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The Authorised OECD Approach
- The Implications of the OECD
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Summary

For decades the attribution of profits has been a subject of discussion. The international tax principles governing the subject are provided in Article 7 of the *OECD Model Tax Convention on Income and on Capital*. Taxation is a prerogative for the states, thus each state decides how to tax business profits. Until today the application and interpretation of tax treaties have varied considerably between the different OECD member states. One risk, by reason of the lack of a consistent application and interpretation, is that it may result in international double taxation, or even less than single taxation. The globalization and the growing cross-border trade increase the need for a broader consensus in this area.

The *OECD Model Tax Convention on Income and on Capital* (hereinafter: OECD Model) originates from the work made by the League of Nations in the 1920s. Since then the concept of attribution of profits to permanent establishments has been developed numerous times, but it was first in 1963 the OECD released the first *Draft Double Taxation Convention on Income and on Capital*. The principles of taxing business profits have evolved in order to meet the rapid changes of the business community.

The Committee on Fiscal Affairs has been working on establishing a broader consensus in the field of business profits. To minimise the negative effects of the variations in application and interpretation by different states, the Committee's Working Party No. 6 on the Taxation of Multinational Enterprises has formulated a Working Hypothesis as to the preferred approach for attribution of profits to a permanent establishment under Article 7 of the OECD Model. The preferred approach should conform to sound tax policy, simplicity and administrability. The development of the Working Hypothesis resulted in the "authorised OECD approach".

In July 2008 the final *Report on the Attribution of Profits to Permanent Establishments* (hereinafter: OECD Report) was released. The OECD Report provides the views of the Committee as how to determine the profits attributable to permanent establishments. The Committee believes that the best way to provide legal certainty in the area is to redraft the Article 7 in order to avoid different interpretations based on countries' practices and the OECD Commentary. The purpose of the OECD Report is to provide the most preferable approach given modern-day multinational operations and trade.

One question relating to the authorised OECD approach, as formulated in the most recent OECD Report, is the actual implication of it. In the scholarly debate contrasting views are expressed on whether a static or ambulatory interpretation should be used. The Council of OECD advocates that the countries should bring their practices in line with the most recent

Commentary, while *Wattel*¹ and *Marres*² believe that a static approach should be used when changes are made to the OECD Model or Commentary.

¹ Wattel, J., Peter, Professor of EC and International Tax Law at the University of Amsterdam and Advocate General with the Netherlands Supreme Court.

² Marres, Otto, Formerly Legal Secretary at the research department of the Netherlands Supreme Court and assistant to Peter J Wattel. Also Tax Lawyer at KPMG Meijburg & Co.

Sammanfattning

Fördelning av vinster till fasta driftställen har länge varit ett omdiskuterat ämne i den skatterättsliga debatten. De internationella skatterättsliga principerna för hur detta ska ske återfinns i Artikel 7 i OECD:s modell för skatteavtal beträffande inkomst och förmögenhet (modellavtalet). Den direkta beskattningsrätten tillhör staternas suveränitet dvs. alla stater bestämmer självständigt om hur de ska beskatta exempelvis företagsvinster. Tillämpningen och tolkningen av skatteavtal har varierat avsevärt mellan OECD:s medlemsstater. Avsaknaden av en enhetlig tillämpning och tolkning ökar risken för internationell dubbelbeskattning eller att beskattning över huvud taget inte sker. Globaliseringen och den ökade gränsöverskridande handeln skapar ett allt större behov av en enhetlig tillämpning och tolkning.

OECD:s modellavtal härstammar från Nationernas Förbunds arbete under 1920-talet. Sedan dess har konceptet om vinstfördelning till fasta driftställen utvecklats otaliga gånger. Men det var först 1962 som OECD gav ut sitt första utkast till ett modellavtal. Principerna för beskattning av företagsvinster har sedan utvecklats för att kunna möta förändringarna i affärsvärlden.

OECD:s skattekommitté har länge arbetat för att skapa en större enhetlighet vid beskattningen och fördelningen av vinster till fasta driftställen. För att minimera de negativa effekter som uppstår vid en inkonsekvent tolkning och tillämpning av skatteavtal, har skattekommitténs arbetsgrupp WP6³ formulerat en arbetshypotes om hur artikel 7 bör tolkas och vilken tolkning som är att föredra. Den föredragna tolkningen ska överensstämma med skatterättsliga principer och vara enkel att använda. Utvecklingen av en föredragen tolkning av artikel 7 har resulterat i "the authorised OECD approach" dvs. den godkända OECD-tolkningen.

I juli 2008 presenterade OECD en rapport om hur vinster ska fördelas till fasta driftställen. Rapporten ger uttryck för OECD:s åsikter om hur dessa vinster ska bestämmas för att på bästa sätt fördelas till de fasta driftställena. Skattekommittén anser att artikel 7 behöver revideras så att den speglar medlemsstaternas agerande och OECD:s kommentarer för att kunna åstadkomma bästa möjliga förutsebarhet. Syftet med rapporten är att förmedla den mest föredragna tolkningen i dagens affärsvärld.

En fråga med koppling till den godkända OECD-tolkningen är vilken faktisk innebörd den nya rapporten har. I den juridiska debatten framförs olika uppfattningar om en statisk eller ambulatorisk tolkning ska ha företräde. OECD förespråkar att medlemsstaterna ska tolka skatteavtalen i linje med den senaste utgivna OECD-kommentaren dvs. tillämpa en ambulatorisk tolkning. Wattel och Marres hävdar däremot att en statisk

³ Working Party No. 6 on the Taxation of Multinational Enterprises.

tolkning ska ske vid förändringar av OECD:s modellavtal eller kommentaren.

Preface

I rörelse

*”Den mätta dagen, den är aldrig störst.
Den bästa dagen är en dag av törst.*

*Nog finns det mål och mening i vår färd -
men det är vägen, som är mödan värd.*

*Det bästa målet är en nattlång rast,
där elden tänds och brödet bryts i hast.*

*På ställen, där man sover blott en gång,
blir sönnen trygg och drömmen full av sång.*

*Bryt upp, bryt upp! Den nya dagen gryr.
Oändligt är vårt stora äventyr.”*

Ur diktsamlingen ”Härdarna” av Karin Boye

Abbreviations

CFA	The Committee of Fiscal Affairs
ECJ	The European Court of Justice
e.g.	For example
et seq	and following
i.e.	id est
IFA	the International Fiscal Association
MAP	Mutual Agreement Procedure
OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	The OECD Guidelines for Multinational Enterprises and Tax Administrations
OECD Model	The OECD Model Convention on Income and on Capital
OECD Report	The final Report on the Attribution of Profits to Permanent Establishments
OEEC	Organisation for European Economic Co-Operation
para.	Paragraph
paras.	Paragraphs
p.	Page
pp.	Pages
PE	Permanent Establishment
VCLT	The Vienna Convention on the Law of the Treaties

1 Introduction

1.1 Background

States have fiscal sovereignty in the field of direct taxation, i.e. the states themselves decide how and when to tax revenues. The fiscal sovereignty in combination with the increasing cross-border operations and trade are posing a potential risk of international double taxation. The OECD recognizes that the practices concerning attribution of profits to permanent establishments vary considerably between the member countries. The variation in interpretation and application of tax treaties give rise to a potential international double taxation. To avoid international double taxation, double tax treaties can be concluded between states. Today, most of the double tax treaties concluded are based on the OECD Model.

