECD article 7(2) at M-23 is still overwhelmingly the basis for business profits article in existing and new bilateral tax treaties: "Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment." It will be noted that both versions use "dealing/s" in the same intra-entity sense. The PE Attribution Draft deals with the 2010 version of article 7 only and does not make clear to what extent the discussion is relevant to the earlier version.

For all of the internal dealings, each arrow in the diagram raises four tax issues:
(1) the treatment of the PE in the PE country (how much profit does that country tax);
(2) the treatment of the PE in the residence/other-PE country (how much “double tax relief” in the form of exemption or credit for the PE country tax does it provide);
(3) the treatment of the head office/other-PE in the PE country (how much head office/other-PE profit does it tax); and
(4) the treatment of the head office/other-PE in the residence/other-PE country (how much head office/other-PE profit does it tax).

These four issues form several pairs and symmetry in the broad sense refers to consistent treatment of the pairs both within country and cross country: ie within country Issues (1) and (2); and Issues (3) and (4); and cross country Issues (1) and (3), Issues (1) and (4), Issues (2) and (3) or Issues (2) and (4).

In fact because the distributive and relief rules of tax treaties operate as between a residence country and a PE country, and the bilateral treaty between two PE countries does not operate generally between them, it may be necessary to separate the residence country and other-PE country cases for some of the four issues above⁶ as at least two bilateral treaties may be relevant in the latter case (the A-B and A-C treaties in the diagram above, not the B-C treaty which seems the obvious one to apply). The discussion of the symmetry issue has generally been in terms of PE-head office dealings and this paper will largely follow suit, though it needs to be recognised that companies do not consist of a single head office and single PE which adds to the complexity of the analysis and its practical application.

To give a practical example, the most significant type of PE economically in the modern world is probably bank branches. Banks operate internationally largely in PE form as a result of the structure of international bank regulation (home country regulation only applies if the bank uses branch form in foreign countries).⁷ Hence Deutsche Bank AG has its headquarters in Frankfurt and has major branches in Asia in Hong Kong, Singapore (regional head office), Sydney and Tokyo. Banks have enormous numbers of international dealings within the single legal entity because of this structure, including notional loans, derivatives, foreign exchange and liquidity support. In terms of the diagram above funds could be raised by the bank in Frankfurt from third party depositors, “loaned” to the Singapore branch which in turn “on-lends” to the Sydney branch which lends to a third party Australian business (though in the real world the transactions/dealings would not be so simple and sequential).

With A as Germany, B as Singapore and C as Australia in the diagram and looking at the notional flow of interest into Singapore from Australia and out of Singapore to Germany using the numbers in the diagram to test the various kinds of symmetry:

Issue (1) – does Singapore determine its tax on the PE by treating the notional interest from Australia (7 on the simple numbers in the diagram) as income and the notional payment to Germany (5) as a deduction, giving taxable income of 2?

⁶ Issue 1 for the dealings between the PE country and the other-PE country is dealt with by the A-B treaty.

⁷ At least for wholesale/business banking as opposed to retail/consumer banking. For the latter it may be necessary to incorporate a local subsidiary as in Australia.

Issue (2) – does Germany determine the amount of income exempt in Singapore (assuming an exemption applies to the PE) by reference to those flows?

Issue (3) – does Singapore levy tax on the notional interest paid to Germany (5) (and if applying net taxation giving a deduction for actual interest paid in Germany by the head office of 4)?

Issue (4) – does Germany treat the notional flow of interest to Germany (5) as income taxable in Germany (with a similar issue for net taxation and a further relief Issue (2) for Singapore tax on the interest if the answer to Issue (3) is yes)?

In terms of tax treaties after the OECD 1998-2010 work and assuming a treaty in the form of the OECD Model 2010 version of article 7, the answers as explained below arguably would be (1) yes for significant international issues, (2) yes for significant international issues, (3) no without variation of treaty provisions and (4) permitted but not required. In terms of full symmetry it would be necessary to answer yes to all four questions for significant international issues (as the answer to the first question under Article 7 is a yes). Symmetry applies only in a limited way under the OECD Model – between (1) and (2) for significant international issues. This was the conclusion of Arnold even though he was analysing just Issues (1) and (2) and though it is not always easy to separate Issues (2) and (4) as we will see. The example above itself only deals with the income flowing in one direction – PE at the end of the world (Australia) to Singapore PE (regional head office) to Germany (residence and global head office) and does not cover income flows from head office outwards where some of the tax questions and their answers may be different.

PE Drafts in outline

The PE Attribution Draft deals with the question whether the changes made to the PE definition and transfer pricing guidelines by BEPS⁸ affect the analysis of attribution of profits to PEs flowing from the 2010 Attribution Report and the new Model article 7(2). One of the changes concerns the warehousing exception to the PE definition in article 5(4)(a), (b) of the OECD Model which has now been limited to exclude cases where warehousing is a central part of the business model of the enterprise.⁹ Assuming that the warehouse is now a PE the question is how much can be taxed in the state of its location.

In the course of analysing that issue, the OECD discusses an example where a specialist warehousing company which stores and manages spare parts owned by its customers previously conducted all its operations in its residence country, but now constructs and staffs a new warehouse in a different country to meet its customers' demands which constitutes a PE in that country. The staff in the country undertake only basic routine functions and the head office provides many value adding services

⁸ OECD/G20 Base Erosion and Profit Shifting Project, Preventing the Artificial Avoidance of Permanent Establishment Status ACTION 7: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation ACTIONS 8-10: 2015 Final Reports.

⁹ An obvious target would seem to be Amazon's warehousing operations for speedy delivery of hardcopy of books, though whether they are captured is yet to be definitely settled as taxpayers are not of course mentioned by name.

to the warehousing operation including knowhow and software to manage the spare parts inventory. The draft concludes in line with the 2010 Attribution Report that a deduction should be allowed to the PE for the value in accordance with transfer pricing principles of the dealings involving services received from head office. It then continues:¹⁰

WRU's head office would no longer have the costs of interest, depreciation and the employee costs, but would have to recognise compensation relating to the operation of the business, including analysis of usage and replenishment policies for customers. In addition, the Head Office would recognise compensation relating to services in providing know-how and software.

In other words the answer to Issue (4) above is now yes. This could be an unintended error but that seems unlikely as it is effectively repeated through three additional variants of the example and the same sentiment appears, though not consistently, in the PE Mismatch Draft and coming from a different perspective. Apart from the mystery of how this answer can be justified under the terms of tax treaties discussed below, it would require major reconfiguration of many countries' domestic tax law and tax treaties for relieving double taxation. It produces symmetry between Issues (1) and (4), but also implies symmetry between Issues (1) and (2), though perhaps in a different form to present.

A significant part of the PE Mismatch Draft deals more generally with notional payments arising under dealings between a PE and its head office. The purpose of the BEPS hybrid mismatch work is to deal with many of the common international tax planning devices often referred to as tax arbitrage, ie tax advantages achieved by the different tax treatment of the same transaction by different countries for different taxpayers.¹¹ For current purposes the two main forms of mismatch are deduction/non-inclusion (D/NI) under which a payment is recognised by the country of the payer as a deduction but is not recognised as income in the country of the recipient and double deduction (DD) under which the same payment gives rise to a deduction in two different countries against different streams of income, both of which can arise for dealings. It is not all tax mismatches that are covered, there has to be an element of hybridity which brings about the result – that two countries characterise the same transaction differently (as debt and equity, or loan and sale) or the same entity differently (as tax transparent partnership or tax opaque company).

