The OECD Project: Transfer Pricing Meets Permanent Establishment

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ABSTRACT

A project undertaken by the Organisation for Economic Co-operation and Development (OECD) is examining the appropriate method for attributing profits to a permanent establishment (PE). The so-called authorized OECD approach applies transfer-pricing principles to the determination of branch profits under article 7 of the model convention. This paper expresses some skepticism regarding both the conceptual foundation and the practical application of the approach.

The method favoured by the OECD extends the already complex and difficult transfer-pricing rules to the legally and factually distinct situation of the branch, or even to a dependent agent PE. Added to the hypothesis upon which article 9 of the model convention is constructed are other hypotheses, or analogies, required to apply transfer-pricing concepts to PEs. The practical application of this process of analogy raises a number of difficult issues, a few of which are noted in this paper, including the definition of "dealings," the problems created by inadvertent PEs, documentation requirements, and potential conflicts arising out of the choice of acceptable methodologies within the authorized OECD approach.

The author considers how the OECD is likely to tackle the current phase of the project—reconciling the authorized OECD approach with the terms of article 7 of the model convention and its commentary—and concludes that while fundamental amendment of the article may be desirable, it is unlikely to occur. He anticipates, instead, changes to the commentary and perhaps model language as an option.

Finally, the author poses the high-level question of whether reliance on the arm's-length principle, on which the transfer-pricing methodology is based, is sensible. He suggests, for further consideration, that perhaps the two subjects—transfer pricing under article 9 and attribution of profits under article 7—should be re-examined as part of the larger question of how the profits of a multinational enterprise should be taxed by the jurisdictions in which it carries on business.

KEYWORDS: ATTRIBUTION ■ OECD ■ PERMANENT ESTABLISHMENTS ■ PROFITS ■ TAX TREATIES

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> *The obscurantists of any generation are in the main constituted by the greater part of the practitioners of the dominant methodology.*
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> Alfred North Whitehead

This policy forum was triggered by a four-year-old project of the Organisation for Economic Co-operation and Development (OECD) regarding the attribution of profits to a permanent establishment (PE). The current version of the project's statement of principle is found in the August 2, 2004 revised discussion draft, part I (general considerations).[1] Following a series of consultations with the private sector in the fall of 2004, Working Party 6 ("WP 6," the international group of tax officials that deals with transfer pricing) and its parent body, the Committee on Fiscal Affairs (CFA), agreed not to finalize the outstanding discussion drafts by January 2005, as originally proposed.[2] Instead, further work will be undertaken (1) to "refine" and finalize the texts, and (2) to revise the commentary on article 7 of the OECD model tax convention[3] and consider the language of the article itself.[4] The target completion date is January 2007.

The ultimate goal of the project is to extend the transfer-pricing guidelines developed in connection with article 9 of the model convention to the circumstance of a PE. Reverting to the opening citation, I observe that when it comes to allocating taxing jurisdiction over the profits of multinational enterprises (MNEs), the dominant methodology is the one used in transfer pricing. More specifically, it is the arm's-length principle applied on a transactional basis, as embodied in the OECD

1 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishment—Part I (General Considerations)* (Paris: OECD, August 2004) (herein referred to as "the discussion draft").

2 In addition to the generic part I, the OECD has published parts II (banking) and III (global trading); part IV (insurance) is to come.

3 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003) (herein referred to as "the model convention").

4 Organisation for Economic Co-operation and Development, "Attribution of Profits to a Permanent Establishment: Revised Timetable for Completion," November 19, 2004 and "Finalising the Work on the Attribution of Profits to a PE," January 27, 2005, online at http://www.oecd.org/.

transfer-pricing guidelines of 1979[5] and the turbocharged 1995 version.[6] In the hope of being provocative, though at the risk of being wrong, I will suggest later in this brief note that the architects of this project may have erred in their timing, rather like the retailer expanding into a mature and declining market. But first, I would like to express (1) a conceptual concern about the very basis of the project, (2) some apprehension about the potential application of the so-called authorized OECD approach, and (3) a view on its relation to the model convention.

"HYPOTHESIS NON FINGO"

With the release of the August 2, 2004 document, the "working hypothesis" of the earlier drafts morphed into "the authorised OECD approach." However, it remains a hypothesis. So, indeed, is transfer pricing.