The work of establishing a common base for interpretation and application of attribution profits to permanent establishments dates back to the work made by the League of Nations in the 1920s. During the years the OECD has released a number of reports on the subject in order to achieve a more common basis for the countries' practices. The OECD are trying to describe the most preferred way of attributing profits to permanent establishments, which has given rise to the name of the "authorised OECD approach". The latest report was released in July 2008 – *the final Report on the Attribution of Profits to Permanent Establishments of the 17 July 2008*. The latest report is describing the preferred approach given modern-day cross-border operations and trade.

1.2 Aim of the Study

The attribution of business profits has always been a subject of discussion. The authorised OECD approach originates from the work of the League of Nations in the 1920s. Since then, the method of attributing profits has been modified several times. By examining the most recent report considering the attribution of profits to permanent establishments, this thesis seeks to provide the reader with an up to date presentation of the authorised OECD approach.

The purpose of the thesis is to examine the impact the OECD Report has on the application and interpretation of tax treaties or on a special provision in a tax treaty. In order to understand the impact of the most recent report a general overview of double taxation law will be presented.

The thesis will also examine whether the most recent OECD Report achieves its goal of clarifying, standardizing and confirming the fiscal situation of taxpayers who are engaged in cross-border activities.

1.3 Method and Material

To fulfil the purpose of the thesis, a legal dogmatic method has been applied. Thus, the thesis is based on legislation and legal doctrine. Furthermore, doctrinal articles relating to the attribution of profits to permanent establishments are also used. The fact that the thesis to a large extent attends the authorised OECD approach as described in the most recent report by the OECD implies that OECD materials, such as the OECD Report, the OECD Model and Commentary, constitute an important basis.

1.4 Delimitation

The OECD Report attends the subject of attribution of profits to permanent establishments. The OECD Report provides general considerations on the subject, but also special considerations regarding banks, financial instruments and insurance companies. This thesis will only be focused on the general considerations on how to determine the profits attributable to a permanent establishment. The limitation is made due to the restricted space, but also because it is not necessary for fulfilling the purpose of the thesis.

The thesis presents the authorised OECD approach for attributing profits to permanent establishments. As of today, it does not exist a generally accepted definition of a permanent establishment. Different countries have their own definition of what constitutes a permanent establishment. The permanent establishment concept has under a long time been a subject of the scholarly debate. This thesis does not attend the problem of the definition of a permanent establishment. In this thesis the author accede to the definition of permanent establishments as stated in Article 5 of the OECD Model. It should be noted that the OECD Report is not addressing the threshold in Article 5 and is not under any circumstances trying to affect the existing standards for determining the existence of a permanent establishment.⁴

1.5 Disposition

The purpose of this thesis, as mentioned above, is to examine the impact the most recent OECD Report has on the application and interpretation of tax treaties or on a special provision in a tax treaty. In order to understand the implication of the OECD Report the thesis starts with a general overview of tax treaty law. The general overview intends to provide the reader with a basic understanding of tax treaty law. It will present the double tax problem and discuss the different instruments for interpretation of treaties. It also

⁴ OECD Report, para. 9.

addresses the question whether a static or ambulatory approach should be used when interpreting the treaties.

The initial chapter is followed by a presentation of the authorised OECD approach as described in the most recent OECD Report. As an introduction, the historical background is presented in order to give the reader an understanding that it is a complicated field of law, which has no obvious solutions. It should also provide the reader with an insight that the increasing globalization requires timelier reports. Thereafter the authorised OECD approach is presented as the OECD describes it in their most recent report.

The profits attributable to a permanent establishment are to be established by a two-step process. This two-step process is performed because the concept of the authorised OECD approach is that the profits to be attributable to a permanent establishment are the profits that the permanent establishment would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions, under the same or similar conditions. Hence, the first step is to hypothesize the permanent establishment as a distinct and separate enterprise.

In the second step the *OECD Guidelines for Multinational Enterprises and Tax Administrations* (hereinafter: OECD Guidelines) are applied by analogy in order to establish the arm's length price of an internal dealing between the permanent establishment and the rest of the enterprise of which it belongs. Under step two the transfer pricing methods contained in the OECD Guidelines are described to give the reader an idea of how the dealings recognised and characterized under step one should be priced on an arm's length basis.

Finally, the last part will be an analysis and conclusion of all of the above. The analysis aims at discussing what impact the OECD Report has on the interpretation and application of tax treaties.

2 Double Taxation and its Avoidance

2.1 General

Technological improvements in communications and transportation keep making the world smaller. This has a positive impact on the global trade, which create a potential risk of international double taxation due to the fact that different countries' tax rules overlap each other. To overcome this problem different methods to avoid double taxation are used. The OECD Model Tax Convention is a model tax convention, which has been developed by the OECD. The main purpose of the model tax convention is to eliminate double taxation and prevent fiscal evasion. The first version of the OECD Model was published in 1963 and has frequently been updated since then. It has under a long time been recognized that it is desirable to clarify, standardize and confirm the fiscal situation of taxpayers who are engaged in cross-border activities. In order to achieve this goal it is necessary that all countries have common solutions to identical cases of double taxation.⁵ Thus, the Council of OECD recommends its members to follow the model when concluding tax treaties in order to achieve a common ground of interpretation. Furthermore, the OECD Model provides a means of settling on a uniform basis the most common problems that arise in the field of international taxation.⁶

2.2 The Double Tax Problem

Whenever a company or an individual undertakes activities in another country, they will be dealing with more than one set of tax rules. In those cases, there is a potential risk for *international double taxation*.⁷ The term international double taxation can be defined as the imposition of income taxes in two, or more, states on the same taxpayer in respect of the same income.⁸ For example, the foreign income or foreign capital of a resident taxpayer is often subject to taxation based on the *principle of residence*. On the other hand, no state waives its right to tax transactions or capital within its own territory even if it derives from a non-resident person. The latter is an expression of the *principle of source*. Consequently, tax rules of different

⁵ OECD Model, p. 7.

