Policy Forum: Attribution of Profits to a Permanent Establishment

The journal's Policy Forum exists primarily to stimulate timely awareness of and debate about contemporary tax issues. In cases where informal debate arises naturally among members of the tax community, we hope the forum commentary serves as both a catalyst and a framework for an informed, informative, and possibly enduring exchange of ideas. In other cases, such as this forum and its intended sequel (described below), our ambitions extend to initiating, organizing, and recording a debate among knowledgeable commentators. Here, the views of contributors confront not only each other but also those of readers, who are invited to join the debate through correspondence that may be published in forthcoming issues of the Journal.

This policy forum is the first of two dedicated to the ongoing international debate about how to apply "accepted" transfer-pricing rules and practices to evaluate the measurement and allocation of income of a single taxpayer with a business presence in more than one jurisdiction—that is, the allocation between a "home office" and a "branch," synonymous with a "permanent establishment" (PE), located elsewhere. The globalization of international business is a phenomenon widely observed but often imprecisely discussed. However, questions provoked by the present debate provide a cogent focus for considering the ability of countries' tax regimes to fairly capture their share of an international tax base in the face of the pressures and uncertainties that globalization raises for typical jurisdictional markets. The primary questions, among perhaps many that need to be addressed, concern very basic aspects of international income measurement, as well as preconceptions about the continuing utility and theoretical integrity of domestic tax rules and practices, and their connection through tax treaties. Because contemporary business is likely to be conducted on functional lines across entities and other organizational manifestations of business presence within an enterprise, rather than merely between legally distinct members of the enterprise, the traditional expectations and tools of international tax analysis are called into question in quite fundamental ways.

In the papers that follow, two experienced and thoughtful practitioners bring their unique perspectives to the issue of income allocation, establishing the poles of the debate. The debate will be extended by other commentators in the sequel planned for a future issue of the journal.

At one level, it seems almost obvious that artificial legal constructions that define and subdivide an enterprise organizationally ought not to interfere with the allocation of economic income—the modern preserve of transfer pricing—within an enterprise and between or among countries in which that enterprise is active. Indeed, the prevailing statement of Canada's transfer-pricing practices, *Information*

Circular 87-2R,[1] surprised practitioners with the straightforward, not to say stark, observation that transfer-pricing guidelines apply to evaluate the income-earning consequences associated with the internal dealings of an enterprise. Indeed, it was the implication that "of course" this is an expected application of transactional transfer-pricing rules that caught many off guard, although the notion of applying systematic functional analysis to understand how a business is conducted and where important elements of value reside is hardly startling. The same expectation is reflected in the continuing study by the Organisation for Economic Co-operation and Development (OECD) of the attribution of profits to a PE. One of the aims of the study is to ascertain and articulate guidelines, to be applied by OECD countries, to inform the application of business profits articles in tax treaties consistent with the OECD model tax convention.[2] In Canadian practice, however, this expectation coexists uneasily with the implications of the *Cudd Pressure Control* case[3] and section 4(b) of the Income Tax Conventions Interpretation Act,[4] specifically with respect to when and how it may be appropriate to recognize "notional" transfers within an enterprise—a term that, though imprecise, reflects the transactional orientation of transfer-pricing analysis and methodology.

"International taxation" (another imprecise—and overused—term) refers to the tax rules and practices of a country focusing particularly on transactions, arrangements, and relationships that are not confined within the country or exclusive to its residents. Primarily, acknowledging the "tax sovereignty" of nations, these rules and practices are captured in domestic legislative, regulatory, and administrative measures concerned, for example, with foreign tax credit, non-resident withholding tax, the taxation of non-residents with an income-earning connection that is equivalent to (though more limited than) that of a resident, the taxation of foreign-source portfolio income, and the taxation of foreign investment and business income earned by controlled foreign corporations.

