Summary of the Proceedings of an Invitational Seminar on the Attribution of Profits to Permanent Establishments

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PRÉCIS

En vertu de l'article 7 de la convention modèle de l'OCDE et des traités fiscaux qui en sont inspirés, le résident d'un état contractant qui exploite une entreprise par l'intermédiaire d'un établissement stable dans l'autre état contractant n'est assujetti à l'impôt dans cet état que sur les bénéfices attribuables à l'établissement stable. À cette fin, le paragraphe 7(2) exige que l'établissement stable soit considéré comme une entité distincte qui traite de façon indépendante avec l'entreprise dont il fait partie. De cette façon, les règles sur les prix de transfert en vertu de l'article 9 de la convention modèle sont applicables aux fins du calcul des bénéfices attribuables à l'établissement stable. On ne sait pas très bien, toutefois, comment les principes applicables en matière de prix de transfert de l'OCDE, qui visent les opérations entre parties liées aux fins de l'article 9 de la convention modèle de l'OCDE, peuvent s'appliquer aux établissements stables puisque, légalement, il n'y a pas d'opérations entre un établissement stable et une autre partie de l'entreprise.

En février 2001, l'OCDE a rendu public un document de travail sur l'imputation des bénéfices aux établissements stables dans un effort en vue d'en arriver à un consensus parmi les pays membres de l'OCDE. Le document propose une hypothèse de travail visant l'attribution des bénéfices aux établissements stables en vertu de l'article 7, à savoir, que les principes directeurs applicables en matière de prix de transfert devraient dans toute la mesure possible s'appliquer aux établissements stables si on fait une analogie entre établissements stables et entités légales distinctes.

Les auteurs du document de travail de l'OCDE demandent au public de leur fournir des commentaires sur l'hypothèse de travail. En réponse à cette demande, un groupe de représentants du gouvernement du Canada, de fiscalistes et de professeurs se sont donc réunis le 22 juin 2001 pour examiner le document de

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travail de l'OCDE et formuler des commentaires constructifs à l'intention de l'OCDE. La rencontre a été parrainée par le ministère des Finances et l'Association canadienne d'études fiscales. Le présent article résume la teneur des discussions qui ont eu lieu à cette occasion et fournit des renseignements contextuels généraux sur le document de travail de l'OCDE.

ABSTRACT

Under article 7 of the OECD model convention, and tax treaties based on that model, a resident of one contracting state carrying on business through a permanent establishment (PE) in the other contracting state is subject to tax in the latter state only on the profits attributable to the permanent establishment. For this purpose, article 7(2) requires the PE to be treated as a separate entity that deals independently with the enterprise of which it is a part. In this way, the transfer-pricing rules under article 9 of the model convention are applicable for purposes of computing the profits attributable to a PE. It is unclear, however, how the OECD transfer-pricing guidelines, which apply to transactions between related parties for the purposes of article 9 of the OECD model convention, can be applied to PEs, since legally there are no transactions between a PE and another part of the enterprise.

In February 2001, the OECD issued a discussion paper on the attribution of profits to PEs in an attempt to achieve a consensus among the member countries of the OECD. The discussion paper advances a working hypothesis to govern the attribution of profits to PEs under article 7, namely, that the OECD transfer-pricing guidelines should be applied to PEs to the maximum extent possible by analogizing PEs to separate legal entities.

The OECD discussion paper requests comments from the public on the working hypothesis. In response to this request, a group of Canadian government officials, tax practitioners, and academics met on June 22, 2001 to consider the OECD discussion paper and to provide constructive comments to the OECD. The meeting was sponsored by the Department of Finance and the Canadian Tax Foundation. This article summarizes the discussions during the meeting and provides some contextual background for the OECD discussion paper.
Keywords: OECD; OECD and models; permanent establishment.

INTRODUCTION

In February 2001, the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development ("the OECD") released a discussion draft on the attribution of profits to permanent establishments (PEs).[1] The discussion draft was prepared by the Steering Group on the Transfer Pricing Guidelines of Working Party No. 6. It is intended as a first step in the development of a consensus among the member countries of the OECD concerning the application of

the transfer-pricing guidelines to PEs in the context of article 7 of the OECD model tax convention.[2]

On June 22, 2001, a small group of Canadian government officials, tax practitioners, and academics met in Toronto to consider the discussion draft and to make constructive comments on the draft for the benefit of the steering group.[3] The participants in the seminar were

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David Ward (Davies Ward Phillips & Vineberg)
Scott Wilkie (Osler Hoskin & Harcourt)
Gordon Williamson (Arthur Andersen)

Participants took part in the seminar as individuals rather than as representatives of their firm or organization. No formal presentations were made. Alain Castonguay, chief, International Taxation, Business Income Tax Division of the Department of Finance and a member of the OECD steering group, explained the purpose and basic operation of the approach advocated in the discussion draft. Gilbert Ménard, chief, International Taxation, Business Income Tax Division of the Department of Finance, gave a brief introduction to the application of the proposal in the discussion draft to financial institutions. The discussions were free-flowing and unconstrained by a highly structured agenda.

This paper summarizes the discussions during the seminar (without, however, attributing comments to particular participants). It is intended to inform the Canadian tax community about the OECD's proposals for the attribution of profits to PEs and the implications for the Canadian tax system. The paper commences with

a description of the background events leading to the production of the discussion draft, including a brief description of the provisions of article 7 of the OECD model convention. This is followed by a description of the approach advocated in the discussion draft ("the working hypothesis") for the attribution of profits to PEs and a brief discussion of some of the implications for the Canadian tax system of the adoption of the working hypothesis. The paper concludes with a summary of the major conclusions emerging from the discussions.

The summary of the seminar discussions has been reviewed by the participants and revised in light of their comments. The rest of the paper is the work of the authors and has not been reviewed by the participants. The summary of the seminar discussions has been sent to the OECD steering group for its consideration as part of the public consultation process.

BACKGROUND

Under article 7 of the OECD model convention, a resident of one contracting state carrying on business in the other contracting state is subject to tax in the latter state only if the resident has a PE in that state and only to the extent that the business profits are attributable to the PE. Article 7(2) provides that the profits attributable to a PE are the profits it would 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 is generally acknowledged that the purpose of this separate and independent enterprise assumption is to facilitate or to require the application to PEs of the transfer-pricing rules (the arm's-length standard) in article 9 of the OECD model convention. However, the precise meaning of the separate entity assumption in article 7(2) and the interplay between it and the other paragraphs of article 7 are matters of enormous controversy, as discussed below. Article 7(4) provides a limited exception to the application of the separate-entity assumption to PEs. Profits may be attributed to a PE by means of a formulary apportionment method if the use of such method has been customary in that country and if the result is consistent with the principles of article 7 (presumably, the arm's-length principle).

Article 7 provides three additional, more specific rules for the computation of the profits of PEs. First, expenses incurred for the purpose of a PE, including head office expenses, must be allowed as deductions even if the expenses are incurred outside the country in which the PE is located or if the expenses are incurred only partly for the benefit of the PE.[4] Second, the method for computing the profits of a PE must be applied consistently from year to year unless there is justification for changing.[5] Third, no profits can be attributed to a PE merely because of its purchasing activities on behalf of the enterprise.[6]

Obviously, the provisions of article 7 of the OECD model convention do not provide sufficiently detailed rules for the computation of the profits of a PE. Moreover, even the broad general statements of principle in article 7 are subject to

dispute. For example, it is not clear whether, if an enterprise has an overall loss, any profits can be attributed to a PE. The commentary on article 7, which was most recently revised in 1994, provides some elaboration as to how the general principles of article 7 should be applied. For example, the commentary deals with the question whether internal transfers of goods or services (that is, transfers between the head office and the PE) should reflect a profit element or should be recorded at cost. Nevertheless, the computation of the profits of PEs remains fraught with difficulties. Despite the 1994 revisions, the commentary on article 7 is inconsistent and incomplete, and arguably inconsistent with the wording of article 7 itself. Country practices still vary enormously, making double taxation or non-taxation likely or even inevitable.