⁶ "What is a tax convention" at the OECDs webpage:

http://www.oecd.org/document/45/0,3343,en_2649_33753_36156205_1_1_1_1,00.html.

⁷ Miller & Oates, p. 57.

⁸ "What is a tax convention" at the OECDs webpage:

http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html.

states overlap each other, which may result in international double taxation.⁹ There are two types of double taxation, economic and juridical.

The *economic double taxation* is a broad term that refers to any situation where the income is taxed twice, i.e. is taxed twice but in the hands of different taxpayers. For example, economic double taxation can arise in the case of taxation of business profits, where the profits are subject to corporate tax on corporate level and the dividends distributed to the shareholders are subject to income tax on an individual level.¹⁰

Juridical double taxation occurs when more than one country attempts to tax the same income. For example, juridical double taxation can arise where a resident of one country derives income from sources in another country, and both countries' domestic legislation would tax that income. It can also arise where each country considers the taxpayer to be a resident under domestic laws.¹¹ Juridical double taxation has a restraining impact on the development of economic relationships between countries. Therefore, most states want to eliminate or at least reduce the international juridical double taxation.¹²

2.3 Double Tax Treaties

2.3.1 General

The purpose of international tax conventions, or treaties, is to allocate the right to tax the same source of income between the two contracting states. In order to avoid double taxation it is common to use double tax treaties. These tax treaties are bilateral or multilateral agreements¹³ between two or more states, referred to as the contracting states. In a tax treaty, the contracting states decide how their tax systems will interact to ensure that the residents of each country will not be subject to double taxation. The tax treaties reduce double taxation by allocating taxing rights between residence and source states on various categories of income.¹⁴

The relationship between tax treaty law and domestic law is established by the so-called golden rule. According to the golden rule, a tax treaty can only limit, not extend the taxing right originated from domestic law. This

⁹ Vogel, p. 2.

¹⁰ Miller & Oates, p. 57.

¹¹ "What is a tax convention" at the OECDs webpage:

http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html.

¹² Hilling, p. 20.

¹³ Tax treaties are normally concluded bilaterally, but a multilateral treaty is concluded between the Nordic countries, see the Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway and Sweden in 1983.

¹⁴ Hilling, p. 20.

principle is to a large extent followed by the world's states, among them Sweden.¹⁵

Treaties are one of the most important sources of international law. Tax treaties are legally binding agreements between the contracting parties, and also the only way for states to create legally binding obligations to each other.¹⁶ For example, the Swedish Government cannot enter such agreements without the consent of the parliament.¹⁷

In general, tax treaties provide that one country may not tax the business profits earned by a resident of the other country, unless that resident has a taxable presence in the form of a permanent establishment (hereinafter: PE) in the first country and the profits are attributable to that PE. Further, tax treaties also reduce juridical double taxation by establishing criteria for determining an exclusive residency status for taxpayers. According to the OECD the most common disputes of juridical double taxation are the disputes over residency or PE status, or over the characterisation of particular items of income and their coverage under particular provisions of the tax treaties.¹⁸

Transfer pricing cases are the best examples of economic double taxation. For example, a tax administration adjusts a price charged between related parties with a resulting tax charged on the additional income in the hands of one related party, where tax has already been charged in another country on that same income in the hands of the other related party.¹⁹

The Council of the OECD has recommended its members to follow the OECD Model when they are concluding tax treaties. The OECD Model is not in itself an international treaty with binding effect. Although, the OECD Model has influenced the legislation worldwide, a large part of the countries that are using the model often deviate from it in certain respects in order to conform to their own national tax system.²⁰

2.3.2 Structure and Application of Double Tax Treaties

Today, most tax treaties are based on the OECD Model and are organized in seven chapters.²¹ The first chapter describes its scope and defines essential definitions of treaty terms. The main part is made up of Chapters III to V, which contains the distributive rules for income and capital tax and legal

¹⁵ Lindencrona, p. 24.

¹⁶ Dixon, p. 53.

¹⁷ Lindencrona, p. 12.

¹⁸ "What is a tax convention" at the OECDs webpage:

http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html.

¹⁹ Ibid.

²⁰ Hilling, p. 49.

²¹ OECD Model, para. 26.

consequences supplementing the distributive rules. Further, Chapter VI provides two methods of eliminating double taxation:

- *the exemption method*: income or capital that is taxable in the State of source or situs is exempted in the State of residence, but it may be taken into account in determining the rate of tax applicable to the taxpayer's remaining income or capital;
- *the credit method*: income or capital that is taxable in the State of source or situs is subject to tax in the State of residence, but the tax levied in the State of source or situs is credited against the tax levied by the State of residence on such income or capital.²²

Finally, Chapter VI contains special provisions that concern the elimination of tax discrimination in various circumstances; the establishment of a mutual agreement procedure for eliminating double taxation and resolving conflicts of interpretation of the Convention; the exchange of information between the tax authorities of the contracting states; the assistance by contracting states in the collection of each other's taxes; the tax treatment of members of diplomatic missions and consular posts in accordance with international law; the territorial extension of the Convention.²³

The OECD Model is applicable to all member states and functions as a directive on how to act upon situations with international double taxation. The application of tax treaties is governed by two or more internal tax systems. The fact that treaties are interpreted by various domestic tax rules can lead to a collision of rules that may result in double taxation. Therefore, it is necessary with principles of interpretation that are acceptable by the contracting states.²⁴ Though, the OECD Model is not binding by law it reflects the common positions of the member states. For that reason, the members commit to follow the OECD Model and Commentary with the exception of the possibility to make reservations.²⁵

According to Article 26 of the VCLT “*every treaty in force is binding in good faith upon the parties to it and must be performed by them in good faith*”.²⁶ This is an expression for *pacta sunt servanda* and follows also by *jus cogens*, i.e. that it is customary law. Thus, the contracting parties are obliged to follow their tax treaty. In situations, where the contracting parties disagree over a precise term of the treaty they may renegotiate in order to reach a compromise. However, in multilateral treaties it is too complicated for all states to agree on every provision. Therefore, international law has resolved the complication by the possibility to make reservations, i.e. a state can become a party without accepting all the provisions thereof.²⁷

²² OECD Model, para. 25.

²³ Articles 24 to 29 of the VCLT.

²⁴ Tyllström & Boström, p. 648.