Article 9 of the model convention permits a state to tax an enterprise on profits that would have accrued to it but that have not so accrued because the conditions imposed in its financial or commercial dealings with an associated enterprise differ from those that would be made between independent enterprises. The article thus requires that a calculation be made under a counterfactual assumption.

The "functionally separate entity" theory that anchors the authorized OECD approach is derived from article 7, paragraph 2 of the model convention, which attributes to a PE

> 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.

This provision superposes two hypotheses: (1) that the PE is a distinct and separate entity engaged in the business carried on by the PE under the same or similar conditions, and (2) that this notional entity deals independently with the enterprise of which the PE is a part.

The authorized OECD approach effectively combines the hypotheses of articles 7 and 9. The hypothetical separate enterprise is supplied with hypothetical functions, assets, risks, and capital. The methodology then precariously balances on this first construction the considerable weight of the transfer-pricing guidelines established under article 9, applied to "dealings" between the PE and the enterprise of which it is a part that are meant to be the analogue of real transactions.

When Sir Isaac Newton expressed the sentiment repeated in the heading immediately above—"I feign no hypothesis"—he was demanding that science rest

5 Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).

6 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995).

solely on the observation of natural phenomena. Taxation is no science, but it, too, can go astray when it proceeds by metaphor rather than by the application of fiscal rules to real things and events. The OECD project constructs an elaborate and complex edifice on the unsteady foundation of a notional equivalence between a phantom separate enterprise and a real one.

APPLICATION OF THE AUTHORIZED OECD APPROACH

Given limitations of space, time, and energy, I will simply highlight a few problems that have risen to the top of my own personal list of concerns.

1. *"Dealings."* This notion is the fulcrum on which the authorized OECD approach turns. I am not entirely convinced that it is susceptible of supporting the intended results. Transfer-pricing issues arise under article 9 only where conditions are made or imposed between associated enterprises that differ from those that would be made between independent enterprises. Transactions between an enterprise and other, unrelated parties are not generally within the scope of the article. For example, the sale of goods or services by a subsidiary to an unrelated customer is not a transaction subject to article 9. That article may, however, be relevant in determining how to treat inputs obtained by the subsidiary from its parent, including intangibles and financial resources. Under article 7, the profits from the arm's-length sales "of" a PE must themselves be apportioned between the PE and other components of the enterprise of which it is a part. This is a different exercise. Is the concept of "dealings" adequate or appropriate for this task?
2. *The inadvertent PE.* Multinational corporations generally know if they have a subsidiary, but the existence of a PE is often a matter of opinion. Applying the authorized OECD approach retrospectively to a PE that the enterprise did not know it had will be a challenge. Government officials have not been as sympathetic to this problem as one might expect, and the reason may be that it is seen as a small price to pay for the greater good of challenging abusive tax avoidance. One admitted purpose of the OECD project is to capture what are perceived to be the vanishing profits of MNEs, spirited away through commissionaire or other arrangements in which a local presence may not constitute a "dependent agent" within the meaning of article 5, paragraph 5 or, even if it does, may attract only a very modest profit allocation. There are two opposing views on this question. Many in the private sector argue that it all boils down to getting the transfer-pricing right. If there is a dependent agent PE, and if the PE assumes significant risks or performs valuable functions, then article 9 and the transfer-pricing guidelines can capture the profit. A number of tax administrations, however, are unconvinced of the theoretical soundness of this argument and, probably more important, worried about its practical effects. They conceive that there are

two distinct profits to be taxed, that of the agent and that of the principal. Be that as it may, the inadvertent PE is a glaring problem.