It is accepted in the PE Mismatch Draft that generally PEs do not necessarily involve hybridity in the sense above as the outcome is produced by the way the tax treatment of PEs is structured. Hence the asymmetry itself is generally treated in the PE context by the PE Mismatch Draft as supplying the necessary element of hybridity. In other

¹⁰ Para 93, p 28. The revenue from the new warehouses activities for customers is attributed to the PE but the PE profit is minimal as it has significant notional expenses from its dealings with head office; the first part of the quote is effectively saying that while warehousing was only carried on in the residence country, all revenue was attributed to the head office and expenses of interest depreciation and staff were likewise recorded there, but when the PE is created that revenue and those expenses are allocated to the PE.

¹¹ OECD/G20 Base Erosion and Profit Shifting Project, Neutralising the Effects of Hybrid Mismatch Arrangements ACTION 2: 2015 Final Report; the DD part of this report does deal with PE cases as noted below and so can cover the same taxpayer.

words it builds upon assumptions about the way in which PEs are taxed, but without being clear to what extent that derives from domestic law or tax treaties.

The solutions for mismatches involving dealings are the usual complex ones of the hybrid mismatch work. For D/NI mismatches the deduction in the PE country is denied as the primary rule, while for D/D mismatches the deduction in the residence country is denied. The solutions in the PE context bristle with even more difficulties discussed below than the BEPS hybrid mismatch report, but for present purposes it is noteworthy that the examples do not provide a direct solution for the case in the PE Attribution Draft relating to the treatment of the head office in the residence country of a deductible notional payment in the PE country.

The link to symmetry in the PE context is obvious – to the extent there is a lack of symmetry for a dealing, a tax advantage may be achieved, but it is effectively symmetry between Issues (1) and (4) or between Issues (1) and (2) that are in question, symmetry here being concerned with the case where one side of a transaction/dealing deducts and the other side does not have a matching inclusion in income or also obtains a deduction in both countries which offsets non-dual inclusion income. It is not intended to analyse the PE Mismatch Draft in its own right partly because that would require effectively another paper on hybrid mismatches but rather with respect to symmetry and its interaction with the PE Attribution Draft.

In evaluating the PE Drafts at a high level, it is useful to restate the purposes of the international income tax system in general and tax treaties in particular, though not in an entirely conventional way. In a world where countries typically levy the income tax on a both a residence and source basis, the international tax system generally seeks to avoid (some) different income tax outcomes for international activities compared to purely domestic activities to remove differences which would otherwise bias economic decision-making against or in favour of international transactions compared to domestic transactions.¹² Tax treaties have historically been the main mechanism for achieving this objective, but in such a way as to interfere as little as possible with the domestic tax system. That system generally remains in place and the tax treaty in limited cases produces lower or no taxation in a country without requiring any far-reaching change to its domestic tax law. It is usually enough for the tax treaty (a relatively short instrument compared to the underlying income tax law) to be implemented in its terms, rather than translated into domestic law in a much longer form. This is a recognition of the importance of tax sovereignty to nation states and leaves a wide range of discretion to countries in tax policy, except when significant differences are likely to result in international situations.

¹² Traditionally the bias against international transactions has been described as double taxation, though double taxation is a meaningless concept in the sense of more than one levy of tax on the same transaction/activity being inherently objectionable. We do not worry about the levy of corporate income tax and GST/VAT on the same sale by a corporation. Similarly double non-taxation is commonly used in the BEPS context as a reference to the bias in favour of international transactions when they produce overall less corporate tax than an equivalent domestic transaction. It is too late to swim against this linguistic tide. The OECD made a modest contribution by dropping the word “double” from the title of its Model in 1992, though for the different reason that tax treaties are about more than double taxation. The summary here does not include the most controversial and contested issue of inter-nation equity, nor give any indication of the related but more specific issues of which country should reduce its tax and why.

While the BEPS project is new in generally requiring more income tax on certain international transactions, it partly continues the historic trend of avoiding deep interference in domestic tax systems by adopting various amendments to the OECD Model and Commentaries, with the addition of a mechanism for much faster delivery in the form of the multilateral instrument published on 24 November 2016.¹³

But the BEPS project also, particularly in relation to Actions 2 on hybrid mismatch arrangements, Action 4 on interest deductions and Action 5 on harmful tax practices provides new international tax standards or convergence, which are novel (for non-EU countries at least) in requiring extensive amendment of domestic tax law to be given effect.¹⁴ This approach to standards/convergence in international taxation has been pioneered in the exchange of information area by the Global Forum on Transparency and Exchange of Information which has required many countries to make significant changes in domestic tax law on the administrative side (such as abolition of bank secrecy) though there are also treaty instruments involved. Requiring changes to substantive domestic tax law without a treaty instrument, just soft law mechanisms of monitoring and peer review, is a further significant shift brought about by the BEPS project. It is not yet known how effective this new direction will be.

It is thus not surprising that the PE Mismatch Draft, which is part of Action 2, is intended to operate by changes in domestic law, but it will in many countries come up against the problem that PE attribution rules on which is it partly built are a matter of treaty law and are not necessarily reflected at all in domestic law: article 7(2) operates as a limit on how much can be taxed under domestic law, not as requiring the method by which taxable profits must be calculated under domestic law.¹⁵ By contrast the PE Attribution Draft is part of the treaty and substantive transfer pricing work of BEPS which is intended to operate through treaties rather than domestic law. Yet by the way it treats Issue (4) in respect of PE dealings and requires symmetry to be extended to the taxation of the head office, it also seems to be requiring significant change to domestic law, not only to the way in which Issue (4) is solved but perhaps implicitly Issue (2). From a transfer pricing view of the world all relevant international tax issues should be driven by the separate entity approach and while the prevailing view is that treaties do not go so far, there is probably nothing to prevent application of this view in domestic law for all four tax symmetry issues raised by PEs, with the possible exception of Issue (3).

In that sense, though they are dealing with different problems, the PE Drafts may end up in the same place in requiring similar changes to domestic law by (almost) fully implementing fearful symmetry, which extends far beyond the immediate concerns of

¹³ OECD/G20 Base Erosion and Profit Shifting Project, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties ACTION 15: 2015 Final Report, OECD, Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system (2016) <http://www.oecd.org/tax/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm>.

¹⁴ See note 11 above for Action 2, OECD/G20 Base Erosion and Profit Shifting Project, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments ACTION 4: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance ACTION 5: 2015 Final Report; for the level of political commitment to the various changes, see OECD/G20 Base Erosion and Profit Shifting Project, Explanatory Statement 2015 Final Reports, para 11, p 6.