This is not a situation in which domestic law can compensate for the deficiencies of the OECD model convention and commentary. From a Canadian perspective, there are surprisingly few provisions in the Income Tax Act[7] dealing specifically with the computation of the profits of non-residents from carrying on business in Canada. Subsection 4(1) of the Act provides even less guidance than article 7 of the OECD model convention in this regard. There is a specific rule dealing with internal transfers of depreciable property,[8] and amendments are pending to deal with inventory and eligible capital property;[9] but other issues relating to the calculation of income or profits of a PE are not addressed at all. The domestic rules of other countries are equally inadequate.[10] Even if domestic laws were adequate, they would inevitably vary, leaving the problem of double taxation or non-taxation unresolved.[11] An international solution through the network of bilateral tax treaties seems not merely desirable but necessary.

The 1994 revisions to the OECD commentary on article 7, referred to above, were based on the OECD's March 1994 report on the attribution of income to PEs.[12] With respect to the pricing of internal transactions between a PE and the head office of an enterprise, the report concluded that

> the arm's length principle by which a charge for goods, services, etc. is based on the price which would have been charged to a third party is generally applicable, but there are a large number of cases where the application of such a test leads to the conclusion that as between unrelated parties acting at arm's length, the agreement which would have been reached between them would have been to allocate a particular expense on the basis of historic cost without regard to which of the two unrelated parties actually incurred the cost initially.[13]

The report suggested that this distinction could be made by determining whether the internal transfer of goods or services is similar to the supply of goods or services by the enterprise to third parties in the ordinary course of its business.[14] If the enterprise provides similar goods or services to third parties, the internal transfer to the PE should reflect an arm's-length price (sometimes referred to as "the direct method"); otherwise, only a portion of the actual costs incurred by the enterprise should be allocated to the PE (sometimes referred to as "the indirect

method"). On the basis of this general approach, the OECD concluded that internal transfers of intangible property should take place at cost and that notional interest on internal funding should not be permitted except in the case of financial institutions.[15]

While the OECD was working on the report on *Attribution of Income to Permanent Establishments*, it was also developing guidelines for the application of the arm's-length principle under article 9 of the OECD model convention. The transfer-pricing guidelines were published in 1995.[16] The guidelines indicate that a future chapter will deal with the application of the guidelines to PEs in the context of article 7. The discussion draft is intended to become, in its final form, the chapter of the guidelines dealing with PEs. The draft suggests implicitly that the 1994 revisions to the commentary on article 7 are not consistent with the transfer-pricing guidelines.

The other relevant background is the OECD's work on electronic commerce. In December 2000, the OECD issued a report dealing with the issue of whether, and under what circumstances, a computer server located in a country could constitute a PE under article 5 of the OECD model convention.[17] This report will be the basis for revisions to the commentary on article 5 to be issued in 2002. The OECD has taken the position that a computer server can constitute a PE in certain circumstances, although ordinarily it will be easy for taxpayers to avoid having a PE in a country unless they want to have one there. If a taxpayer has a PE in a country as a result of having a server there, the next question is, what are the profits attributable to that PE? In February 2001, the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("the business profits TAG") issued a discussion paper on this question.[18] The discussion paper analyzes the determination of the profits of a PE engaged in e-tailing activities under the existing provisions of article 7 of the model convention and under the working hypothesis proposed in the discussion draft. In general, the approach suggested in the discussion draft and the analysis in the discussion paper with respect to electronic commerce are consistent. The discussion paper of the business profits TAG is more outspoken in its criticism of the existing rules in the commentary on article 7. It calls the lack of any markup on internal transfers of intangibles "rather outdated"[19] and suggests that this practice "produces a somewhat perverse result."[20] The two papers should be read together, since each informs the other.

THE WORKING HYPOTHESIS

The discussion draft acknowledges the diversity in national laws with respect to the computation of the profits of a PE and the lack of a uniform approach to the interpretation and application of article 7. This acknowledgment is an essential prerequisite to the development of a workable common approach. The discussion draft also rejects basing its proposals on the existing provisions of article 7, and characterizes those provisions as a limitation on the development of a new approach.

Thus, the discussion draft sets as its goal the formulation of "the most preferable approach to attributing profit to a PE under Article 7 given modern-day multinational operations and trade," unconstrained "by either the original intent or by the historical practice and interpretation of Article 7."[21] This proposed analytical approach is as refreshing as it is unusual. Too often, the OECD accepts the existing provisions of the model convention as untouchable, and as a result, it bends them out of shape to accommodate new developments. According to the discussion draft, identifying the best approach for the attribution of profits to PEs is the first task; making consequential changes to article 7 or its commentary to authorize that approach is the second step. Nevertheless, the discussion draft is ultimately constrained to a large extent by the existing provisions of article 7, and much of its content is an analysis of those provisions.

The essence of the working hypothesis adopted in the discussion draft is that the transfer-pricing guidelines should be applied to PEs to the greatest extent possible by analogizing PEs to separate legal entities. One important implication of this approach is that the phrase "the profits of an enterprise" in article 7(1) must refer not to the overall profits of the enterprise, but to the profits that the PE would have earned if it had been a separate enterprise. Thus, profits may be attributed to a PE despite the fact that the enterprise has an overall loss. The only limitation that the reference in article 7(1) to the profits of the enterprise imposes on the computation of profits of a PE is that there is no force-of-attraction principle. Profits that are derived from the country in which the PE is situated but are unrelated to the PE may not be taxed by that country under the principles of article 7.

Article 7(2) is the cornerstone for the application of the working hypothesis. For the purpose of attributing profits to PEs, article 7(2) postulates the PE as a hypothetical enterprise that is distinct and separate from the enterprise of which it is a part and that deals independently with the other parts of the enterprise. Thus, article 7(2) incorporates the arm's-length standard in the context of PEs. In so doing, it provides the foundation for the use, by analogy, of the transfer-pricing methodologies set out in the transfer-pricing guidelines when attributing profits to a PE. In this context, the application of the working hypothesis involves the following two steps:[22]

1) a functional and factual analysis to determine the activities carried on (functions performed) by the PE as a separate entity and the conditions or attributes of the PE under which such activities are carried on; and
2) the application to the PE as a separate entity of the transfer-pricing methodologies set out in the guidelines.

With respect to the first step, the transfer-pricing guidelines apply to transactions between separate legal entities dealing not at arm's length and require those transactions to be priced similarly to comparable transactions between arm's-length persons. The fundamental difficulty in the application of the transfer-

pricing guidelines to PEs is that, because a PE is not a separate entity, there are no transactions between a PE and another part of the legal entity of which it is a part. Therefore, the first step in the working hypothesis involves carrying out a functional and factual analysis while assuming that a separate legal entity exists based not on legal form but on economic principles (functions performed, assets used, and risks assumed). The purpose of this step is to determine the activities and responsibilities of the overall enterprise that are carried out by the PE. Since the assets are owned by the enterprise as a whole, the attribution of assets to a PE must be based not on legal ownership but on the use made by the PE of assets in its business determined on a factual basis.[23] Similarly, since risks are legally borne by the enterprise as a whole, the attribution of risks must be based on the assumption that the PE will assume the risks inherent in or created by its own functions.[24]

Under the first step, the hypothesized separate legal entity not only must be engaged in similar activities to the PE, but also must be performing those activities under similar conditions. These conditions include both the external environment in which the functions of a PE are performed ("external conditions") and the internal attributes of the enterprise to which the PE belongs ("internal conditions").[25] In determining internal conditions, the functional and factual analysis is intended to provide an understanding of the economic relationship between the PE and other parts of the enterprise and to supply a basis for identifying, if possible, comparable relationships involving separate legal entities.