²⁵ Owens & Bennett, p. 1.

²⁶ Article 26 of the VCLT.

²⁷ Dixon, pp. 65 et seq.

2.3.3 Interpretation of Double Tax Treaties

2.3.3.1 General

Double tax treaties can be described as having a dual nature. On one hand, they are international agreements entered into between states to regulate the exercise of their fiscal jurisdiction. On the other hand, they become a part of the domestic law of each of the contracting states.²⁸ Given that tax treaties are seen to be embedded in national law they should also, or at least should, conform to EC Law.²⁹ National and international law govern the interpretation of tax treaties, but also the OECD Model and its Commentary plays an important role.

Below the instruments important for the interpretation of tax treaties will be presented. Initially the Vienna Convention on the Law of the Treaties, which is the key instrument for the interpretation of tax treaties, will be presented. This will be followed by a presentation of the OECD Model and Commentary, where the legal status of the OECD material will be discussed, but also its importance for treaty interpretation. Also the interpretation rule provided in the OECD Model will be presented. This chapter also contains a discussion whether the interpretation of tax treaties should be static or ambulatory, which is of utmost importance for the analysis.

2.3.3.2 The Vienna Convention on the Law of the Treaties

As mentioned above, treaties are one of the most important sources of international law. Given that, it is important to have rules that govern the creation, interpretation, reservation and termination of these legally binding instruments.³⁰ The interpretation of tax treaties is governed by public international law, specifically by the Vienna Convention on the Law of the Treaties of May 23, 1969 (hereinafter: VCLT).³¹ The rules of the VCLT have also been held to be customary international law, which imply that the obligations of the treaty may be binding on all states.³² Unlike most domestic law, treaties are “purposive” and their interpretation must be agreed upon between the contracting states.³³

Articles 31 to 33 of the VCLT are the relevant provisions for interpreting international agreements. According to these rules the text of the treaty is of primary importance, i.e. the “ordinary meaning” of the terms used in the treaty. Article 31(1) state that treaties “*shall be interpreted in good faith in accordance with the ordinary meaning to be given the terms of the treaty in*

²⁸ Baker, p. 20.

²⁹ Lang, p. 18.

³⁰ Dixon, p. 53.

³¹ The Vienna Convention entered into force on January 27, 1980.

³² The Territorial Dispute Case (Libya v Chad), 1994 ICJ Rep 6.

³³ Miller & Oates, p. 108.

their context and in the light of their object and purpose". When examining the "ordinary meaning" it is essential to look at the entire agreement and not the wording of one single provision, i.e. look at the context of the treaty.³⁴

In the past the subjective intent of the parties to the treaty was of highest importance, but today it is only important if it is explicitly expressed in the text. It should be noted that the "ordinary meaning" rather consists of the terms of internationally uniform legal usage developed by the contracting states or in a certain specialized areas, such as tax law, than of the terms of everyday usage.³⁵

According to Article 31(2) the context of the treaty shall comprise not only the text, including its preamble and annexes, but also any relating completing documents made in connection with the treaty. According to Article 31(3) subsequent agreements and state practices should also be taken into consideration. If subsequent agreements and state practices change the original agreement, the changes will only be effective under domestic law if it fulfils the domestic laws requirements for the applicability of treaties.³⁶ When using this approach problem of translation and other cultural differences may arise.³⁷

If the "ordinary meaning" is obscure or leads to a manifestly absurd or unreasonable result the solution is to be found in Article 32. This Article deals with the use of the "*travaux préparatoires*" of a treaty, i.e. the supplementary means of interpretation.³⁸ These accompanying materials relating to the treaty shall only be used in the case of doubt.³⁹

Article 33 considers bilingual or multilingual agreements in the way that the Article states that the text "*is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.*"⁴⁰

For example, Swedish internal law does not provide means for interpretation of international agreements. However, Sweden has ratified and incorporated the VCLT into Swedish law. Thus, the interpretation of international agreements in Sweden is governed by the VCLT.⁴¹

2.3.3.3 The OECD Model and Commentary

As mentioned above, the OECD Model and Commentary play a vital role for the interpretation of tax treaties. Due to the fact that as many double tax treaties as possible should be based on the OECD Model, the Commentary

³⁴ Vogel, p. 29.

³⁵ Ibid.

³⁶ Ibid., 30.

³⁷ Miller & Oates, p. 108.

³⁸ Dixon, p. 73.

³⁹ Vogel, p. 30.

⁴⁰ Article 33(1) of the VCLT.

⁴¹ Tyllström & Boström, p. 649.

is accepted as an overall interpretation guide.⁴² Moreover, it provides a source from which the courts of the different states can seek a common interpretation.⁴³ The legal status of the OECD Model and Commentary is a bit unclear in relation to the treaty interpretation rules of the VCLT. According to *Wattel* and *Marres*, the version of the Commentary at the time of the conclusion of a particular bilateral tax treaty may under certain circumstances be considered as the “context” for purposes of interpreting a treaty. Those circumstances are the following;

- when the tax treaty in question was based on that Model, and
- if it was presented to the national parliaments as based on that Model.⁴⁴

The number of conventions concluded between member states shows the importance of the OECD Model and Commentary, but also the fact that the conventions concluded follow the pattern and most of the provisions of the OECD Model.⁴⁵ Further, the OECD Model has extended far beyond the OECD area in the way that it is used as a basic document of reference in negotiations between member and non-member states, and even between non-member states in the field of double taxation and related problems. The worldwide recognition of the provisions of the OECD Model and their incorporation into many bilateral conventions have helped make the OECD Commentary to a widely accepted guide on how to apply and interpret provisions of existing bilateral conventions. Due to the fact that the network of tax conventions continues to expand, the importance of a generally accepted guide becomes even more important.⁴⁶ Another aspect is that the OECD Model and Commentary serves as a reference for taxpayers, tax administrations and the courts.⁴⁷ It can be argued that this is of utmost importance, as it gives them a chance to legal certainty.

The OECD Model has a general rule stated in Article 3 (2) concerning the interpretation of undefined terms used in the Convention. It has been problematic to determine which legislation that should be referred to in order to establish the meaning of undefined terms. Either a reference should be made to the legislation in force when the Convention was signed or to that in force when the Convention is being applied. In 1995 the Committee of Fiscal Affairs (hereinafter: the CFA) decided that the latter interpretation should prevail.⁴⁸

The interpretation of a tax treaty based on the OECD Model is assisted by its commentaries. The commentaries are, as above presented, well known and easy accessible. The use of the draft text of the OECD Model brings a strong presumption that the contracting parties have consented the

⁴² Lang, p. 25.