¹⁵ 2010 Attribution Report para 9, p 13.

the drafts. In another sense, however, they may end up pulling in different directions. The 2010 Attribution Report was particularly concerned to remove the limits on the separate entity approach in the previous Commentary on article 7 as it related to interest, royalty and management fee deductions for PEs of limiting deductions for intra-entity dealings giving rise to such payments from a PE to the extent they are not matched by equivalent third party expense – putting aside enterprises whose business was trading in money (banks), intellectual property and providing management services. The PE Attribution Draft similarly assumes deductions for such dealings.

The PE Mismatch Draft will deny deductions to PEs for D/NI mismatches as the primary rule to the extent that the enterprise cannot prove that there is dual-inclusion. For DD mismatches denial of deductions arises in the residence country, but many cases may involve both D/NI and DD mismatches, in which event the D/NI rule prevails. So the common result of the draft will be denial of deductions in the PE country, contrary to the PE Attribution Draft. Given that the latter is an interpretation of treaty provisions that override domestic law, while the former operates through domestic law, a priority issue arises.

Some history of symmetry for business profits

In terms of the four issues above, the overwhelming focus in the past has been on Issue (1) in the attribution context – article 7 is generally viewed as concerning when the PE country may tax (when there is a PE) and how much it can tax (the profit attributable to the PE's activities based on the separate entity arm's length principle) so that symmetry was not directly in issue. Over the years, there has been growing interest in the extent to which article 7 is relevant to relief in the residence country – Issue (2) in a residence-PE scenario and one of the main concerns of Arnold's article. Issue (3) became an explicit focus during OECD projects on attribution of profits to PEs in the 1998-2010 attribution work, and Issue (4) is blithely adopted or assumed in the PE Drafts, though surprisingly there is little explicit awareness of the history and the interactions of the issues in those drafts. As Arnold has dealt with the overall history fairly fully,¹⁶ the account here will summarise the history broadly and focus on a few areas which Arnold did not cover partly because he did not have access to archival material now in the public domain.

The original articulation of the separate entity arm's length principle for attributing profits to PEs and the drafting of the standard treaty provision on business profits was the work of the League of Nations in the 1930s and 1940s which left a large number of unanswered questions in its train. Most of that work concerned only part of Issue (1) as the main case considered was dealings in goods in the direction from the head office to the PE (purchased/manufactured by head office and sold by the PE), with the particular concern of ensuring that the PE country received a suitable share of the profits.

1957-1977

When the matter was taken up by the OEEC through its Fiscal Committee in 1957, it was pointed out that it was possible that profits could be deliberately moved into a PE

¹⁶ Note 2, 313-318.

as opposed to out of the PE and that the drafting of the article needed to deal with this case as well. After some misunderstandings of the point being raised (and some toing and froing in the drafting), it was settled that the article would be drafted in terms of concurrent jurisdiction to tax the PE for the PE and residence country, with an obligation for each to apply the arm's length principle to the profit of the PE, as indicated by the words "in each Contracting State". What this implied in terms of Issue (2) (and incidentally Issue (4)) was not elaborated due to the piecemeal way in which the original OECD draft model was drafted over 7 years with different groups working on different articles.¹⁷ At the time the business profits article was being drafted, work had not started on the relief article, so it was not possible for the Commentary produced for article 7 to provide any guidance on Issue (2). As is often the way with the OECD, the Commentary having then been settled, no real attempt was made to revise it once the overall draft model was completed. The limitation on deductions for dealings by PEs involving notional interest, management fees and royalties to a share of actual such costs of the enterprise was also introduced at this time for a variety of theoretical, pragmatic and practical reasons.¹⁸

During the course of revision of the draft model for publication in 1977, Issue (2) and to a degree Issue (4) were raised as article 9(2) on corresponding adjustments between separate associated enterprises was adopted. It was considered whether a similar provision was appropriate in article 7 and decided that it was not as article 7(2) required the application the application of the separate entity arm's length principle to PE profits in each state.¹⁹ Nothing was added to the Commentary, however, to make clear that the principle in article 7(2) applied to Issue (2) as well as Issue (1). Similarly little change occurred in relation to the limitations on deductions though the issue attracted some discussion.²⁰

1989-1993

As a result of agitation over various PE attribution issues at the IFA Congress in 1986, the OECD again tackled the issue in 1989-1993. On this occasion for the first time symmetry was a clear focus of the work, as the main concern was different tax treatment in different countries. A questionnaire was circulated and replies received from 17 countries, of which 11 were foreign tax credit countries and six were exemption countries in relation to PE profits (the balance has shifted since so that the relative number of credit and exemption countries has probably more than reversed). The three issues of interest for present purposes are the different measurement rules

¹⁷ That the drafters at one stage thought that the problem was the taxation of the head office apparently in the residence country (Issue (4)) is shown by an intermediate draft, FC/WP7(59)1 at 4, 9 March 1957, "Where an enterprise of one of the Contracting States carries on business in the other State through a permanent establishment situated therein, there shall be attributed to that permanent establishment and to the part of the enterprise in the first-mentioned State the profits which the permanent establishment and that other part of the enterprise respectively might be expected to make if they were distinct and separate enterprises engaged in the same or similar activities under the same or similar conditions and dealing quite independently with each other." The archival material referred to in this paper uses the OEEC/OECD documents numbers and is available at www.taxtreatieshistory.org.

¹⁸ For a detailed analysis of this issue see Vann, *Do We Need 7(3)? History and Purpose of the Business Profits Deduction Rule in Tax Treaties* in Tiley ed, *Studies in the History of Tax Law* Volume 5 (2012) 393-425, Arnold, note 2 above, 331-333.

¹⁹ FC/WP7(70)2 paras 15-26 pp 6-11, 12 November 1970.

²⁰ FC/WP7(67)1, 27 February 1967.

applied by many residence countries compared to PE countries in relation to PE income, particularly in the context of relief, the different views that countries take on the limitation of PE deductions on certain dealings and the “existence of two different methods for eliminating double taxation, the right of each country to define profits earned abroad according to its domestic law, as well as the different approaches to the determination of the timing of the realisation of a gain or loss and to foreign currency translation”²¹.

In relation to relief it was recognised that there are systemic differences between taxation of PEs’ income in the PE country and in the residence country. The residence country is usually taxing the worldwide profits of the enterprise on a realisation basis, ie when third party transactions occur rather than intra-entity dealings, while the PE country operates much more on the basis of dealings. Most income taxes still operate on a realisation basis though there are elements of full accruals in some areas (such as original issue discount, financial transactions more generally) and residence country credit and exemption systems are often structured around this realisation approach. The residence country will have full information about the enterprise and so is also practically equipped to tax on a global basis in this way. By contrast the PE country largely operates off the PE’s accounts, which are usually internal management accounts prepared on a dealings basis; in addition the PE country usually has much less information about third party dealings outside the country and in the case of outbound transfers of assets from the PE to the rest of the enterprise, it is likely that the PE will never know when third party income is realised.