The second step in the application of the working hypothesis involves determining the arm's-length return that the PE should earn in respect of the functions performed, assets used, and risks assumed by it (determined under the first step) compared to the returns earned by comparable independent enterprises. This step involves the application of a suitable transfer-pricing method set out in the guidelines: comparable uncontrolled price (CUP), resale price, cost-plus, profit split, and transactional net margin method (TNMM). The problem, of course, is that these methods apply to transactions between legally separate entities, whereas there are no transactions between a PE and other parts of an enterprise. Applying the guidelines by analogy, the discussion draft suggests that the working hypothesis should be applied to "dealings" between a PE and other parts of the enterprise.[26] A "dealing" is "a real and identifiable event," such as the use of an asset, transfer of inventory, or provision of services, determined by a real functional and factual analysis.[27] The contractual terms of a transaction are used to determine the risks, responsibilities, and benefits transferred between legal entities. Although there are no contractual terms for dealings between parts of an enterprise, by analogy the terms of a dealing can be established by reference to accounting records and contemporaneous internal documentation.[28] In the absence of such records and documentation, the terms of a dealing can be inferred from the conduct of the PE and other parts of the enterprise as well as all other facts and circumstances.[29] A functional analysis can then be used to check whether the terms of the dealing reflect the true facts.[30]

Except in rare circumstances, once the dealings between a PE and other parts of the enterprise have been determined, the tax authorities must not disregard those dealings in applying the transfer-pricing guidelines. This approach in the discussion draft is similar to the proposition in the transfer-pricing guidelines that the tax authorities must respect the actual transactions entered into by associated enterprises.[31]

The discussion draft rejects the current approach in the commentary on article 7 for determining whether interbranch dealings should take place at cost or include a markup.[32] Under that approach, the essential question is whether the internal dealings are of the same kind that the enterprise ordinarily engages in with third parties.[33] For example, if the enterprise sells goods or provides services to an arm's-length third party, similar goods or services provided to the PE should reflect an arm's-length profit. Instead, the discussion draft suggests that the comparability analysis in the guidelines can be applied by analogy to PEs. A comparability analysis involves consideration of the characteristics of property or services, functional analysis, economic circumstances, business strategies, and the terms of interbranch dealings. In most cases, profit will be attributed to a PE in respect of interbranch dealings on the basis of comparable transactions between independent entities. In some cases, the PE and other parts of the enterprise may be considered to be joint participants in a cost-sharing arrangement.

The discussion draft then discusses in detail the application of comparability analysis to the use of tangible and intangible capital property by a PE, the provision of services to (by) a PE by (to) another part of the enterprise, and the funding of the activities of a PE. As mentioned earlier, according to the discussion draft, both tangible and intangible capital assets are to be attributed to a particular part of an enterprise on the basis of use.

If a PE uses a tangible capital asset from the time of its acquisition by the enterprise, profits are attributable to the PE on the assumption that the PE acquired and used the asset as a separate entity.[34] According to the discussion draft, no internal dealing would be recognized with respect to that asset.[35] In contrast, a dealing would have to be recognized and properly characterized in the case of a temporary or permanent change in the use of the tangible capital asset within the enterprise to which the PE belongs (that is, if the asset is used by another part of the enterprise before the PE starts to use it). Since there are no contractual terms to help in this characterization, all facts and circumstances would have to be examined, including, most importantly, the intent of the parties.[36] The discussion draft provides a non-exhaustive list of factors to be considered in determining such intent.[37] After this factual examination has been completed, the nature of the dealing would be assessed on the basis of what arm's-length parties would have done in comparable circumstances.[38]

Intangible capital assets often arise as a result of research and development or marketing activities undertaken by the enterprise itself rather than by an acquisition of such assets.[39] In this context, the current commentary on article 7 states

that because it is extremely difficult to allocate the creation of such intangible property to one part of the enterprise, notional royalties should not be allowed between different parts of an enterprise.[40] The discussion draft rejects this approach where the function of creating the intangible can be attributed to one part of the enterprise.[41] It lists factors to be considered in determining whether a PE was involved wholly or partly in the creation of the intangible.[42] A PE that participates in the creation of intangible property is entitled to receive a return comparable to that of an arm's-length party performing a similar function.[43] If a PE uses intangible property created by another part of the enterprise, the PE can deduct a notional royalty payment computed by reference to comparable transactions between arm's-length parties.[44] Finally, where an intangible is used both by the PE and by other parts of the enterprise, the PE will most likely be considered to have acquired a beneficial interest in the property or a non-exclusive right to use it (rather than ownership of the entire property or an exclusive right to use it).[45] If a PE is considered to have acquired a beneficial interest in intangible property, it will be entitled to depreciate the fair market value of the interest.[46] Alternatively, if the PE is considered to have acquired a right to use the property, it will be entitled to deduct a notional arm's-length royalty.[47]

With respect to services performed by the PE for other parts of the enterprise (and vice versa), the discussion draft provides that profits should be attributed to a PE by applying, by analogy, the transfer-pricing guidelines.[48] However, the discussion draft also acknowledges that the application of the working hypothesis to the provision of services presents two issues that require further examination. First, is it desirable to prevent a head office from passing on expenses it incurred in providing services to a PE if the PE could have obtained the same services from a third party at a lower cost?[49] Second, is it always appropriate to preclude a head office from passing on expenses relating to "shareholder" activities?[50]

With respect to capital allocation and funding issues, the discussion draft proposes that an arm's-length amount of "free" capital (equity) should be attributed to a PE for tax purposes, whether or not such amount has otherwise been allocated to the PE for other purposes.[51] Under the working hypothesis, the allocation is made by first attributing assets to the PE on the basis of use and, where necessary, risk weighting or adjusting the book values of those assets.[52] The next step involves the determination of the amount of "free" capital required to cover the assets attributed to the PE and support the risks assumed in accordance with one of the following methods:

1) the allocation of the "free" capital of the enterprise as a whole to its various parts in accordance with where the assets are used and the associated risks assumed;[53] or
2) some type of thin capitalization approach under which the equity of the PE would be determined by reference to a minimum equity requirement under domestic law or the debt-equity ratio of comparable independent enterprises.[54]

Another funding issue is whether an internal transfer of funds should be considered a "dealing" that could give rise to the deduction of notional "interest." The discussion draft suggests that notional interest should be recognized only for PEs of financial institutions.[55] For other PEs, only the appropriate portion of the actual interest expense incurred by the enterprise should be attributed to a PE. The discussion draft, however, does not draw any firm conclusions on whether a fungibility approach or a tracing approach should be used for this purpose.[56]

The discussion draft clarifies that article 7(3) should not be interpreted as imposing limitations on the application of the arm's-length principle to the computation of income attributable to PEs.[57] Some countries have interpreted article 7(3) as requiring the deduction of costs even if they exceed arm's-length amounts and as prohibiting the deduction of expenses in excess of actual costs incurred.[58] For purposes of the working hypothesis, article 7(3) simply means that the deduction of expenses should not be denied because the expenses are incurred outside the country in which the PE is situated or are not incurred exclusively for the purposes of the PE.[59]

Article 7(4) authorizes the use of apportionment methods applied to the total profits of an enterprise to attribute profits to a PE if the use of such methods is customary. The discussion draft suggests that article 7(4) is fundamentally inconsistent with the arm's-length principle and should be disregarded for purposes of the working hypothesis.[60] Similarly, the discussion draft concludes that article 7(5), which provides that no profits can be attributed to a PE with respect to mere purchases, is unnecessary and unjustified.[61]

The second part of the discussion draft involves a detailed examination of the application of the working hypothesis to PEs of banks. (PEs of other financial institutions will be dealt with by the OECD.)