However, since two or more states could otherwise establish credible, principled claims to apply their tax rules to the same taxpayer or the same income, additional arrangements have been put in place to enable states to allocate and resolve their competing tax claims on a more or less consensual basis, a priori and in the event of disputes, by way of negotiation with each other. This constraint on the application of domestic "international tax" rules is typically and most commonly found in bilateral tax treaties that are more or less consistent with established "models"—primarily the OECD model convention and others (such as the United States model convention) based on it—which record a basic common approach or expectation among countries for avoiding multiple taxation of taxpayers and their income

1 *Information Circular* 87-2R, "International Transfer Pricing," September 27, 1999.

2 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 OECD model convention").

3 *Cudd Pressure Control Inc. v. The Queen*, [1995] 2 CTC 2382 (TCC); aff'd. [1999] 1 CTC 1 (FCA).

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

while preserving the legitimate tax claims of the treaty partners. Broadly, treaties reflect different taxing priorities between the state that is the "source" of a taxpayer's income and the state of "residence" of that income earner with respect to passive (investment or capital) income and business income.

Not surprisingly, the allocation of a business-income tax base between contending claimants—that is, tax jurisdictions—raises important and often difficult questions about how to establish the requisite connection, or attribution, of taxable profits to those jurisdictions. These questions become more difficult (and perhaps even theoretically irresolvable), and the solutions adopted by taxpayers themselves may be unreliable, where the affected taxpayers are related to each other and accordingly the terms and conditions of arrangements between them are not necessarily limited by the commercial strictures of unrestricted arm's-length dealing. In a nutshell, countries' transfer-pricing rules and practices and their broad international consensus on the so-called arm's-length principle manifest in the OECD transfer-pricing guidelines[5] exist to relieve the uncertainty and unreliability of profit allocations, and resulting state-to-state allocations of income tax base, associated with the integrated business conduct of parties with common interests within a single organization or enterprise.

The application of the "arm's-length principle" to "transactions" between members of an enterprise with distinct legal personality has proved difficult enough. The same exercise for arrangements economically inherent in a single legal personality is complicated more than incrementally, demanding in the first instance—even before getting to the art and "science" of transfer-pricing analysis—a hypothetical transactional framework equivalent to that which would exist if branches were entities (and wishes were horses, to appropriate a nursery rhyme's imaginative yearnings?). However, the debate occasioned by the OECD's attribution of profits project has even more profound implications. Even for traditional entity-to-entity arrangements with a corporate group, it has led to a critical re-examination of jurisdictional principles framed by the "permanent establishment" and "business profits" articles of tax treaties and of transfer-pricing rules and practices, the significance and implications of which have unfairly been taken for granted. Traditional interpretations and applications of these pillars of international taxation may, in fact, be inadequate, inviting a fundamental reconstruction of how international income is measured and determined to be more relatively connected to a state seeking to establish and preserve a taxable, and possibly the primary taxable, liability.

With characteristic wit and wisdom, Robert Couzin questions the assumptions and preconceptions underlying the OECD approach to transfer pricing. His critical reflections on the arm's-length principle generally and its specific application in attributing profits to a PE are framed with a reference to obscurantism—"opposition to the spread of knowledge" or "a deliberate vagueness or abstruseness"—serving the interests of those setting the present limits of a debate or approach. This is a much more eloquent way of suggesting that in our doctrinaire adherence

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

to typical manifestations of transfer pricing, we deliberately ignore the possibility that the emperor may be wearing no clothes. Couzin notes the collision between the arm's-length principle, which posits a complete absence of distortion occasioned by related-party dealing, and the essential characteristics of an enterprise for which this "principle" is meant to be a useful, if not necessary, analytical device. His observations extend to questioning the utility of a transaction-based analytical regime where the most problematic aspects of income measurement may be occasioned by intrinsic organizational characteristics of a multinational organization that are not transactional in the traditional legal sense (if at all).

Couzin notes that the approach underlying many transfer-pricing determinations is in the nature of a profit split. This result, in a manner of speaking, is all that article 9 of the OECD model convention addresses; there is nothing there about transactional pricing, the allocation of revenue and expenses, or methodologies raised to the status of science. In a discussion peppered with critical observations in this vein, Couzin confronts the theoretical, and not merely practical, implications of formulary apportionment and concludes by inviting us to reflect on the possible desirability of a more direct international or global profit split approach. Important to this invitation are his observations to the effect that the inherent characteristics and manifestations of multinational organization and corporate group behaviour reflected in the complex weave of an enterprise's commercial and functional existence collide with a tax regime for the attribution of profits that "presupposes no special intangibles, no peculiar market penetration policies, no disaggregated services floating about the group, etc."