This realisation approach does not mean that residence relief systems ignore the dealings entirely. An exemption country will usually recognise an outbound transfer from head office at market value for tax purposes but then allow an offsetting provision which is only released when third party income is realised. A credit country will need to calculate the PE profits for foreign tax credit limit purposes. The OECD work on this occasion showed that there were great divergences in the precise details of countries’ domestic law on relief by exemption or credit (Issue (2)), a fact long recognised in the OECD Commentary on relief which leaves many of the details to domestic law. The OECD did recognise that there would be cases where relief was ineffective, and other situations involving outbound transfers of capital assets from head offices or PEs which the enterprise may never sell where the recognition of dealings was the best way of ensuring against over-taxation. Rather than requiring changes in domestic law relief and other rules, it recommended the use of the mutual agreement procedure to deal with problems, generally with the residence country following the transfer pricing tax treatment of the PE country, ie symmetrically using the same arm’s length prices as the PE country, even if that was not the treatment under domestic tax law of the residence country for the particular situation. It was considered that occasions of over- and under-taxation would be rare and hence did not require alignment of domestic law.

²¹ OECD, Attribution of Income to Permanent Establishments (1993 – 1993 Attribution Report), republished as ch R(13) in 2014 Full Version, note ?? above, para 2 pp 2-3. For more recent country surveys of PE attribution, see Russo, Tax Treatment of “Dealings” Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty (2004) Bulletin for International Taxation 472, International Fiscal Association, The attribution of profits to permanent establishments (2006) 91b cahiers de droit fiscal international..

The implication of these comments are important to understanding some of the difficulties in the PE Drafts. Issue (2) can be solved by the mechanisms just described and does not require direct use of symmetry; further Issue (4) does not arise for residence countries in most cases as they do not include any income from a dealing with the PE in head office income and there is no checking how much third party income is actually included as that would require significant compliance.

In relation to the other differences between countries dealt with in the 1989-1993 work the analysis is the same. Some slight easing of the limits on deductions for dealings involving interest, management fees and royalties are adopted but generally they remain. Otherwise different country views are to be dealt with by similar mechanisms as those just outlined. So to this point symmetry receives little support as a general principle to apply to Issues (1), (2) and (4). Nonetheless symmetry does appear expressly for the first time in the OECD Commentary in the changes recommended by the work. This, however, has to do with two particular problems which are unrelated to the main issues being considered in this paper.

Australia raised a complaint that dealings generally can produce artificial results which reads like a statement of its single entity approach to the taxation of PEs.²² The OECD dismisses the comment but then goes on to a different issue of the accounts of the PE and head office not reflecting the same numbers and/or of the dealings not reflecting the substance of what is being done. In the very different context of capital allocation to PEs and its relationship with interest deductions claimed by PEs, it is stated that even if the PEs and head office accounts of loans and interest payments are symmetrical results will be partial (meaning it seems that the profits figure for PE and head office will be changed from what they otherwise would be and so in this context even symmetrical accounts will not be sufficient to justify deductions). As a result the Commentary was amended to limit the use of PE accounts if they were not symmetrical with the head office and to not use such accounts for capital allocations even if symmetrical.²³

Both uses of symmetry are decidedly odd in view of the discussion of relief in the 1993 Attribution Report but they disappeared from the Commentary in 2010. It follows from what was said above about the different nature of head office and PE accounts and the related domestic tax rules that symmetry may well not exist in the accounts (whether tax or management); the OECD itself recognises that they will likely be in different currencies which will pose difficulties (not to mention languages, accounting/tax rules etc).

The problem raised by a requirement of symmetry in the accounts (whatever exactly it means) is demonstrated by a Canadian case where a PE of a US company was created

²² See TR 2001/11 for the main Australian Taxation Office (ATO) ruling on the topic. Australia maintained an Observation on the OECD Commentary in the period 1994-2005 rejecting the recognition of dealings under the single entity approach, 2014 Full Version, above note ??, ch C-7 p 96. Shortly after the questionnaire was completed Australia changes back to an exemption system for double tax relief for foreign PEs of Australian companies. This is another structural variant of the exemption system on a realisation basis as the exemption operates at the gross actual income level and actual deductions related to such income are denied on the basis that they relate to exempt income. This kind of system is not specifically discussed in the 1993 Attribution Report but is raised in the PE Mismatch Draft, see below.

²³ Note 22 above, pp 9-10, 16-17, 33-34, 39.

in Canada by equipment used to cap an oil-well. The PE claimed a deduction for notional rent on the equipment paid to head office implying an equipment lease form of dealing while domestic Canadian tax law provided depreciation based on the market value of the equipment when it entered Canada (and so recognised a different dealing effectively of sale by the head office to the PE). Various reasons were given for disallowing the claimed rental deduction but one reason given by one judge was that the notional rent was not recognised in the US tax return of the taxpayer and so led to double non-taxation which was contrary to the purpose of tax treaties.²⁴ Accounting evidence was that the US return was a consolidated tax return for the taxpayer and all its subsidiaries so that the notional rent even if in the accounts would have disappeared on consolidation. The questions of whether the significant real service fee paid to the taxpayer by the owner of the oilwell was included in income in the US and of how the US foreign tax credit system based on actual income and expense operated were simply not looked at by the judge. If they had been it would have been obvious to the judge that the third party income was indeed present in the return.

1998-2010

WP6 wanted to deal more systematically with symmetry in its extensive PE attribution work in this period and produced a 2004 draft with a separate section on symmetry.²⁵ Further work by WP6 was prevented by the OECD, however, on the basis that the remit of the work was to elaborate attribution to the PE under article 7 and WP6's symmetry work related to article 23 on relief, ie WP6 was limited to Issue (1) and could not look at Issue (2), nor by implication Issues (3) or (4). The discussion was therefore dropped from later versions of the attribution work. Once the attribution work of WP6 was in its final stages, a Joint Drafting Group involving Working Party 1 on Tax Conventions (WP1) and WP6 was given a separate mandate to redraft the Model and Commentary to give effect to the WP6 work and deal with other treaty issues arising, which put symmetry back on the table but largely in the hands of the tax treaty experts in WP1, not WP6.

Symmetry between Issues (1) and (2) in the context of this work is the core of Arnold's article and so will not be traversed in detail here, but rather Arnold's (and by 2010 the OECD's) conclusions will be summarised and the implications for symmetry discussed. Arnold's object was to provide some meaning to the words "in each Contracting State" in article 7(2). Working from what has been the more or less universal assumption about the operation of tax treaties from the beginning that taxable profits are determined by domestic law subject to consistency with treaty obligations, Arnold identifies a number of general ways in which different calculations of profits could arise between states under domestic law and treaties: permanent differences, timing differences, income classification (conflicts of qualification), transfer pricing and different income attribution/sourcing rules (attribution in the article 7 sense, not the often-used sense nowadays of income being assessed to different taxpayers). He concludes that the words "in each Contracting State" are probably directed only to transfer pricing and require countries to take the

²⁴ Cudd Pressure Control Inc v R [1998] FCA 1019, McDonald JA at paras 11, 30-33

²⁵ OECD, Discussion Draft on Attribution of Profits to Permanent Establishments – Part I (General Considerations) (2004) available at <http://www.oecd.org/ctp/transfer-pricing/33637685.pdf>, paras 30-48 pp 12-16.

same view on this matter, but he also recommends that this should be made clear ideally by an express provision like article 9(2) of the Model providing the mechanism to bring about symmetry. The Commentary already made clear that timing differences and conflicts of qualification were dealt with by article 23, as was one aspect of attribution/sourcing. He recommends that the Model or Commentary make clear that other aspects of attribution/sourcing are dealt with by treaties and that permanent differences arising otherwise are not affected by tax treaties.