IMPLICATIONS OF THE WORKING HYPOTHESIS FOR THE CANADIAN TAX SYSTEM

As discussed briefly above,[62] the Canadian Income Tax Act contains very few provisions dealing with the computation of income of non-residents from businesses carried on in Canada. Subsection 4(1) provides that the income from a business carried on in Canada must be computed on the assumption that the taxpayer had no income or loss except from that business and was allowed only those deductions reasonably applicable, wholly or partly, to that business. Otherwise, with few exceptions, the income derived by a non-resident from a business carried on in Canada is computed in accordance with the rules applicable to residents. The exceptions involve deemed acquisitions and dispositions when property (inventory, depreciable property, and eligible capital property) commences or ceases to be used in a business carried on in Canada.

If the working hypothesis is adopted by the OECD, the questions are, what are the implications for the Canadian tax system and, more particularly, are any legislative changes necessary? The brief discussion that follows does not purport to

constitute a detailed analysis of these issues; rather, it is intended to show that there are serious implications for the Canadian tax system and that some amendments to the Act will be necessary.

Under the current and proposed provisions of the Act, certain dealings between a PE and its head office are deemed to take place at fair market value.[63] These provisions are consistent with the working hypothesis. However, the working hypothesis permits the use of property by a PE to be characterized in various ways (as a sale, lease, or cost contribution arrangement in the case of tangible capital property) depending on the circumstances. In contrast, the provisions of the Act assume that the property is owned by the PE and do not permit any other characterization for the use of the property. For example, under subsection 13(9), if a non-resident commences to use depreciable property in a business carried on in Canada, the property is deemed to have been acquired at its fair market value at that time. As a result, the taxpayer is entitled to claim capital cost allowance based on that fair market value. Under the working hypothesis, for purposes of a treaty, the use of the depreciable property by the Canadian PE might be considered to be a lease of the property by the PE from the head office, depending on the facts and circumstances. This conflict between the treaty and the Act would be resolved in favour of the treaty. Therefore, the question arises whether it would be necessary or desirable to amend the Act to conform to the working hypothesis.

With respect to some dealings between a PE and other parts of an enterprise, the Act is silent. There are no express rules in the Act, for example, dealing with the provision of services by (to) a PE to (by) another part of the enterprise or with the capital structure of a PE. In this situation, section 4 of the Income Tax Conventions Interpretation Act[64] becomes relevant. This provision generally requires amounts to be included and deducted in computing the profits of a PE (notwithstanding the provisions of a tax treaty other than an express provision) in accordance with the provisions of the Act applicable to residents engaged in the same business activities. Therefore, unless article 7 is amended appropriately, section 4 of the Income Tax Conventions Interpretation Act arguably prevents the operation of the working hypothesis if it conflicts with the provisions of the Act.

Just as the transfer-pricing rules of the Act were amended to accommodate certain aspects of the OECD transfer-pricing guidelines, so the application of those guidelines, by analogy, to PEs appears to require certain amendments. For example, the authority under paragraph 247(2)(b) of the Act to recharacterize certain transactions that would not have been entered into by arm's-length persons clearly does not, but should, apply to dealings between a PE and other parts of an enterprise, because the provision applies only to transactions. Similarly, the contemporaneous documentation requirements, including penalties, in subsections 247(3) and (4) do not, but should, apply to the dealings of a PE.

As discussed subsequently in the summary of the seminar discussions, if notional payments by a PE are to be deductible in computing the profits attributable to the PE, serious consideration should be given to the imposition of Canadian withholding tax on such notional payments. Under subsection 212(13.2) of the Act, a

non-resident whose business is carried on principally in Canada or who is engaged in manufacturing, processing, mining, or certain oil and gas activities in Canada is deemed to be resident in Canada for purposes of part XIII withholding tax with respect to amounts paid to non-residents to the extent that such amounts are deductible in computing taxable income earned in Canada. This provision needs to be extended to all types of businesses carried on in Canada by non-residents and to notional payments deductible in computing taxable income earned in Canada. The need for this rule is demonstrated by the decision in *Twentieth Century Fox Film Corp. v. The Queen*.[65] In that case, the minister sought to apply part XIII withholding tax on notional royalties in respect of the use of films and videotapes which were deducted in computing the income of a Canadian branch of a US resident corporation. Since the royalties were considered reasonably attributable to the Canadian business, the court concluded that regulation 802 precluded the imposition of part XIII withholding tax on these amounts. However, the court also seemed to imply in obiter that part XIII withholding tax would not normally apply to a notional payment.

SUMMARY OF SEMINAR DISCUSSIONS

Introduction

The seminar began with a brief introduction by Alain Castonguay of the Department of Finance. He described the background work of the steering group since 1997, leading to the publication of the discussion draft, and explained that the draft was a work-in-progress. Several issues remain unresolved, including the proper treatment of dependent agent PEs and the testing of the working hypothesis with respect to global trading and non-bank financial institutions such as insurance companies (to be discussed in chapters III and IV of a subsequent version of the draft). The steering group is very interested in receiving comments from the public on the discussion draft before completing its work.

The first question addressed in the seminar was whether the working hypothesis set out in the discussion draft is the correct approach, in theory and principle, to the attribution of income to a PE, putting aside for the moment issues of practical implementation and application. The participants unanimously agreed that, in theory and principle, it is the correct approach. According to the participants, not only does article 7(2) require the application of the arm's-length principle to PEs, but it is also desirable in tax policy terms for articles 7 and 9 to operate similarly to the maximum extent possible.

Underlying the analysis in the discussion draft is the assumption that foreign branches and foreign subsidiaries should be treated similarly from a tax policy perspective. There was extensive discussion of this assumption. Despite significant differences between the tax treatment of branches and subsidiaries in most worldwide tax systems, some participants suggested that these differences did not justify or require any difference in the way the income of these entities is computed. Others argued that the only significant difference between branches and

subsidiaries is the absence of any documentation for the dealings (transactions) of branches. In contrast, the relationships between associated enterprises are usually governed by legally binding contractual arrangements.

This line of discussion led quickly to the concept of dealings between a PE and other parts of an entity, which was agreed to be the key aspect of the working hypothesis. It was suggested that the working hypothesis made it necessary to provide rules for a PE with respect to matters that a subsidiary could decide itself. Thin capitalization rules were cited as an example. Under the tax laws of many countries, the capital of a subsidiary of a non-resident corporation can be established with any amounts of debt and equity subject only to a safe harbour debt-equity ratio for purposes of domestic thin capitalization rules, and possibly to the arm's-length standard in article 9 of the model convention. With respect to a branch, it would be necessary to ascertain the respective amounts of its debt and equity by reference to the capital structure of similar independent enterprises. The discussion returned to the key element of dealings later in the seminar.

The Proper Interpretation of Article 7 of the OECD Model Convention

Having agreed that the working hypothesis is the correct approach in principle, the participants engaged in a spirited debate concerning the proper interpretation of the existing provisions of article 7 and whether, without amendment, article 7 could accommodate the working hypothesis. On these issues there was a surprising range of views. The divergence of views confirms the lack of consensus among OECD members, noted in the discussion draft, on a common interpretation of article 7 and, arguably at least, provides evidence that article 7 requires amendment.