⁴³ Vogel, p. 33.

⁴⁴ *Wattel & Marres*, p. 234.

⁴⁵ OECD Model, p. 9.

⁴⁶ *Ibid.*, p. 10.

⁴⁷ *Owens & Bennett*, p. 1.

⁴⁸ OECD Model, Commentary on Article 3, para. 11.

Commentary as a means of interpretation.⁴⁹ National courts, as opposed to tax authorities, seem to rely on the Commentary when interpreting tax treaties. The position of the Commentary has been explained in different ways. One way is to consider the commentaries to be a part of the “preparatory work” of each treaty based on the OECD Model. Another way is to interpret the commentaries as a part of the context of each treaty. Yet another is to consider the treaties based on the OECD Model to include the commentaries as a kind of multilateral treaty, where the commentaries are seen to leave a “soft” obligation on the contracting parties.⁵⁰

In Sweden there are numerous cases where the Swedish courts have taken the OECD Model and Commentary into account when interpreting tax treaties.⁵¹ For example, in the *Shell case* the Swedish Court used the OECD Guidelines when interpreting Swedish internal law.⁵² The Court states that although the OECD Guidelines are not binding, it throws light on the matter in question. In another case, RÅ 1996 ref. 84, the Court pointed out the importance of the OECD Model and Commentary by stating that there are normally reasons for assuming that the contracting parties intended to achieve a result in accordance with the recommendations of the OECD if the tax treaty or a special provision of a tax treaty is formed in accordance with the OECD Model.⁵³ Various reports published by the OECD have been used not only to interpret tax treaties, but also for the interpretation of internal law. According to *Tyllström and Boström*, the Swedish legislator intended such a legal usage as he ratified the provisions in accordance with the OECD Model.⁵⁴

2.3.3.4 Static or Ambulatory Interpretation of Tax Treaties?

The predicament of static or ambulatory interpretation of tax treaties occurs in principle in two situations: The first situation arises when post-treaty changes are made in national law where the treaty refers to national law. The second situation arises when post-treaty changes are made in the OECD Commentary on which the treaty is based.⁵⁵

With respect to the first situation, the question is whether the national law at the time the treaty was concluded or the national law at the time the treaty is applied should be consulted. According to *Wattel and Marres*, an

⁴⁹ Skaar, p. 45.

⁵⁰ *Ibid.*, p. 46.

⁵¹ RÅ 85 1:6, RÅ 1985 Aa 11, RÅ 1987 ref 158, RÅ 1991 not 228, RÅ 1991 not 677, RÅ 1993 ref 91 I and II, RÅ 1995 not 68, RÅ 1995 ref 91, and RÅ 1996 ref 84. In RÅ 1999 ref 58 the Council of Advances Tax Ruling took guidance by the OECD Model and the Swedish Supreme Administrative Court did not change the outcome of the case. In RÅ 1993 not 677 the Court of Appeal and the Justices of dissenting opinion in the Supreme Administrative Court considered the OECD Model Convention.

⁵² RÅ 1991 ref. 107.

⁵³ Lang, pp. 348 et seq.

⁵⁴ *Tyllström & Boström*, p. 655.

⁵⁵ *Wattel & Marres*, p. 223.

ambulatory interpretation must be the starting point due to the fact that the practical and effective application of the treaty is effected and that the legislator has given its approval to both the treaty provisions referring to national law and to later changes in that national law.⁵⁶

The main arguments in favour of the ambulatory interpretation are that the circumstances at the time the tax treaty was concluded and the national law are constantly changing. Therefore, a treaty interpretation based on references to provisions, insights or assumptions that are obsolete may be very difficult to apply and may lead to an unreasonable and unsatisfactory result.⁵⁷

Skaar believes that an ambulatory interpretation should be used, but with some limitations. The ambulatory approach should be used unless major changes in the domestic laws have been made and those changes require another way of interpretation. It is important that an ambulatory interpretation do not affect the core of the treaty or the general principle deduced from it.⁵⁸

With respect to the second situation, the question is which version of the Commentary that should be consulted if the Commentary or OECD Model is changed after the date of conclusion of the tax treaty. The fact that the Commentary at the time of the conclusion can be seen as having received parliamentary approval makes *Wattel* and *Marres* believe that a static interpretation should be the starting point. Thus, later versions of the Commentary have not received the same democratic legitimacy.⁵⁹

The main arguments in favour of the static interpretation of international tax treaties are legal certainty and *pacta sunt servanda*. The static interpretation implies an interpretation based on the circumstances and insights at the time the treaty was concluded. Due to the fact that a treaty is an agreement between two parties and that its interpretation therefore has to be based on the insights and intentions of the parties at the time of the conclusion of the agreement, later developments are therefore in principle irrelevant.⁶⁰

To sum up the situation, according to *Wattel* and *Marres* the ambulatory interpretation approach should be used when changes are made to national law that the treaty refers to, while the static interpretation approach should be used when changes are made to the OECD Model or Commentary.

It should be noted, that the OECD Council recommends its members to bring their practices in line with the most recent Commentary, which in the

⁵⁶ *Wattel & Marres*, p. 223.

⁵⁷ *Ibid.*

⁵⁸ *Skaar*, p. 54.

⁵⁹ *Wattel & Marres*, p. 224.

⁶⁰ *Ibid.*, p. 222.

authors view are to be seen as an expression for the an ambulatory interpretation.⁶¹

2.4 Concluding Remarks

The globalization and the increased cross-border trade are giving rise to more conflicts of different countries tax rules. Different countries are using different principles, such as the *principle of residence* and the *principle of source*, as a basis for taxation, which as above mentioned may create more situations of potential international double taxation. For decades the OECD Model has been used as a model when concluding tax treaties between countries. Even countries that are not members of the OECD use it as a template. Despite the fact that the OECD Model and Commentary only are considered as “soft” law, it can be argued that they have attained a very important position in the international law arena. According to the author’s opinion, the worldwide use and recognition of the OECD Model and Commentary as a means to resolve conflicts of the different countries’ domestic tax laws only enhance its importance.

The interpretation of double tax treaties is mainly governed by the VCLT. As mentioned in Chapter 2.3.3.2, the interpretation rules of the VCLT are considered as customary law, which imply that the rules should be followed by all states, not only by the OECD member states. Even the worldwide recognition of the OECD Model and Commentary implies that many states, not only OECD member states, follow it. Consequently, the rules of interpretation are not only reserved to OECD member states. Thus, it can be argued that the fact that both the OECD Model and Commentary and the rules of interpretation provided by the VCLT only strengthen their position in international law.