These outcomes were largely achieved in 2010: article 7(3) parallels article 9(2), article 7(2) makes clear in its opening words that the principle it contains applies both in the PE state and for residence relief under article 23, there is detailed guidance on attribution in both the Commentary and the 2010 Attribution Report which seems to deal fully with attribution/sourcing issues, while the Commentary makes clear that any other permanent differences in taxable profit measurement under domestic law of the PE and residence states are not dealt with. The phrase “in each Contracting State” remains intact though rendered more or less irrelevant, but nonetheless extensive, though not complete, symmetry between Issues (1) and (2) is achieved through the Model and 2010 Attribution Report. Domestic law is left intact and the treaty operates as a limit on how much the PE country can tax and for how much profit the residence country has to provide relief. Domestic tax policy, including the details of the computation of profits and the detailed operation of the relief mechanism are generally unaffected and it is only for significant international issues that treaty symmetry bites.

While much more systematic than the 1989-1993 work, and finally achieving the abandonment of the limitations on deductions of notional royalties and management fees though multiplying the complexities of interest deductions for actual and notional payments, the outcomes of this large project are in the same spirit as earlier PE attribution work in the recognition of the myriad details and policies involved in countries’ calculation of taxable business profits and the need to avoid extensive changes to domestic tax law to give effect to tax treaty obligations, the importance of providing mechanisms to resolve differences related to international aspects of Issues (1) and (2), and the elusiveness of consensus on interest deductions.

In the drafting of the Model and Commentary changes to give effect to the attribution work generally, including beyond article 7, consideration was given to Issue (3), and to symmetry between Issues (1) and (3). The focus was on cases where the dealing was a notional lease from head office to the PE of immovable property situated in the PE country involving the payment of notional rent to head office, or a notional loan from head office involving notional interest from the PE. In the case of separate entities, such transactions would give additional taxing rights to the PE country under articles 6 or 11 of the OECD Model concerning income from immovable property (unlimited taxing rights) and interest (tax limited to 10% of the gross amount of interest).

The 2010 Commentary provides that as article 7(2) operates only for the purposes of articles 7 and 23, the separate entity arm’s length principle applied to the dealing does not turn the amount arising under the dealing into income from immovable property or interest as defined in those other articles and thus give additional taxing rights to the PE country, ie no symmetry. If, however, the PE country does not agree with this

conclusion, then it should seek to modify the terms of 2010 article 7 in its tax treaties either to extend symmetry to articles 6 and 11 or to deny deductions for such amounts, in either case producing symmetry between Issues (1) and (3).²⁶ Generally the symmetry question will not arise in any event because the 2010 Attribution Report provides that immovable property used by the PE is generally to be treated as owned by the PE (so largely excluding a lease from head office as a possible dealing), and that for non-financial enterprises, dealings in the form of loans will not be recognised unless the enterprise has a fully-fledged treasury operation.²⁷

In one sense these matters were not new. Even though notional interest was generally only deductible for non-financial enterprises to the extent it reflected interest paid by the enterprise to third parties according to the Commentary prior to 2010, it was implicit that more such interest could be deducted by a PE than arose in the PE state because “borne” by the PE under article 11 and thus taxable there. Similarly there were some comments in the Commentary which could be interpreted in a similar way to the 2010 Attribution Report for tangible assets.²⁸ The reasons for these earlier conclusions have nothing to do with symmetry between Issues (1) and (3); 2010 was the first occasion that this symmetry aspect was addressed. For its part WP6 has until now steered clear of these and similar issues.²⁹

PE Attribution Draft in more detail

The surprise in the PE Attribution Draft from a symmetry perspective (but by no means the only problem in the draft) thus is the adoption of symmetry for Issues (1) and (4). It will be evident from the previous discussion that while symmetry has been a focus since the late 1980s, symmetry for Issues (1) and (4) has been generally

²⁶ 2014 Full Version, above note ??, Commentary on article 5, paras 28-29 pp C(7)11-13. Although at times the language is quite general and thus could also be regarded as relevant to Issue (4), it is clear from the context that Issue (3) and symmetry from the PE country perspective are the focus. [There are no such treaties? – to be checked]

²⁷ 2010 Attribution Report, above note ??, Pt I para 75 pp 28-29 (immovable property), paras 152-171 pp 43-46 (interest). For financial services enterprises the OECD has always recognised notional financial dealings. Under the OECD Model royalties are not taxable at source, but in the large majority of actual treaties source taxation is permitted. There are no similar limitations on dealings involving intellectual property in the 2010 Attribution Report so that symmetry between Issues (1) and (3) is likely to arise mainly for notional royalties in practice.

²⁸ For interest three cases can be distinguished: (i) where the PE itself borrows for the purposes of its business, (ii) where the head office or another part of the enterprise borrows specifically for the purposes of the PE’s business and (iii) where the head office borrows for the purposes of several PEs or for the enterprise generally, eg to finance general enterprise overheads, and a particular PE benefits from the overheads and thus the borrowed funds. The Commentary on article 11 para 27 makes clear that the arising rule in article 11(5) only applies to the first two cases essentially to avoid complex issues of apportionment and tax being applied to only part of the interest payment. In the period 1994-2005 the Commentary on article 7 para 18.1 reflected that interest was deductible in all three cases producing a difference between the deductible amount and the amount sourced in the PE country under article 11. The US recognises this outcome by levying a branch interest tax on the paying PE for the amount of the difference (excess of deductible amount over amount covered by the interest article) but other countries accept the outcome in the Commentary. Although the 2008 and 2010 business profits Commentary no longer contain the explicit reference to the three cases, they have not changed the outcome in this kind of case. For tangible property, see 2014 Full Version, note ?? above, ch C-7 pp 81-82 on the history of paragraph 21.

²⁹ 2010 Attribution Report Pt III para 5 and footnote 1, pp 108-109 (interest), BEPS Actions 8 to 10 2015 Final Reports pp 68-69 (transfer pricing work on intangibles not relevant to definition of royalties under OECD Model).

assumed not to arise under transfer pricing principles nor to be required by treaty, but rather symmetry for Issues (1) and (2). Further as the answer to Issue (3) is now clearly no under treaties, unless a specific treaty extends the separate entity arm's length principle in article 7(2) to the whole treaty, symmetry between Issues (3) and (4) likewise generally does not arise under transfer principles and is not required by tax treaties.

The draft is presented as an application of transfer pricing principles in a treaty context and the results are presented as being required by treaties in 2010 form. In case it is not clear from the preceding analysis, the treaty conclusion that head office has to include the notional revenue (or notional expense) from a dealing in its calculation of taxable income of the enterprise is simply incorrect. Article 7 operates only for the purposes of taxation of the PE and for the purposes of relief; it does not mandate a calculation of head office income on a separate entity arm's length basis and if that is to be required the Model must be further modified to bring about this result.³⁰ On the other hand there seems to be nothing in treaties which would preclude a country from drafting its domestic law in this way for taxing head office and if the draft intends to convey a suggestion to that effect, the question then becomes how does such drafting interact with the symmetry required for Issues (1) and (2) which has been put on a much clearer footing by the new Commentary.