Several issues arose concerning the wording of article 7(1), which is set out here for convenience:

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

First, some participants questioned how the wording of this provision could be interpreted to support the "relevant business activity" meaning set out in the discussion draft.[66] Under this interpretation, the phrase "profits of an enterprise" means the profits that the entity earns from the particular type of business, broadly or narrowly defined, part of which is carried on by the PE. It was pointed out that the actual phrase in article 7(1) is "[t]he profits of an enterprise of a Contracting State"; that "enterprise of a Contracting State" is defined in article 3(1)(d) to mean an enterprise carried on by a resident of a contracting state; and, further, that by virtue of article 3(1)(c), the term "enterprise" applies to the carrying on of any business. These definitions suggest that "enterprise" refers to a business rather

than the entity carrying on the business. Both definitions are, however, subject to the caveat that the context otherwise requires. Moreover, the term "enterprise" in the phrase "the enterprise carries on business" used in both the first and second sentences in article 7(1) appears to be a reference to the entity rather than the business.[67] The discussion draft itself indicates that "references to the 'enterprise' or to 'the enterprise as a whole' should be interpreted as describing the juridical entity,"[68] although it is unclear whether the draft is referring just to the usage in the draft or to the meaning for purposes of article 7.

Second, and more important, some participants argued that the wording of the second sentence of article 7(1) (in particular, the words "but only so much of them") limits the profits attributable to a PE to the total profits of a business or entity (depending on the resolution of the "relevant business activity" issue discussed in the preceding paragraph). Thus, if an entity had an overall loss, no profits could be attributed to a PE. The discussion draft rejects this interpretation summarily.[69] The group agreed that, even if this interpretation were possible on the basis of the wording of article 7(1), it would be inconsistent with the treatment of a PE as a separate entity, and that it should be possible for a PE to make profits while the entity as a whole had a loss. Some participants thought that, because article 7(2) is more specific than article 7(1), article 7(2) overrides, or at least clarifies, article 7(1) in this respect.

Third, even the precise meaning of the term "profits" generated debate. The discussion draft suggests that, because the term is not defined in the OECD model convention, the country in which the PE is located can apply its domestic law to determine the profits of a PE.[70] However, in putting forth this interpretation, the discussion draft does not mention the caveat in article 3(2) of the model convention that undefined terms do not have their meaning under domestic law if the context requires otherwise. Moreover, according to the discussion draft, the residence country computes the profits of the PE for purposes of the elimination of double taxation in accordance with its domestic law, which "may well differ from the amount of profits attributed by the host country."[71] The draft declines to address this issue. However, one of the primary purposes of the discussion draft is to formulate a common interpretation of article 7 in order to minimize double taxation. Also, article 7(2) mandates expressly that the profits attributable to a PE shall apply "in each Contracting State." These words are virtually meaningless if the host and residence countries determine the profits of a PE under their respective domestic laws, since the amounts so calculated will inevitably differ. One solution put forward to deal with this problem involved an interpretation of article 3(2) that requires the residence country in applying article 23, dealing with relief of international double taxation, to adopt the source country's determination of the profits of the PE as long as it is in accordance with article 7.

The relationship between articles 7(1) and 7(2) also stimulated a lively debate. Article 7(2) establishes both the assumption that a PE is a separate entity and the principle that the PE deals at arm's length with the enterprise of which it is a part. Some participants thought that many of the difficulties in the interpretation of

article 7(1) could be resolved by reference to article 7(2). They argued that article 7(2) was not inconsistent with article 7(1), but a clearer statement of its principles. Some argued that if the two provisions were considered to be inconsistent, article 7(2) should prevail because it is more specific. Others thought that article 7(1), as the primary rule concerning the attribution of profits to a PE, could not be so easily relegated to a secondary role.

Most participants accepted that article 7(3) did not preclude the use of arm's-length prices for dealings between a PE and the head office in accordance with article 7(2). Some participants thought that article 7(3) and the words "[s]ubject to the provisions of paragraph 3" in article 7(2) could support an argument that only an allocation of actual expenses was allowed in computing the profits of a PE. Everyone agreed that article 7(3) should not restrict the application of the arm's-length principle to PEs and that this interpretation should be clarified, possibly by deleting the opening phrase in article 7(2).

The group was divided on the necessity for amendments to article 7 to accommodate the working hypothesis. Most participants thought that amendments were either necessary or desirable. Some participants thought that some amendments, such as the deletion of the opening words of article 7(3), were desirable but unrelated to the working hypothesis. Serious concern was expressed about the difficulty of amending the OECD model convention, as compared to amending the commentary, and about the implications of amendments to the model convention for existing tax treaties that incorporate the current wording of article 7. In this context, some participants thought that it was preferable, as a first step, to amend the commentary on article 7 to incorporate the contents of the discussion draft, and then to amend article 7 itself as a longer-term measure. Another concern expressed was whether a complete reversal of the position in the commentary (for example, a change from the current commentary that payments for the use of intangibles are not deductible to the new position under the working hypothesis that they are deductible) would be followed by the courts without an appropriate change in the wording of article 7 itself. Finally, it was pointed out that the existing wording of article 7 could not support the deduction of notional interest expenses for PEs of financial institutions but not for other PEs.

Identifying the PE as a Separate Entity

With respect to the first step in the application of the working hypothesis (a functional and factual analysis of the activities of a PE and the conditions under which such activities are carried on), the group generally agreed that such an analysis could be successfully applied to a PE. Some participants thought that the functional and factual analysis required under article 9 was different from the analysis required for a PE under article 7. They raised concerns about the lack of any documentation to identify the activities of a PE as compared to a subsidiary. Others argued that documentation was often lacking, even with respect to transactions

between a parent corporation and its subsidiaries, particularly in relation to management and administrative services, use of intellectual property, and so on. Some participants agreed that PEs could be required to create and identify relationships with other parts of the enterprise in the same way as a subsidiary. They pointed to branch accounts as reasonably equivalent to the financial statements prepared for subsidiaries, with the exception of the debt and equity components of the balance sheet. Others argued that a PE and a subsidiary were different, and they pointed to the possible uncertainty concerning the existence of a PE and the absence of any independent capital structure for a PE as compared to a subsidiary. Branch accounts were not equivalent to financial statements for a subsidiary, it was argued, because the financial statements reflected legal contracts and relationships entered into by a subsidiary that had no counterpart with respect to a PE.

The question was raised as to how to distinguish between a PE engaged in contract manufacturing for the head office and a PE engaged in manufacturing on its own account as a separate entity. Some participants thought that a functional and factual analysis of the PE would not provide any answer to this question. Others argued that the PE and the head office could be required to document the nature of their intended relationship and pointed out that the same issue could arise in a parent-subsidiary context.

With respect to the determination of risks assumed by a PE, the discussion draft suggests that this issue can be resolved by the functional and factual analysis of the PE's activities.[72] According to some participants, the assumption of risk is inherently a legal issue. In the absence of legal transactions between a PE and the other parts of the enterprise, any allocation of risks to the PE would be arbitrary and unreliable.

Identifying the Dealings Between the PE and Other Parts of the Enterprise

As mentioned earlier, the key element of the working hypothesis is the identification of the dealings between a PE and other parts of an enterprise. Appropriately, most of the discussion focused this issue. The discussion draft indicates that a dealing should be recognized "where it relates to a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc)."[73] Further, the branch accounts will provide the starting point for determining whether a dealing exists. Some participants pointed out that the branch accounts simply reflected the taxpayer's position as to the characterization of the dealings of the PE and that, because of the absence of any legal consequences, such characterization might be made exclusively for tax reasons. They argued that there was nothing behind the characterization of the dealing (such as a legally binding contract) against which to test the taxpayer's characterization. In other words, although typically documentation constitutes a

record of transactions and arrangements that are not defined by the documentation process, with respect to PEs, documentation will in many respects define the basis for taxation. In contrast, other participants argued that the facts, in particular the conduct of the PE and the head office, would operate as an effective constraint on the ability of taxpayers to create dealings just for tax purposes. The facts will usually demonstrate whether or not an asset is used by a PE, which is part of the first step in the application of the working hypothesis. However, the facts may not show how the asset is being used (for example, as a sale, lease, or cost contribution arrangement) by the PE. In this respect, the documentation simply represents the taxpayer's position as to the characterization of the use of the asset by the PE and does not reflect any underlying reality. Some participants pointed out that related parties could choose the type of legal arrangement they preferred to enter into and amend the arrangement whenever they wished. As a result, legally binding contracts between related parties could not be considered to be as limiting as contracts between unrelated parties.