3. *Documentation*. Documenting transfer pricing has become an industry, although perhaps a deadweight loss for the economy. The challenge of meeting the diverse and divergent documentation requirements of national tax authorities is time-consuming and expensive. To the extent that governments have made any attempt to coordinate their requirements, such as the PATA initiative, their efforts have not received high marks from those at the compliance end of the stick. The authorized OECD approach adds a new dimension to this irritant, demanding that taxpayers document the imaginary "dealings." Moreover, they must document not only the existence but the characteristics of such a chimera—for example, whether the use of equipment by a branch was a use qua notional owner or qua notional lessee. If the PE is inadvertent, the documentation requirements will apply retrospectively to enterprises that did not know there was anything to document.
4. *The attribution cafeteria*. It should come as no surprise to anyone who has watched the OECD consensus mechanism in action that, as the drafts progress, they become more detailed but less prescriptive. The authorized OECD approach is actually a universe of authorized approaches, a smorgasbord to please the varied palates of the WP 6 members. Flexibility is a modern virtue, but in international taxation, it can lead to double taxation. The authorized OECD approach places considerable reliance on article 23 of the model convention to eliminate any double taxation that might otherwise result from different menu choices. If the state in which the PE is located attributes profits in accordance with a method falling within the ambit of the authorized OECD approach, such attribution is (or so the authors of the discussion draft say) "in accordance with the Convention" and, presto, the other state must allow recognition of the foreign tax. Would that life were so simple.

THE MODEL CONVENTION

It is not clear whether the authorized OECD approach is authorized only by the OECD or also by the text of article 7. One could well ask how a few lines in article 9 can support the load of the transfer-pricing guidelines. The legal issues arising under article 7 are even more serious because of its enigmatic drafting. Nor is there a longstanding practice to justify such an approach to the application of article 7, whereas the transfer-pricing guidelines at least have the sanction of precedent and wide acceptance.

Clarification of this question is necessary to avoid both uncertainty and inconsistency. This can best be done in bilateral conventions, either by changing article 7 or, as a second-best solution following the recent US-UK approach, by adopting some kind of interpretive instrument. In the latter case, the parties agreed, in anticipation of the conclusion of the OECD attribution project, that the transfer-pricing guidelines will apply, by analogy, to determine the profits attributable to a

PE. The paragraph in the exchange of notes, although relatively brief, recites the key elements of what has since become the authorized OECD approach.[7]

In the OECD context, the solution demands joint action by two "working parties"—groups of tax officials to whom the activity of the CFA is effectively delegated. WP 6 is charged with transfer pricing, while WP 1 has carriage of the model convention. Each has its own assigned staff within the secretariat, now known more magniloquently as the Centre for Tax Policy and Administration. The authorized OECD approach was developed under the auspices of WP 6. I assume there was input from WP 1 staff, but the thrust of the project reflects an institutional decision that this is a transfer-pricing issue. From here on, the two working parties will have to work together to determine what is required with respect to article 7 and its commentary in order to accommodate the authorized OECD approach.

The possibilities are limited.

1. *Amendment of article* 7. Although the CFA announcement leaves the matter open, for the reasons cited in the second point I doubt that extensive changes to article 7 will be proposed. I think that is unfortunate. Such a major shift in the manner in which article 7 is applied would be better accomplished by a visible and dramatic change in the treaty text. One may, however, anticipate some peripheral amendments to article 7, as prefigured in the discussion draft, such as the elimination of paragraph 4.
2. *Amendment of the commentary.* Recent WP 1 practice places faith in the ability of the commentary to take one where one needs to go, without the bother of amending the articles themselves. Commentators often express discomfort with the use of the commentary as a quasi-legislative instrument, particularly when the text postdates the period to which it is sought to be applied. However, I believe that all or substantially all of the accommodation, regarding both transitional (not to be underestimated) and permanent issues, will be accomplished by modifications and additions to the commentary.
3. *Models for bilateral text.* This alternative is a subset of or addition to the second. The commentary now contains a number of examples of model text that states may adopt if they feel so inclined in order to achieve a particular result, or if they are not comfortable that they can achieve the result they want merely by relying on the commentary. It is possible that WP 1 will design article 7 language that accommodates the authorized OECD approach for those who feel they need it. Given the US-UK precedent, WP 1 might also draft text for side agreements or protocols.

The relationship between the authorized OECD approach and the model convention is far from academic. If changes to article 7 are legally necessary in Canada

7 "United States Response to United Kingdom Note Setting Forth Additional Agreements Regarding the U.S.-U.K. Double Taxation Convention, Signed July 24, 2001," online at http://www.treas.gov/offices/tax-policy/library/uknotes.pdf.

to justify the application of the authorized OECD approach under our conventions, either these conventions will have to be amended or a treaty override, presumably an amendment to the Income Tax Conventions Interpretation Act, will be required. If the final OECD product includes substantive changes to the commentary and only "technical" changes to article 7, perhaps with an observation that the latter amendments are desirable but not strictly necessary, then the long-debated and unresolved question of the status of the OECD commentary will become even more important.