It was noted above in the discussion of the 1993 Attribution Report that generally exemption and credit systems operate on a realisation basis. This proposition now requires further analysis. That same work in its discussion of symmetry in a different context noted that with suitable (extensive and not very probable) assumptions about the accounts, the profit of the PE and the profit of the head office on a separate entity basis will sum to the profit of the enterprise if accounts are prepared symmetrically. That is true in a general sense but most domestic relief systems do not operate by summing PE and head office accounts as the 1993 Attribution Report itself recognised. Once actual revenue and expense of the enterprise are the basis of a residence country relief system, there seems to be little room for Issue (4) which in effect is subsumed into Issue (2).

If the details of tax systems are examined, however, as usual there is a continuum – no country is really ever a pure exemption country or a pure credit country and there is no ideal or paradigm for either system – it is necessary to consider different permutations that countries adopt to know if ever and when Issue (4) is relevant. To take an extreme where relief and Issue (2) is in principle irrelevant, consider a residence country which has a true territorial system and only taxes income which is sourced there. So long as the domestic source rules align with the (implicit) source rules in treaties where source taxation is permitted under the treaty, then a treaty relief article will have no work to do. To be consistent with its treaties, the source rule for business profits would require the adoption of the separate entity arm's length principle to determine the profits of the head office, ie Issue (4) would be answered yes by the country's domestic law, or alternatively to provide relief in cases when the domestic source rules allocated too much profit from a treaty perspective to the head office. In the 1993 report the French system is classified at one point as exemption but

³⁰ See note ?? above for the kind of drafting necessary. For treaties not in 2001 form, it is clear from the discussion above that the result is not required.

it may be more accurate to regard it as a territorial system which explains why it taxes the head office on outbound transfer and not on realisation of income by the enterprise from third parties.³¹

At the other extreme is the foreign tax credit regime where realisation is usually applied fully (actual income and expense) for taxable income of the enterprise and the amount of tax in the PE country is only checked to see that the amount of profits taxed there does not exceed the article 7(2) amount for foreign tax credit limit purposes (calculated under residence country tax rules as modified by the treaty). When the foreign tax credit is calculated on a worldwide basis, the system can work without too much problem so long as any sourcing rules in domestic law for credit purposes do not treat actual revenue and expense as domestic or foreign contrary to the implicit treaty rules.

If the limit is country by country, then it becomes necessary in determining the credit limit on business profits per country in cases where the enterprise has PEs in more than one country and those PEs have dealings among themselves to use the arm's length separate enterprise principle in the limit calculation. Otherwise if credits for a particular country's tax calculated on that basis are disallowed as exceeding the credit limit because of a different calculation method (assuming away all but the international reasons for variation in such calculations), there would seem to be conflict with treaty relief obligations for treaties in OECD form. Although most actual treaties involving relief by foreign tax credit usually make reference to use of the residence country's domestic law in calculating the credit there is still an obligation to relieve in accordance with the treaty principles. For treaties using the 2010 version of article 7(2), the cross reference to article 23 would seem to incorporate the separate entity arm's length principle directly into that article, and arguably the words "in each Contracting State" for other treaties following other model versions of article 7 produce the same result as concluded by Arnold.

In the case of exemption systems there is similar country variation. Some countries use actual revenue and expense to calculate the taxable profit of the enterprise in total and then simply subtract the PE profits calculated under the separate entity arm's length principle, which like credit systems does not calculate head office profits on a separate entity arm's length basis. As a variant countries may exempt actual gross PE income which leads in many but not all countries to disallowance of associated actual deductions. Other countries operate a provisioning system which does recognise outbound transfers and so moves to some extent towards a yes answer to Issue (4) but again this seems generally to be an artefact of domestic law and not to be driven by treaty relief requirements.³²

It is possible that a foreign tax credit system could be run by summing PE and head office profits each calculated in a symmetric way under the separate entity arm's length principle. Such a system would be treaty consistent, but clearly treaties in normal form do not require such an approach and it does not seem to be common. It would appear at first sight an odd exemption system that summed the PE and head office profit and then subtracted the PE profit, though it could arise under an

³¹ 1993 Attribution Report, above note ??, paras 6, 21, 23.

³² Russo, note ?? above, favours the first approach to exemption for satisfying treaty obligations.

exemption with progression system (in which the tax rate on the income is set by the worldwide income but the amount of tax is determined on the head office income only). Notwithstanding the various possibilities it seems in practice that Issue (4) is not clearly answered yes except under full territorial systems taxing income only on a source basis, and not on a residence basis. Where it is, the answer flows from domestic law and is not required by tax treaties.

To require by an international standard or suggest by convergence or best practice that countries operate their tax systems for relief on this summation basis involving separate calculation and recognition of head office taxable profit would involve considerable re-engineering of domestic tax law in many countries. Such an exercise does not seem feasible as an international exercise on PE attribution grounds given that no clear policy advantages for transfer pricing, taxation of PEs and relief for PE taxation in the residence country flow from such a system. If an obligation to do so were created by a tax treaty provision a significant change to the approach of minimal treaty interference in the design of domestic tax systems would occur. Moreover if such a system were adopted, then it would be natural to look for symmetry between Issues (3) and (4) which the large or prosperous residence countries that seem to be behind the general proposals in the PE Attribution Draft would definitely not want (as leading to more taxation at source). It may, however, in any event become the easiest way to implement the domestic law proposals of the PE Mismatch Draft to which the discussion now turns.

PE Mismatch Draft in more detail

While the PE Mismatch Draft has one example that seems to cross over directly with the 2010 Attribution Report, it generally ignores the many detailed solutions in that report, which raises an initial issue of what is the relationship between the PE Drafts. At the policy level it is to be noted that the PE Mismatch Draft is part of Action 2 of the BEPS project which is grouped under the policy rubric of coherence of the corporate income tax, meaning that the international tax system should not generally produce international non-taxation and when that is the unintended outcome of particular rules in tax systems, then the income should be taxed somewhere and it does not matter too much where – which of all the BEPS Actions is most obvious in Action 2. By contrast Actions 7-10 to which the PE Attribution Draft relates have a specific policy anchor of taxing income in the country where the value adding activity occurs.