The discussion then moved on to consideration of the statement in the discussion draft that the dealings of a PE identified by reference to the branch accounts and other internal documents must be respected by the tax authorities:

> Except in the two circumstances outlined at paragraph 1.37 [of the transfer-pricing guidelines], tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a PE and so "should not disregard the actual *dealings* or substitute other *dealings* for them."[74]

The two circumstances referred to in paragraph 1.37 of the transfer-pricing guidelines are, first, where the substance of a transaction differs from its form, and second, where arm's-length parties would not have entered into the transaction entered into by the related parties.

Since a dealing between a PE and the head office is a notional construct, some participants had difficulty understanding how there could be "actual dealings" and why the tax authorities would be precluded, as a general principle, from challenging the taxpayer's characterization of the intended dealings. Further, it was unclear how the two exceptional circumstances could be applied in the case of a PE. It was suggested that paragraph 74 of the discussion draft should be clarified and might benefit from following the approach used in paragraphs 12 and 12.1 of the commentary on article 7. These paragraphs emphasize the importance of the branch accounts as the basis for computing the profits of a PE where they are based on internal agreements. The commentary suggests that the tax authorities could accept the accounts "to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise."[75]

In general, the group thought that the explanation of the concept of dealings in the discussion draft was not sufficiently clear. Some participants thought that

there should be a clear definition of the term "dealings." Others argued that the draft should distinguish clearly between the events that result in dealings and the characterization of those events for purposes of computing the income of a PE. The tax authorities cannot disregard the former because they are essentially factual; however, they are not bound by the taxpayer's characterization of the events. For example, the use of a capital asset by a PE is determined on the basis of the facts. However, the use of that asset by the PE may be characterized as a sale, a lease, or a cost contribution arrangement. This characterization is notional because there is no actual sale, lease, or cost contribution arrangement in law.

A question was raised about whether dealings between a PE and the head office could be changed. In the case of a subsidiary corporation, any change in the transactions between the subsidiary and its parent corporation would ordinarily be reflected in legal contracts. By analogy, dealings could change if the change were documented properly and were in accordance with the facts. Some participants were not entirely comfortable with this analysis.

Dealings in Capital Assets

According to the discussion draft, where the use of a capital asset by one part of an enterprise shifts to another part of the enterprise, a dealing should be recognized. Whether this dealing should be treated as a sale, a lease, or a cost contribution arrangement will depend on a factual analysis, including the subsequent conduct of the parts of the enterprise and any relevant documentation.[76] The discussion draft then sets out a non-exhaustive list of factors to be considered in determining the intent of the enterprise with respect to the change in use of the asset.[77]

The seminar participants were agreed that characterizing the change in use of a capital asset as a sale, lease, or cost contribution arrangement would be difficult in many cases. The *Cudd Pressure* case[78] was referred to as illustrative of the difficulty. Some of the participants were of the view that, because the snubbing unit in that case was used by the PE for a temporary period, it would have been more appropriate to characterize the dealing as a lease rather than a sale. They questioned the position in the discussion draft that there was no need to distinguish between temporary and more permanent changes in the use of assets.[79] Others argued that because the taxpayer had never rented the snubbing unit to third parties, it would not have rented it to the PE on the assumption that the PE was a separate entity dealing independently with the head office. In response, it was pointed out that nor was the taxpayer in the business of selling snubbing units.

The group was uniformly of the view that increased emphasis should be placed on the need for contemporaneous documentation of any dealings between a PE and other parts of the entity involving capital assets. Such documentation would be extremely important in characterizing the change in use of an asset as a sale, lease, or other arrangement. It was suggested that, at the least, contemporaneous documentation should be added to the list of factors relevant to the determination

of the intent of the enterprise,[80] and should be highlighted as the most important of those factors.

Some participants questioned the position in the discussion draft that no dealing should be recognized where a PE uses an asset from the time of its acquisition by the enterprise.[81] According to the draft, in this situation, the PE should be treated as the owner of the asset. Analogizing the PE to a subsidiary, it was suggested that an enterprise has a choice: the asset could be acquired by or on behalf of the PE and used by it, in which case the dealing between the PE and the head office would likely be treated as a sale, or the asset could be acquired and leased to the PE. Which characterization is more appropriate depends on all the circumstances, but, in particular, on how the dealing is documented by the enterprise at the time.

Intangible Property

The current commentary on article 7 takes the position that intangible property is owned by the enterprise as a whole and cannot be allocated among the parts of the enterprise. As a result, it is inappropriate for dealings with respect to intangibles to take place at fair market value; in other words, notional royalties cannot be deducted in computing the profits attributable to a PE.[82] The discussion draft is critical of the current position in the commentary and indicates that the working hypothesis requires that intangible property used by a PE should be treated the same as tangible capital property.[83]

The participants agreed in principle with the suggested treatment of intangible property in the discussion draft. However, it was suggested that different approaches might be appropriate for different types of intangible property. For example, franchising was raised as a situation in which comparable transactions with arm's-length franchisees might be available. Also, several participants were critical of the non-exhaustive list of factors that the discussion draft indicates should be considered to determine whether a PE has participated in the creation of intangible property.[84] They suggested that two factors were much more important than the others: (1) if the PE directs the research and development activities resulting in the intangible property and (2) if the research and development expenses are recorded in the branch accounts and are supported by contemporaneous documentation.

Services

Under the current commentary on article 7, services provided by the head office to a PE must be accounted for at cost rather than at an arm's-length amount unless the enterprise provides similar services to third parties.[85] According to the discussion draft, the commentary is inconsistent with the arm's-length principle in this regard.[86] However, the draft goes on to state that "there are times when the arm's length principle would result in a transaction taking place without the realisation of a profit."[87] Participants found this aspect of the treatment of dealings involving services to be confusing and suggested that it be clarified. It was also

pointed out that dealings involving services would often arise in circumstances where it was unclear whether or not a PE existed.

Capital Structure

The determination of the debt and equity of a PE and the deduction of notional interest are particularly troublesome aspects of the application of the working hypothesis to PEs. Time and again the seminar discussions returned to these issues.

Currently, the commentary on article 7 does not authorize the deduction of notional interest in computing the profits of a PE, except in the case of a PE of a financial enterprise because the ordinary business of a financial enterprise involves loaning funds to third parties. Although the discussion draft rejects the position in the commentary, it proposes to continue the ban on the deduction of notional interest "for administrative simplicity."[88] Accordingly, in computing the profits attributable to PEs, other than PEs of financial institutions, only part of the actual interest expense incurred by an entity would be allocated to the PE, on the basis of either factual tracing or formulary apportionment.

Some participants expressed the view that the prohibition on the deduction of notional interest by taxpayers other than financial institutions could not be justified under the working hypothesis and the application of the arm's-length principle to PEs. Others suggested that it did not make sense to treat debt financing in one way but other types of financing, such as leasing, in another. As mentioned earlier, concern was expressed about how a functional and factual analysis of the activities of a PE would assist in determining the amount of debt and equity to be allocated to a PE. Considerable discretion is available concerning the establishment of the capital structure of a subsidiary corporation, subject to domestic thin capitalization rules and possibly the arm's-length standard in article 9 of the OECD model convention. By analogy, the same flexibility should be available in the case of PEs. However, the application of the working hypothesis would arguably require the establishment of precise amounts of debt and equity for PEs based on the capital structure of comparable independent enterprises. Therefore, the results under article 7 for a PE and the results under article 9 for a subsidiary would be different unless domestic law provided some flexibility by way of an independent enterprise test in determining both thin and fat capitalization for PEs. Issues were also raised concerning the realization of foreign currency gains and losses on notional debt. The group did not have any solutions for these problems. It was suggested that article 11 (interest) and perhaps article 24 (non-discrimination) of the OECD model convention might be revised to distinguish between interest on related-party and third-party debt, and that any deduction of notional interest by a PE should be accompanied by a symmetrical deemed income receipt by another part of the enterprise. Many participants were concerned about the practical problems of attributing notional amounts of debt and equity to PEs, especially since it would often be difficult to identify dealings between the head office and

the PE in this regard. Even a requirement for contemporaneous documentation was not thought to be sufficient to allay these concerns.