The interpretation of treaties is, as mentioned above, principally governed by the VCLT. It should be noted that also the OECD Commentary provides guidance on how to interpret double tax treaties. The scholarly debate provides different views of which legislation to refer to in order to interpret the tax treaties. The contrasting ideas are either to refer to the legislation that was in force when the tax treaty was signed (*static interpretation*) or refer to the legislation in force when the tax treaty is being applied (*ambulatory interpretation*). The CFA believes that the ambulatory interpretation should prevail, which is supported by the author of this thesis.

International law has many weaknesses. The development of international law can only be achieved by the states themselves. Different organisations such as the United Nations and other international organisation may propose changes, but the development still relies on the political will of sovereign states.⁶² The absence of formal institutions with a general compulsory

⁶¹ Wattel & Marres, p. 225.

⁶² Dixon, p. 13.

jurisdiction may give rise to a slow customary law making process, which can be devastating when new rules rapidly are needed.⁶³

⁶³ Dixon, p. 13.

3 Attribution of Profits to Permanent Establishments

3.1 General

The attribution of profits to permanent establishments (hereinafter: PEs) has always been a subject of discussion. Business profits are the most important income under tax treaty law, and most of the income derived from international economic activities falls under its scope. The main principle in that field of law is that the state of residence has the right to impose tax on the enterprise's business profits, unless the enterprise has a permanent establishment in the other contracting state to which such profits are attributable.⁶⁴ The international tax principles for attributing business profits to a PE are provided in Article 7 of the OECD Model.

The lack of a common interpretation and application can lead to double taxation or non-taxation. Therefore, the CFA decided to examine how the principles developed in OECD Guidelines should be applied in the case of PEs. As a first step, a Working Hypothesis (hereinafter: the WH) was developed. The basis for the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken and how the guidance in the Guidelines could in analogy be applied to attribute profits to a PE in accordance with the arm's length principle of Article 7 of the OECD Model. The development of the WH has been constrained neither by original intent nor by historical practice and interpretation of Article 7. The work of the WH aimed at formulating the most preferred approach given modern-day multinational operations and trade. Thus, the work and conclusions of the WH are viewed as the "Authorised OECD Approach".⁶⁵

The International Fiscal Association (hereinafter: IFA) has confirmed that the countries' practices and interpretation vary considerably between the member states and in order to achieve a greater consensus the OECD released, in July 2008, a final report on the subject. The final *Report on Attribution of Profits to Permanent Establishments* provides the view of the OECD's Committee on Fiscal Affairs, on how the profits attributable to a PE should be determined.⁶⁶

⁶⁴ Vogel, pp. 315 et seq.

⁶⁵ OECD Report, p. 7.

⁶⁶ Final Report on the Attribution of Profits to Permanent Establishments of the 17 July 2008.

3.2 Historical Development

In 1955 the Council of the Organisation for European Economic Co-operation (the OEEC) adopted its first recommendation concerning international double taxation. At that time, 70 bilateral general conventions had been signed between countries that now are members of the OECD. This was to a large extent due to the work made by the League of Nations in 1921, which led to the first model bilateral convention in 1928 and, finally to the Model Conventions of Mexico (1943) and London (1946). The principles in these conventions were followed with certain variants in many subsequent bilateral conventions. However, the lack of a fully and unanimously accepted principle of allocation of business profits led to that the Fiscal Committee in 1956 drafted a convention that would effectively resolve the double taxation problems between OECD member countries and that also would be acceptable to all member countries. In 1963 its final *Report on Draft Double Taxation Convention on Income and Capital* was released and it was adopted on 30 July 1963.⁶⁷

The Fiscal Committee's successors CFA revised the draft of 1963, which resulted in a publication in 1977 of a new Model Convention, *Model Double Taxation Convention on Income and Capital*. The pressure to update and adjust the Model Convention to changing economic conditions progressively increased. Methods of tax avoidance and evasion became more sophisticated and in the 1980s the globalisation and liberalisation accelerated rapidly. As a consequence, the CFA continued to examine the 1977 Model Convention, which resulted in a number of reports that recommended amendments to the Model Convention and its Commentary. Due to this, in 1991 the CFA adopted the concept of an ambulatory Model Convention providing periodic and timelier updates and amendments without waiting for a complete revision.⁶⁸

In 1992 the Model Convention was published in a loose-leaf format as a first step of an ongoing revision process that periodically could be updated to ensure that the Model Convention accurately reflected the views of the member states at any point in time. The influence of the Model Convention had extended far beyond the OECD member countries and in order to better conform with the evolution of international tax rules and principles the CFA opened up to benefit from the input of non-member countries, other international organisations and other interested parties in 1996.⁶⁹

In July 2008 the final version of the *Report on Attribution of Profits to Permanent Establishments* was released. The OECD Report provides

⁶⁷ OECD Model, Introduction, paras. 7 et seq.

⁶⁸ Ibid., paras. 8 et seq.

⁶⁹ Ibid., para. 11.

guidance on the principles for attributing profit to PEs under Article 7 of the OECD Model.⁷⁰

3.3 The Authorised OECD Approach

3.3.1 General

Over the years, the CFA has spent a lot of time and effort trying to ensure a more consistent interpretation and application of Article 7 of the OECD Model. In 1977 the Model Convention was adopted and only minor changes of the wording of the Article and the Commentary of the 1963 Draft Convention was made. Under the 1980s it was recognized that the determination of profits to PEs could give rise to some uncertainty, which led the CFA to undertake a review of the question. In 1993 the review resulted in a report, *Attribution of Income to Permanent Establishments*, and to subsequent changes of the Commentary. Despite the previous work, the application and interpretation of member and non-member countries varied considerably. Thus, the problem was not solved. To provide the taxpayers with more certainty, the CFA indicated in its report *Transfer Pricing for Multinational Enterprises and Tax Administrations* that further work would address the problem. In 2008, that work resulted in the final version of the *Report on Attribution of Profits to Permanent Establishments*. The purpose of that report has been to formulate the most preferable approach on attributing profits to PEs under Article 7 given modern-day multinational operations and trade.⁷¹ The report provides general considerations on the subject, but also special considerations regarding banks, financial instruments and insurance companies.