So when the two policies are in play, which governs? Some equivocal guidance may be found in the other Actions under the coherence rubric. Action 3 on CFC regimes notes that while transfer pricing rules generally apply in priority to CFC rules the rules can still apply to cancel results flowing from transfer pricing. Action 4 on interest deductions and Action 5 on harmful tax practices both reject the use of a transfer pricing approach to the specific issues in question though it would be possible to devise a transfer pricing solution to them; nonetheless in a broad sense both those Actions support the idea of taxing where value adding activity occurs. There is further work underway on the relationship of transfer pricing and interest deductions dealt with in other Actions. Action 2 itself states that “differences in the value ascribed to a payment (including through the application of transfer pricing) do not fall within the scope of the hybrid mismatch rule” but this is limited to value and not the many other

issues which transfer pricing can encompass and the PE Mismatch Draft so far as it concerns the dealings of PEs is by its nature largely a transfer pricing topic.³³

At several points in what follows, the question is raised whether the PE Mismatch Draft is treaty consistent, particularly in the light of the 2010 Attribution Report as applicable to the current OECD article 7(2). In the Action 2 2015 Final Report there is a chapter which discusses this issue for the proposals in that report, which in some cases concern PEs such as DD mismatches but not to the same extent as the PE Mismatch Draft. In the case of article 7, there is bland reliance on the 2010 Commentary to the effect that once the separate entity arm's length principle has been applied, then it is up to domestic law to calculate business profits and determine what is income and what is deductible in that process. While that is correct in some obvious cases (such as deductibility of entertainment expenses) and while article 7 operates only as a limit, the 2010 Attribution Report requires approaches of domestic law to significant international issues which depart from the separate entity arm's length principle as interpreted in the report not to be applied in calculating the limit imposed on PE country taxation by article 7(2) and symmetric requirements for residence country relief under article 23. As appears below, many of the situations discussed seem to implicate those principles. This is the proposition which underlies Arnold's analysis and if it can be ignored then article 7(2) is entirely without effect.³⁴ This issue also engages BEPS Action 6 – a discussion for another day.³⁵

It is difficult to fit the PE Drafts together in the details relating to dealings because the examples do not match sufficiently to make direct comparisons and there is no real discussion of the application of article 7(2) in the PE country directly and only a little around the related treaty question of relief. It may be that WP11 has proceeded on the basis that transfer pricing is limited to value which would explain why they seem to have missed many interaction issues. The discussion will proceed through the relevant examples in the PE Mismatch Draft to show why it is difficult to compare the PE Drafts directly and to catalogue the interaction issues. As the same issues recur without seeming to move to any resolution, the discussion of the comparison and interaction gets shorter in proceeding through the examples.

The analysis of mismatches involving dealings in section 3 of the draft starts with Figure 3 concerning a provision of IP to a PE which then earns third party income from its use. The PE includes the third party payments in income and deducts a

³³ References to 2015 Reports Actions 2-5.

³⁴ Note ??? above, ch 15; similar comments apply to PE discrimination under OECD Model article 24(3) as the PE Mismatch Draft is frank in admitting that the PE rules are different to the parallel rules for separate resident entities in not actually requiring hybridity as for separate entities; to the extent the analysis in ch 15 relies on the view in the Commentary on article 24 that non-discrimination does not apply to inter-related treatment of two entities, there is a substantial body of case law across countries which takes a contrary view, see Avery Jones and others, Art 24(5) of the OECD Model in Relation to Intra-Group Transfers of Assets and Profits and Losses (2011) 3(2) World Tax Journal 179-225. In relation to relief it is admitted in ch 15 that treaty conflicts may arise; the PE Mismatch Draft, note ??, para 16 regards one of the recommended changes to domestic law as subject to a contrary relief provision in tax treaties (limitation of branch exemption in domestic law overridden by tax treaty exemption).

³⁵ OECD/G20 Base Erosion and Profit Shifting Project, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances ACTION 6: 2015 Final Report, paras 56-59, pp 79-85. The multilateral instrument, note ?? above, also has specific PE anti-abuse provisions emanating from Action 6 that will require consideration.

notional royalty to head office as the PE country regards the IP as owned by head office. The head office does not include in income either the third party income as it is exempt in that country or the notional royalty as the head office country attributes the ownership of the IP to the PE, thus producing a D/NI outcome. The clear implication of the example, which is similar in some ways to the warehousing example in the PE Attribution Draft is that the head office would have included the notional royalty in income if it regarded the IP as owned by head office and so shares the same view as that draft but here it is not indicated whether this is the result of domestic law or treaty so it does not go as far as that draft. No specific solution is provided to the example but the draft immediately provides a hybrid mismatch rule for which the primary rule denies the deduction to the PE and a secondary rule applying in the residence country if there is no primary rule in the PE country includes income for the head office.

In terms of the 2010 Attribution Report and Model this is all back to front. First, the economic ownership of the IP is a matter specifically dealt with at length so that the treaty should settle that issue, failing which the new dispute resolution provision in article 7(3) is relevant. Secondly, assuming that the resolution of ownership is in favour of head office the treaty will likely require a deduction in the PE country which would seem to override the domestic law mismatch rule; alternatively if the ownership resolution is in favour of the PE country no deduction is required by treaty and the mismatch rule would only be required to deny the deduction if the domestic law of the PE country still permitted it (the treaty no longer being an issue). Thirdly, if there no mismatch rule in the PE country but one in the home office country, conversely a treaty will require an exemption if ownership of the IP is appropriately under transfer pricing principles located in the PE. Fourthly there is a distinct lack of specification about the example in terms of what rules derive from domestic law and what from treaty, which makes the final outcome hard to determine. Note also that it is assumed that the residence country exemption system operates on the actual third party gross income which may also be the assumption in the PE Attribution Draft warehousing example though it is not stated.

The next example based on Figure 4 involves a third party borrowing by head office, provision of some of the funding to the PE and lending by both head office and PE to third parties. Though not specifically stated, the impression is that the taxpayer is not itself a bank (because it is stated that the third party lender to the taxpayer is a bank but silent about the taxpayer). There are two variations designed to illustrate the concept of what is a deemed payment which attracts the D/NI PE mismatch rules and a pure allocation of expense which does not. In the first the PE country recognises a dealing between HO and PE but in practice just allocates a percentage of the actual expense. This does not meet the concept of deemed payment and even though the head office country would regard the PE interest expense as different to the PE country (which of the many possible reasons for doing so is not specified) so that a mismatch in outcomes arises, the mismatch does not attract the D/NI mismatch rules but can trigger the DD mismatch rules.

The second variation is a dealing recognised by the PE country where the notional payment is not calculated by reference to a share of external expense. Nonetheless to the extent that there is external expense referable to the notional expense the PE D/NI mismatch rule does not apply but it does for the effective mismatch as the head office country again allocates less interest expense to the PE (again for reasons which are

unstated) than the PE country does. The head office as in Figure 3 exempts the PE third party income received and now denies a deduction of the amount of interest expense it regards as belonging to the PE as it relates to exempt income (a possible but not inevitable approach to the deduction issue under domestic law). There is a similar amount of mismatch as in the first variation but because there is now a deemed payment by the PE the D/NI mismatch rule applies for reasons that are unstated in the draft other than by the way deemed payment is defined. In the context of the discussion below of the dual-inclusion income exception, one assumes that the reason here is the same on the deduction side that there is no mismatch to the extent a branch notional deduction is matched in some sense by an actual expense.

Similar comments apply as above in relation to how all this applies in relation to the PE Attribution Draft. The 2010 Report and Model deal with when interest expense is simply allocated and when a dealing is to be recognised. The many reasons why different interest deductions may be recognised in different countries is dealt with elaborately and solutions provided in many cases. Though for capital allocation and for the relationship between income and interest expense more than one authorised OECD approach is provided in the PE Attribution Draft, there is considerable detail on how such differences are to be settled to produce a single result. There is no indication why all that learning is not applicable and does not provide a solution to both cases which eliminates the mismatches. It may be that the intention is to address the problematic nature of the interest expense issue in the PE context over many years and not just to deal with the 2010 approach. Alternatively it may be intended to bypass the practical difficulties of resolving the issue under attribution even if legally there is theoretically a solution.