Treaty Issues Other than Article 7

The discussion draft is limited to issues arising from the application of the working hypothesis to PEs under article 7 of the OECD model convention. Related issues concerning other aspects of the model convention were considered to be beyond the scope of the discussion draft.[89] Despite this disclaimer, the seminar participants agreed that several other issues involving the model convention are inextricably linked to the application of the working hypothesis to PEs.

First, it was noted that the continuing appropriateness of the concept of permanent establishment, defined in article 5 of the model convention as the threshold for source country taxation of business profits, was threatened by changing models of commercial practice, in particular electronic commerce. Obviously, any significant change in the threshold for source country taxation might affect the determination of the amount of business profits subject to tax by the source country. However, omission of consideration of this issue was not regarded as a serious shortcoming in the discussion draft.

Second, the discussion draft and the OECD model convention do not deal with the imposition of withholding tax on notional expenses that are deductible in computing the profits attributable to a PE under the working hypothesis. This issue is extremely important because of the potential erosion of the source country's tax base by the deduction of notional expenses such as interest and royalties. Under the working hypothesis, if a PE uses tangible or intangible capital property owned by the entity and the dealing between the PE and the head office is considered to be a lease or a licence, a notional arm's-length rent or royalty will be deductible in computing the profits of the PE. However, no actual payment is made because the PE and the head office are just parts of a single legal entity. If the entity is resident in a country that does not tax the profits of the PE, or taxes those profits at a significantly lower rate than the rate applicable in the source country, there will be a significant incentive for taxpayers to claim notional expenses for PEs. Applying the underlying assumption of the discussion draft that PEs and subsidiaries should be treated alike, if a subsidiary were involved, it would make actual rental or royalty payments to its non-resident parent, and those payments would be subject to source country withholding tax, at least potentially, and probably residence country tax with a credit for the source country withholding tax.

The group agreed that, in principle, notional expenses deductible in computing the income attributable to a PE should be subject to withholding tax if an actual payment of the same character paid by a subsidiary to its parent in similar circumstances would be subject to withholding tax. This would require changes to the domestic laws of most countries to allow the imposition of withholding tax on notional amounts. It would also be necessary to amend the OECD model convention to permit source countries to levy withholding tax on notional payments,

although it is not clear what amendments would be required. It was noted that it would be appropriate for countries to decide for sound tax policy reasons not to subject certain notional payments to withholding tax, just as certain actual payments are exempt from withholding tax.

Third, the discussion draft does not deal with the crucial issue of relief from double taxation. However, the basic purpose of the discussion draft is to establish a common interpretation of article 7 in order to minimize the possibility of double taxation or non-taxation. While the draft indicates that the working hypothesis "should ideally be applied by countries symmetrically, i.e. in the same manner regardless of whether they are the host or the home country,"[90] it goes on to suggest that because of article 23 of the model convention and the domestic laws of the residence country, symmetrical treatment may not be achieved in all situations. As mentioned earlier, the discussion draft does not discuss the meaning of the words in article 7(2) requiring that the profits attributable to a PE be the same "in each Contracting State." The group was unanimous in the view that the issues involving article 23 and the elimination of double taxation should be addressed as part of the consideration of the application of the working hypothesis to article 7. However, there was no detailed discussion of the article 23 issues.

Tax Administration and Compliance

Issues of tax administration and compliance surfaced frequently during the seminar discussions. There was general agreement that PEs should be required to document their intended dealings contemporaneously. This contemporaneous documentation requirement would put PEs in a similar position to subsidiaries, which are already subject to such a requirement. Also, it was thought that such a requirement would restrict the ability of taxpayers to artificially create dealings giving rise to notional deductions. The discussion draft did not deal extensively with documentation requirements and suggested that the approach used in the transfer-pricing guidelines could be applied to PEs without difficulty.[91] The participants agreed that the documentation requirements were essential to the successful application of the working hypothesis to PEs, although there was no agreement on the precise nature of such requirements. They also agreed that the discussion draft did not sufficiently emphasize the importance of documentation requirements and did not adequately examine the issues concerning documentation of intended dealings.[92]

There was some discussion of the possible consequences if a taxpayer did not prepare contemporaneous documentation of a PE's dealings. By analogy to a subsidiary corporation, substantial penalties could be imposed under domestic law.[93] Alternatively, the deduction of notional expenses could be disallowed unless the dealings giving rise to the expenses were properly documented. Concern was expressed that these types of penalties should not be too draconian. In many situations, it might be unclear whether or not a PE existed. It might be too burdensome to require taxpayers to file tax returns with a computation of the income of a PE supported by contemporaneous documentation of any dealings engaged

in by the PE if the taxpayer was reasonably taking the position that no PE existed. There was agreement that the OECD should consider these issues further.

Some concern was expressed that many tax administrations would be unable to apply the transfer-pricing guidelines to PEs without substantial additional resources. The existing transfer-pricing rules applicable to associated enterprises are already heavy consumers of the resources of tax administrations. Moreover, the necessity under the working hypothesis to postulate a PE as a notional separate entity, as well as notional dealings between the PE and other parts of the entity, involves large areas of uncertainty with the resulting possibility of increased disputes between taxpayers and tax administrations. The functional and factual analyses that are necessary to resolve these issues are likely to be time-consuming and expensive. Some participants argued that these analyses were required under existing tax treaties and in the case of parent-subsidiary relationships, and that, in any event, there was no alternative.

There was a brief discussion, but no consensus, about the extent and severity of the problems related to the attribution of income of PEs under existing article 7. The concern underlying this discussion was that the administrative burden resulting from the working hypothesis could not be justified if the problems of the current rules were not serious.

Some practitioners expressed the view that problems concerning the computation of income attributable to PEs arose infrequently and were usually resolved satisfactorily through negotiations with the tax authorities. They pointed to the absence of cases, foreign or Canadian, dealing with the attribution of income to a PE—the *Cudd Pressure* case being exceptional in this regard—as evidence that the current rules (or lack of rules) work reasonably well in practice. It was also pointed out that in many situations any problems resulting from doing business through a PE could be avoided through the use of a subsidiary corporation.

Other practitioners argued that there were significant problems under the current rules and that these problems would be exacerbated by the growth of electronic commerce, cross-border trade in services, and the development of free trade blocs such as the European Union and the North American free trade alliance. This issue is an important one, and it deserves more attention by the OECD steering group.

It is generally conceded, as discussed earlier, that there is no consensus among the member countries of the OECD concerning the interpretation of article 7 of the model convention. The fundamental purpose of the discussion draft is to establish a common interpretation of article 7 on which countries can agree. Perhaps it is appropriate for the OECD to consider whether the lack of a common interpretation of article 7 is currently causing serious problems of double taxation or non-taxation, or whether the problems are merely theoretical possibilities. If the deficiencies in article 7 are more theoretical than real, it is questionable whether it is necessary or desirable to make the transfer-pricing guidelines more thoroughly applicable, by analogy, to PEs.