Earlier, two broad interpretations of Article 7 of the OECD Model have been used by the OECD member states, the “*functionally separate entity*” approach and the “*relevant business activity*” approach. Despite the fact that these approaches in many cases produce the same result, they may lead to double taxation and therefore the member states have decided to adopt the “*functionally separate entity*” approach as the authorised OECD approach.⁷² The authorised OECD approach implies that the profits attributable to a PE are the profits that the PE would have earned at arm’s length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions.⁷³ The authorised OECD approach only sets a limit on the amount of profits attributable to a PE that may be taxed in the host country of the PE, thus it does not intend to inflict with domestic law. Furthermore, the authorised OECD approach requires a two-step analysis for the interpretation of Article 7(2) of the OECD Model.

⁷⁰ Final Report on the Attribution of Profits to Permanent Establishments of the 17 July 2008.

⁷¹ OECD Model, p. 188.

⁷² OECD Report, p. 12.

⁷³ Article 7(2) of the OECD Model.

First, a functional and factual analysis is performed in order to hypothesize the PE as a distinct and separate enterprise. Second, a comparability analysis is performed to determine the profits of the hypothesized distinct and separate enterprise.

The development of the authorised OECD approach was not constrained by the original intent or by the historical practice and interpretation of Article 7 of the OECD Model. The CFA has decided that the best way of implementing the authorised OECD approach, thus giving the taxpayers and the tax administrations maximum legal certainty, is to redraft Article 7 along with a new Commentary. The new improved Article 7 is planned to be released in the next update scheduled for 2010, but is already released in a draft form. The new revised Commentary is already taken into account in the OECD Report, at least to the extent that it does not conflict with the existing Commentary. Thus, the new revised Commentary is included in the 2008 update of the OECD Model.⁷⁴

The revised Commentary included in the 2008 update constitutes a clarification of the interpretation of Article 7 of the OECD Model. The changes made are intended to incorporate the two-step approach described in the OECD Report. It also intends to encourage the taxpayers to prepare and maintain documentation, such as accounting records, which will be used to attribute profits to PEs.⁷⁵

The changes made in the revised Commentary and in the OECD Report are considered to improve the fiscal situation, which therefore should be applied directly. If there is a conflict between the guidance in the OECD Report and the existing Commentary, the latter should prevail according to a “conflict rule”.⁷⁶

3.3.2 Step One – Hypothesizing the Permanent Establishment as a Distinct and Separate Enterprise

According to the authorised OECD approach a PE must be hypothesized as a distinct and separate enterprise in order to determine its profits. A PE is not legally distinct from the rest of the enterprise of which it is a part, thus the assets, risks and “free” capital are attributable to the entire enterprise as a whole and not only to the PE. Article 7(2) of the OECD Model states that business profits are to be attributed to a PE in the same way, as they would have been if the PE “*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*”. The wording of the paragraph corresponds to Article 9 of

⁷⁴ Bennett, p. 469.

⁷⁵ Ibid.

⁷⁶ Ibid.

the OECD Model as regards the “arm’s length principle”.⁷⁷ Nonetheless, a PE is in fact not a legally distinct enterprise as the associated enterprises, which makes it impossible to rely on legally binding contracts to determine if an undertaking is made at arm’s length or not. Given that, it is necessary to make a complete analysis of all facts and circumstances of the internal and external dealings.⁷⁸

In most cases, separate accounts are used to ascertain the profits attributable to the PE.⁷⁹ The question is to what extent accounting records should be relied upon when they are based on agreements between the head office and its PE. They cannot qualify as legally binding contracts, but if the accounts of the head office and the PE are both prepared symmetrically and reflect the functions performed by the different parts of the enterprise they should be accepted by the tax authorities. If the accounts are not symmetrically prepared, they should not be regarded as reflecting the real facts of the situation. Consequently, records and documentation must satisfy certain requirements in order to be accepted as real facts of the situation.⁸⁰

3.3.2.1 The Functional and Factual Analysis

The functional and factual analysis under step one is based on the same methodology as the comparability analysis of the OECD Guidelines in situations involving associated enterprise in Article 9 of the OECD Model. However, in the PE situation there is only one legal entity and there cannot be binding contracts within the same legal entity. Consequently, it was necessary to develop a mechanism to carry out a functional and factual analysis that would allow hypothesizing the PE as a distinct and separate enterprise.⁸¹ Due to the fact that it is not possible to use a legal analysis, the OECD decided that a functional analysis should be used.

The concept of a functional analysis is supported by the application of the arm’s length principle in Article 9 of the OECD Model. Furthermore, the OECD Guidelines provide considerable guidance on how to perform this analysis. As a result of the legal difference between a PE and an associated enterprise, the functional analysis of Article 9 must be supplemented with a factual analysis. The chosen solution, a functional and factual analysis, examines the functions performed by the personnel of the entire enterprise, i.e. the “*people functions*”, and assesses what significance they have in generating profits to the business.⁸² People functions can range from support or ancillary functions to significant people function relevant to the attribution of economic ownership of assets and the assumption of risks.⁸³

⁷⁷ OECD Model, Commentary on Article 7, para. 14.

⁷⁸ OECD Report, para. 20.

⁷⁹ OECD Model, Commentary on Article 7, para. 16.

⁸⁰ *Ibid.*, 19.

⁸¹ Bennett, pp. 467 et seq.

⁸² Report, p. 30, para. 91.

⁸³ OECD Report, p. 14.

The term “*significant people functions*” (hereinafter: SPF) is implying on the functions performed by the important people within the enterprise. Those functions are important for determining the economic ownership of assets and the assumption of risks. The SPF varies from business sector to business sector and from enterprise to enterprise within the same sectors. It is also possible that an enterprise has more than one SPF relevant for the assumption of risk and to the economic ownership of assets. However, even if it is important to identify the SPF under the first step, it is also important to analyse other factors performed by the PE since the profits or losses of the PE will be based on all its activities.⁸⁴

3.3.2.2 Attribution of Assets

Under the authorised OECD approach, the PE must be hypothesized as if it were a distinct and separate enterprise. In order to do so, assets must be attributed to the PE. The factual position is that assets belong to the enterprise as a whole, which imply that the first step of the authorized OECD approach must be to find means of attributing economic ownership of the assets. The broad consensus provides that the assets generally are to be attributed to the part of the enterprise, which performs the SPF relevant to the determination of economic ownership of assets. Thus, the functional and factual analysis will examine all the facts and circumstances to determine to what extent the assets of the enterprise are used in the functions performed by the PE. It will also examine the conditions under which the assets are used and other factors when determining the economic ownership.⁸⁵

The attribution of economic ownership of assets has consequences for both the attribution of capital and interest-bearing debt and the attribution of profits to the PE. The assets of an enterprise can be divided into tangible assets and intangible assets. Concerning the attribution of assets, tangible and intangible assets are attributed in different ways, which will be described below.