Again the specification of each country's law and to what extent treaties play a part is incomplete. As well as the exemption in the residence country operating at the level of the gross income of the branch, it is now assumed that the exemption system denies deductions for actual expense related to that income. The assumption of inclusion of notional payments under the dealing in head office income for Figure 3 disappears unexplained in the Figure 4 discussion. It is likely, however, due to the netting of the notional interest deduction and the share of the actual interest deduction.

Figure 4 is also used to illustrate the operation of the dual inclusion income rule. To the extent that the same deduction is allowed in both countries, it is not a problem if it is offset against the same income. Either the PE or the residence country, whichever is applying a mismatch rule, enacts a rule that "that the amount of deemed branch payments will not exceed the amount of dual inclusion income" which ensures that there is no deduction for notional payments without equivalent income and "that the total amount of net income subject to tax in both jurisdictions is no less than the total net income of the taxpayer as a whole". In terms of the various symmetries identified in this paper, this is a way of ensuring symmetry between Issues (1) and (4) and suggesting an approach of though which gives way to avoid the mismatch depends on whether the PE or residence country is applying the rule. It seems to suggest an approach of summation of PE and head office income discussed above in the context of the 1993 Attribution Report.

The calculations in the particular example provided, however, which relate to the head office country apparently applying the secondary rule are based on actual income and

actual expense of the whole enterprise and then deducting the “the net amount of branch income recognised under Country B law”. It will be recognised that this is not the summation approach but rather similar to a common form of exemption system also discussed above at various points except that it is not described as involving the exemption system (or the credit system – there is a brief mention of the credit system but essentially for where the PE is in loss). Rather it seems that it is determining head office income to be taxed by the head office country, ie Issue (4), but as a pure mismatch rule and ignoring relief.

There is, however, a significant variation that the residence country does not calculate PE income applying its own law but the law of the PE country. If taken literally this means that in relation to all the possible reasons for variation between countries’ calculations of income and the many varied policies involved, the head office country gives way to the PE state. Read against the background of the Action 2 2015 Final Report, however, it seems that what is intended here is that the head office will include the same items as the PE does for income and expense but will be applying its own rules on measurement, inclusion, deductibility, timing etc, or to put it another way that the head office does what it would be required to do anyway under the 2010 Attribution Report if it is applicable.

Or maybe not. The discussion of this example in the PE Mismatch Draft just described is followed by two short specific sections on the primary rule and secondary rule in this context and for that latter provides that the solution is for the inclusion of an amount in income by the head office country in applying the secondary rule. If it is intended to be entirely separate from the PE Attribution Draft, the comments already made are again relevant. The final example on dealings covering DD mismatches comes closest to the an awareness of the PE attribution world in the sense that it refers to tracing and fungibility as the two different but common methods for associating income with interest deductions in domestic law, which are much discussed in the 2010 Attribution Report. The PE Mismatch Draft proceeds again on the basis that the DD rule is necessary to solve mismatches produced if one country uses tracing and the other fungibility without making any attempt to coordinate the results with the 2010 Attribution Report.

If the PE Mismatch Draft is read in the light of the PE Attribution Draft, it is difficult not to be confused as to what the former draft is providing as general principles for mismatches beyond the specific facts presented and assumptions about domestic law made in each case leading to a particular conclusion, ie extrapolation is difficult. One way of reading the draft is that it would make it easier for countries to legislatively implement and practically apply mismatch rules if they treated dealings involving deductible PE notional payments to head office as giving rise to income of the head office. That would at first sight make it easier to measure the extent of the mismatch in the cases involving dual deductions (as opposed to DD cases) or dual inclusion income in applying the D/NI mismatch rule. As already indicates that would involve a significant restructuring of the domestic tax law of many countries beyond what the draft requires. Moreover it would also flow into the structure of exemption systems in domestic law in favour of the summation type rather than the actual income and expense type.

On the other hand, the draft contemplates a number of different forms of residence country tax systems which suggests that whether a mismatch arises in the first place depends on the precise features of the domestic law system. As the Canadian case referred to earlier shows, it is necessary to put aside simple or single views of symmetry in applying dual deduction or dual inclusion issues. Moreover in finding the extent of a mismatch it is necessary in many but not all cases to compare apples and oranges, ie actual income or expense and notional income and expense, and in any event to provide links between particular income and deductions of either kinds. In the simple world of linear examples in the draft, such an exercise is feasible but in the real world it is well known that such simple mechanisms break down almost immediately. It is generally accepted to be impossible practically for banks to link the flows under the dealings with the flows under transactions with third parties or other dealings in any sense other than by more or less artificial accounting conventions.³⁶

This practicality issue is recognised in the PE Mismatch Draft (as it is in the Action 2 2015 Final Report) and indeed the OECD even has an oft repeated boilerplate mantra for the problem:

countries would be encouraged to identify appropriate implementation solutions that preserve the intended outcomes under the deemed branch payments rule while avoiding unnecessary complexity. It will generally be the case that accounts showing the income and expenditure of the taxpayer will have been prepared under the laws of both jurisdictions using domestic tax concepts. Tax administrations should use these existing sources of information and tax calculations as a starting point for identifying deemed branch payments and whether the resulting deduction has been set-off against dual inclusion income

When, however, one looks for illumination of these oft repeated nice sentiments, nothing is forthcoming. This language harks back to the discussion of symmetry in the 1993 Attribution Report (in a different context) where symmetrical accounts were assumed to provide a solution and introduced as a documentation requirement which was not applicable in all cases in any event and has since been withdrawn.

Conclusion

The alternative approaches in the attribution work over the years have been to get as much guidance and consensus as possible among countries and then to require countries to seek to resolve issues which that guidance could not achieve a uniform outcome. It is likely that a similar approach will be needed for PE mismatches but there are a number of differences which mean that there is less chance of it happening. The mismatch rules work through domestic law not tax treaties so there is no mechanism to bring the countries together and the mismatch rules often automatically put countries at loggerheads with each other (through the use of an arbitrary tax

³⁶ See TR 2005/11 for an ATO ruling recognising pooling of funds in relation to loans; for some time the ATO refused to extend the same ideas to derivatives and other areas, though it released a paper accepting the same approach for derivatives in 2015. Foreign bank branches in Australia receive this treatment by Income Tax Assessment Act 1936 Pt IIIB in relation to loans, forex and derivatives but not liquidity support and the ATO has refused to apply the same approach to liquidity charges made in dealings involving foreign banks and their Australian PEs, ATO ID 2012/90, 91, 92.

somewhere policy combined with reactive rules). In any event with no clear resolution of the intended interaction of the PE Attribution Draft and the PE Mismatch Draft and the treaty priority between them, we are likely to see challenges to the operation of whatever PE mismatch rules are enacted by countries.

Blake, Songs of Innocence and of Experience (OUP facsimile edition 1970)