PEs of Financial Institutions

Most of the seminar was devoted to discussing part I of the discussion draft, which deals with the application of the working hypothesis to PEs other than those of banks and other financial institutions. Little time was available to discuss part II, which addresses the application of the working hypothesis to PEs of banks. Gilbert Ménard of the Department of Finance gave a brief introduction to the work of the steering group and an explanation of some of the special difficulties with respect to bank PEs. It was suggested that the distinction between banks, other financial institutions, and other entities was not very clear in the discussion draft and that the distinction should be clear because of the significantly different treatment accorded to different types of PEs.

SUMMARY OF POINTS ON WHICH AGREEMENT WAS REACHED

Virtually all of the seminar participants agreed with the following points:

1) The working hypothesis represents the correct approach, in theory and principle, to the attribution of income to PEs. The arm's-length principle in article 9 of the OECD model convention should also apply to PEs under article 7 to the maximum extent possible.
2) The concept of "dealings" between a PE and other parts of an enterprise, and in particular, the distinction between events and the characterization of events, should be clarified.
3) Taxpayers should be required to document contemporaneously the intended dealings of a PE for purposes of computing its income. The discussion draft should deal in detail with these documentation requirements (for example, the nature of documentation required, the role of branch accounts, the consequences of the lack of contemporaneous documentation, etc.).
4) In principle, notional expenses that are deductible in computing the income of a PE should potentially be subject to source country withholding tax and to residence country tax (if the residence country does not otherwise tax the income derived in the source country) with a credit for the source country withholding tax.
5) The implications of the working hypothesis for the relief of international double taxation under article 23 of the OECD model convention should be addressed.

Notes

1 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (Paris: OECD, February 2001) (herein referred to as "the discussion draft").

2 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model convention").

3 The seminar was sponsored by the Department of Finance and the Canadian Tax Foundation.

4 Article 7(3) of the OECD model convention.

5 Article 7(6) of the OECD model convention.

6 Article 7(5) of the OECD model convention.

7 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

8 Subsection 13(9) of the Act.

9 Proposed subsections 10(12), 10(13), 14(14), and 14(15) of the Act.

10 See Organisation for Economic Co-operation and Development, *Model Tax Convention: Attribution of Income to Permanent Establishments*, Issues in International Taxation no. 5 (Paris: OECD, 1994).

11 Ibid.

12 Ibid.

13 Ibid., at paragraph 15. See also OECD model convention, commentary on article 7, paragraph 17.1.

14 *Attribution of Income to Permanent Establishments*, supra note 10, at paragraph 31, and OECD model convention, commentary on article 7, paragraph 17.1.

15 *Attribution of Income to Permanent Establishments*, supra note 10, at paragraphs 14 and 20, and OECD model convention, commentary on article 7, paragraphs 17.4 and 18.3.

16 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf).

17 Organisation for Economic Co-operation and Development, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary in the Model Convention on Article 5* (Paris: OECD, December 22, 2000).

18 Organisation for Economic Co-operation and Development, *Attribution of Profit to a Permanent Establishment Involved in Electronic Transactions*, A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (Paris: OECD, 2001).

19 Ibid., at paragraph 86.

20 Ibid., at paragraph 84.

21 Discussion draft, part I, paragraph 6.

22 Discussion draft, part I, paragraph 43.

23 Discussion draft, part I, paragraphs 54 and 55.

24 Discussion draft, part I, paragraph 56.

25 Discussion draft, part I, paragraph 45. External conditions include, for example, characteristics of the relevant market in which the activities of the PE take place. Internal conditions include, for example, the characteristics of the property or services provided and business strategies. See OECD, *Transfer Pricing Guidelines*, supra note 16, at paragraphs 1.19 to 1.35.

26 Discussion draft, part I, paragraph 67.

27 Discussion draft, part I, paragraph 69.

28 Discussion draft, part I, paragraph 71.

29 Ibid.

30 Discussion draft, part I, paragraph 72.

31 Discussion draft, part I, paragraph 74. See also OECD, *Transfer Pricing Guidelines*, supra note 16, at paragraph 1.37.

32 Discussion draft, part I, paragraph 89.

33 OECD model convention, commentary on article 7, paragraph 17.1.

34 Discussion draft, part I, paragraph 91.

35 Ibid.

36 Discussion draft, part I, paragraph 95.

37 Discussion draft, part I, paragraph 96. The list of factors includes whether the PE existed when the asset was acquired, whether the activities of the PE have changed, and whether the PE has responsibility for repairing the asset in the event of damage.

38 Discussion draft, part I, paragraph 97.

39 Discussion draft, part I, paragraphs 109 to 110.

40 OECD model convention, commentary on article 7, paragraph 17.4.

41 Discussion draft, part I, paragraph 112.

42 Discussion draft, part I, paragraph 114. These factors include whether the PE directs the research, whether the PE records the research expenses in its branch accounts, and whether the PE was in existence and was exploiting similar intangible property when the particular property was created.

43 Discussion draft, part I, paragraph 115.

44 Discussion draft, part I, paragraph 116.

45 Discussion draft, part I, paragraph 117.

46 Discussion draft, part I, paragraph 118.

47 Discussion draft, part I, paragraph 119.

48 Discussion draft, part I, paragraph 124.

49 Discussion draft, part I, paragraph 125.

50 Discussion draft, part I, paragraph 126.

51 Discussion draft, part I, paragraph 138.

52 Discussion draft, part I, paragraphs 143 to 145.

53 Discussion draft, part I, paragraph 150.

54 Discussion draft, part I, paragraphs 151 to 158.

55 Discussion draft, part I, paragraph 157.

56 Discussion draft, part I, paragraph 161.

57 Discussion draft, part I, paragraph 174.

58 Discussion draft, part I, paragraph 173.

59 Discussion draft, part I, paragraph 174.

60 Discussion draft, part I, paragraph 180.

61 Discussion draft, part I, paragraph 182.

62 Under the heading “Background.”

63 See subsection 13(9) and proposed subsections 10(12), 10(13), 14(14), and 14(15) of the Act.

64 RSC 1985, c. I-4, as amended.

65 85 DTC 5513; [1985] 2 CTC 328 (FCTD).

66 Discussion draft, part I, paragraphs 14 to 21.

67 The ambiguity in the meaning of the term "enterprise" is not unique to article 7; it also occurs in articles 5(1), 5(5), 5(6), 9(1), and 24.

68 Discussion draft, part I, paragraph 10, at footnote 3.

69 Discussion draft, part I, paragraphs 35 to 36.

70 Discussion draft, part I, paragraph 37.

71 Ibid.

72 Discussion draft, part I, paragraph 57.

73 Discussion draft, part I, paragraph 69.

74 Discussion draft, part I, paragraph 74.

75 OECD model convention, commentary on article 7, paragraph 12.1.

76 Discussion draft, part I, paragraph 95.

77 Discussion draft, part I, paragraph 96.

78 *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630; [1999] 1 CTC 1 (FCA).

79 Discussion draft, part I, paragraph 108.

80 Discussion draft, part I, paragraph 96.

81 Discussion draft, part I, paragraph 91.

82 OECD model convention, commentary on article 7, paragraph 17.4.

83 See text accompanying notes 39 to 47, supra.

84 Discussion draft, part I, paragraph 114.

85 OECD model convention, commentary on article 7, paragraphs 17.5 to 17.7.

86 Discussion draft, part I, paragraph 123.

87 Ibid.

88 Discussion draft, part I, paragraph 157.

89 Discussion draft, part I, paragraph 9.

90 Discussion draft, part I, paragraph 33.

91 Discussion draft, part I, paragraph 166.

92 In paragraph 8 of the discussion draft, it is indicated that documentation will be addressed after the testing of the working hypothesis has been completed. According to the participants, documentation is a necessary condition for the proper application of the working hypothesis and should be addressed as part of the working hypothesis itself.

93 See, for example, the penalties under subsections 247(3) and (4) of the Act.