Our two commentators did not exchange their ideas before submitting their papers for publication, and their common direction is striking.

Possibly informed by different practical encounters with transfer pricing, François Vincent, KPMG's Canadian transfer-pricing practice leader, also confronts the complexity of PE profit attribution according to the evolving OECD approach. Like Couzin, Vincent recognizes the practical need in tax practice to be able to count on the application of precise rules to actual circumstances and the practical dangers for taxpayers and tax administrations of not being able to rely on instructive and predictable allocation rules. In a different but no less compelling way, Vincent also notes the antithesis between the arm's-length principle and the characteristics of a multinational enterprise that are the very reason for its existence. This "principle" works only if one disregards those elements of a multinational enterprise that make it possible to achieve the efficiencies of integrated dealing that are the hallmarks of such an enterprise. Vincent's critical reflections on the characteristics and compulsions of traditional transfer pricing provide the basis for his suggestion of a global profit split approach.

Vincent observes that functional analysis, a cornerstone of modern transfer pricing, essentially entails an assessment of the distribution of profit for the entire enterprise—that is, the entitlement of various elements of the enterprise to lay claim to a share of that profit. Indeed, it might be suggested editorially that functional analysis (an analysis of the deployment of human and capital resources within an enterprise, and the assignment of value and organizational significance to them in relation to transactions from which income is earned) is a kind of formulary apportionment that uses a more diffuse formula than that typically associated with this methodology, and that also reflects the significance of the human, capital, and revenue and expense (profit) elements of the combined application of treaty-based PE and business profits articles. On this basis, Vincent would observe that the analysis essential to a formula-based global profit split is already suggested by the more or less common approach of countries to transfer pricing—which, as both commentators remark, in any event involves the splitting of profits. Vincent acknowledges the possible arbitrariness of formulaic analysis but wonders whether it is any more arbitrary than applying an equivalent analysis after the fact, for example, in an audit setting. In a manner of speaking, Vincent's theory is that while transfer pricing is inherently imprecise, perhaps it is better at the outset to adopt predictable standards that clearly establish the limits of this imprecision, rather than leaving it as an abstraction needing to be resolved by the selective application of a menu of possible analytical devices, long after the income measurement determinations have been made by an enterprise.

Vincent astutely points out that tax authorities need to adopt common standards or approaches and offers an important practical insight. Essentially, income measurement and allocation associated with traditional transfer-pricing analysis, as well as the present exercise to determine standards for profit attribution, primarily concern the interests of tax jurisdictions; multinational commerce is the playing field on which countries sort out their relative entitlements to a common tax base arising from what taxpayers do and how they do it. Accordingly, independent tax authorities need to adopt, articulate, and apply analytical approaches that each acknowledges to its counterparts and that are well known to taxpayers. In that connection, the recently concluded memorandum of understanding between the Canadian and US competent authorities[6] directed to the establishment of an informed and informative framework for resolving instances of possible double taxation, and more generally the constructive application of the mutual agreement procedure in the Canada-US income tax convention, is a reflection that tax authorities must effectively provide the cartilage for the frictionless interaction of tax systems, and that they are aware of this.

Vincent's proposed global profit split methodology expresses a practical solution that mirrors Couzin's more policy-oriented commentary on the desirability of global profit apportionment. The issues presented by the OECD's study of profit attribution are thus joined by the two papers in this forum. The sequel to this discussion will extend the debate. Again, we invite readers to contribute by commenting on the thoughts of these commentators or, indeed, by advancing their own perceptions of issues arising from the study.

Scott Wilkie
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6 On June 3, 2005, the Canadian and US competent authorities signed a memorandum of understanding to establish principles and guidelines for improving the performance and efficiency of the mutual agreement procedure under the Canada-US income tax convention.