THE F WORD

Formulary apportionment is blasphemy in transfer-pricing circles. Both international business and, indeed, governments have resolutely opposed it as an alternative to transactional transfer pricing. The most common objection is that it could work only if everyone agreed on the formula and such agreement is impossible. In addition, formulas based on factors such as sales and wages do not provide a fair allocation of tax revenues and are open to manipulation. Our experience in Canada validates all of these concerns.

Instead, taxpayers and tax administrations rely on the transactional application of the arm's-length principle. This approach is widely accepted and deeply entrenched; the sunk costs of governments, enterprises, and professionals in transfer pricing are huge. However, it too is not without its difficulties and its critics. Transfer-pricing methodology works best where associated enterprises engage in discrete intercompany transactions, unintegrated into any larger whole, of a type that mirrors those between unassociated enterprises. Furthermore, information regarding such unrelated transactions must be readily available to both administrators and taxpayers. Alas, if such cases were ever common, they surely are not today. The practicality of applying transactional arm's-length pricing methodologies in real life, particularly to determine the allocation of profits within the largest and most complex MNEs, is coming increasingly into question.

I perceive, albeit dimly, some degree of convergence between these antitheses. It is not a dialectical synthesis of opposites but, rather, a search for a methodology (or, more likely, methodologies) that can alleviate the increasing obduracy of transfer-pricing problems.

It is noteworthy that many competent authority settlements and advance pricing agreements (APAs) are based on profit splits, even though these were relegated to methods "of last resort" in the OECD's 1994 transfer-pricing guidelines. The profit split is often, in practice, a formulary, non-transactional approach. While one can claim that the profit split reflects the way in which unassociated enterprises would behave if similarly situated, the reality is that these solutions to intractable transfer-pricing cases are an attempt to apportion the profits of an integrated enterprise among competing tax authorities on a fair and verifiable basis.

I do not mean to suggest that tax authorities are accomplishing sub rosa what their governments have officially and repeatedly eschewed. They have not established and could not establish a covert form of formulary apportionment. I cite this activity rather to suggest that perhaps, and only perhaps, the evolution of the application of the transfer-pricing guidelines has something to tell us about the traditional obstacles to a system based on apportionment.

First, competent authority settlements and APAs are usually bilateral. They rarely involve multiple players. In fact, the whole world does not have to agree to the same "formula," but only the jurisdictions intimately and significantly involved with the particular enterprise. Canada, for example, could operate a reasonably effective system if it reached agreement with a few key trading partners, continuing to rely on transactional arm's-length transfer pricing with others. This is what federal states commonly do, and it is where Europe may be heading.

Second, the apportionment deals that are struck with competent authorities are not based on crude and rigid "factors." The formulas are bespoke, taking into account the specifics of the industry and the geography.

Third, apportionment methodologies supplement rather than replace transactional transfer pricing. Where the good old comparable uncontrolled price works, it still presents advantages of certainty, predictability, and consensus. If an enterprise in state A sells widgets to an affiliate in state B, and it also sells widgets of the same kind and in the same circumstances to unrelated purchasers in state B, then there is something to be said for determining the profits of the enterprise by reference to those arm's-length sales. But this presupposes no special intangibles, no peculiar market penetration policies, no disaggregated services floating about the group, etc.

A bit of lateral thinking would not hurt the subject of transfer pricing.

The relationship between these reflections and our subject, attribution of profits to a PE, is that the authorized OECD approach is, arguably, heading resolutely in the wrong direction. The Holy Grail would be an enterprise-wide profit split, taking into account both incorporated affiliates and PEs, on a basis that is fair, reasonably predictable, and verifiable. This goal may be unreachable, but it certainly is not advanced by the elaborate and complex architecture of the authorized OECD approach. The project focuses narrowly on the PE and does not purport to step back to look at the enterprise as a whole.

Perhaps such a magisterial effort as is apparent in the development, testing, and presentation of the authorized OECD approach might better be directed toward resolving the manner in which global tax revenues on business profits should be shared among nations.