3.3.2.2.1 Tangible Assets

Tangible or physical assets can be machines, factories and buildings etc. According to the OECD “tangible assets” includes “immovable property” as the term is used in Article 6 of the OECD Model.⁸⁶ The members of OECD have different opinions on how to attribute tangible assets within single enterprises. One view is that the attribution of tangibles should be based on a determination of the SPF relevant to the economic ownership of those assets. The contrasting view is that the place of use should be the sole criterion for attributing the tangibles, especially in the case where a fixed place of business exists due to those assets. The members of the OECD have

⁸⁴ OECD Report, paras. 15 et seq.

⁸⁵ Ibid., paras. 21 et seq.

⁸⁶ Ibid., p. 33, footnote 10.

concluded that these two options more or less end up with a similar result. However, the lifetime of the tangible asset may give rise to different profit allocation over the years. Therefore, a pragmatic solution was sought and the broad consensus decided that the actual use of the tangibles should be the basis for attributing economic ownership.⁸⁷

3.3.2.2.2 Intangible Assets

According to the OECD Guidelines the term “intangible property” refers to rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets.⁸⁸ Chapter VI of the OECD Guidelines distinguishes two groups of intangibles, the *marketing intangibles* and other *commercial intangibles*, which are referred to as trade intangibles.⁸⁹ The trade intangibles include patents, know-how, designs and models used for the production of a good or provision of a service, while marketing intangibles include trademarks and trade names that help the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols or pictures that have an important promotional value for the product.⁹⁰

The guidance on the treatment of intangible assets given in the OECD Guidelines could be applied in analogy in a PE context.⁹¹ As regards the trade intangibles two situations can be considered. The first situation is when the intangible asset is developed by the enterprise, and the second situation is where the intangible asset has been acquired from another enterprise.⁹²

Under the first step of the authorised OECD approach it is necessary to use the functional and factual analysis to determine what kind of intangible assets the PE are using and under what conditions, i.e. does the PE own the intangible solely or jointly with another part of the enterprise. In the first situation, the SPF relevant for determining the economic ownership of internally developed trade intangibles are those which require active decision-making and management of individual risk and portfolios of risks associated with the development of the intangible asset. The functional and factual analysis should describe and evaluate the dynamics of the enterprises’ research and development (R&D) programme, particularly the nature of the critical decision-making and the level at which those decisions are taken.⁹³ The main risk the developer of the intangible asset stands is that the development is unsuccessful or is not successfully implemented and thereby might create a financial loss.

⁸⁷ OECD Report., para. 104.

⁸⁸ OECD Guidelines, para. 6.2.

⁸⁹ Ibid., para. 6.1.

⁹⁰ Ibid., paras. 6.3 et seq.

⁹¹ OECD Report, para. 110.

⁹² Ibid., para. 113.

⁹³ Ibid., para. 114 et seq.

Under the authorised OECD approach the developer would have to bear that risk and therefore it would have sufficient free capital attributed to it to support the risk assumed.⁹⁴ The fact that a failure in developing an intangible asset does not only affect the owner, but also the intended use (if any) raises the question whether the use and intended use should be a factor in determining the economic ownership.⁹⁵ Under the authorised OECD approach it is not the intention to use that determines the economic ownership. Instead the extent to which the intended user performed the relevant SPF, e.g. by taking (or taking part in) the initial decision to develop the intangible or undertaking the active management of the R&D programme, that is considered. The fact that capital follows risks means that the part of the enterprise that is considered to be the economic owner of the intangible will be attributed free capital to support the associated risks.⁹⁶

In the second situation, the SPF relevant for determining the economic ownership of acquired trade intangibles, i.e. tangible assets acquired outright or through a licensing agreement, are the same as of internally developed intangibles, i.e. the SPF related to active decision-making and management of risks. The SPF might include an evaluation of the acquired asset and of the management of risks that follows from the acquisition. Further, the fact that intangibles can be acquired in various stages of development may affect the identity of the SPF relevant to the determination of economic ownership.⁹⁷

Regarding the marketing intangibles, the fundamental principles are the same as for the trade intangibles (see above). The fact that marketing intangibles may have been developed in the past and maintained under a long period may cause problems when trying to determine the economic ownership.⁹⁸

It should be noted that there are hybrid intangibles, i.e. intangibles that do not fall within the scope of neither the trade or marketing intangibles. For example, a company's reputation for quality or for performing R&D may have a significant impact on the company's profits. The reputation is not really a trade intangible, though it is earned by the manufacturing divisions, instead the value of the reputation is more closely linked to marketing.⁹⁹

⁹⁴ OECD Report, para. 120.

⁹⁵ *Ibid.*, para 121.

⁹⁶ *Ibid.*, para. 122.

⁹⁷ *Ibid.*, paras. 123 et seq.

⁹⁸ *Ibid.*, para. 128.

⁹⁹ Wright & Nelson, p. 23.

3.3.2.3 Funding

3.3.2.3.1 General

An enterprise requires capital to finance its business activities, the cost of creating or acquiring assets and to assume the risks associated with the ongoing business activities. Capital can derive from three sources;

- contributions of equity of shareholders,
- retained profits, and
- borrowings.¹⁰⁰

The first two are referred to as *equity capital* and *source*, while the latter is referred to as *debt capital*. Generally tax law does not give deductions for payments made to equity holders, whereas deductions are generally given for payments of interest or interest equivalents to the holder of debt capital.¹⁰¹

The authorised OECD approach recognizes the fact that a PE needs a certain amount of funding. The required funding consists of both “free” capital and interest-bearing debt. Once the amount of funding has been determined, the next step is to determine what amount that is made up of “free” capital.¹⁰²

3.3.2.3.2 Free Capital

The functional and factual analysis will attribute “free” capital, i.e. funding that does not give rise to a tax-deductible return to the PE for tax purposes ensuring an arm’s length attribution of profits to the PE. The starting point is that the PE is treated as having sufficient capital to support the functions it undertakes, the assets it is using and the risks it assumes. Under the authorized OECD approach, the economic ownership of assets is attributed to a PE based on where the SPF relevant to the determination of economic ownership is performed. Furthermore, the risks are attributed based on where the SPF relevant to the assumption and/or management of the risks is performed. When the functional and factual analysis has attributed the appropriate assets and risks to the PE, the next step in attributing an arm’s length amount of profits to the PE is to determine how much of the entire enterprise’s “free” capital is needed to cover the risks and assets attributed to the PE.¹⁰³

The OECD Report presents a number of approaches for attributing “free” capital. The approaches presented are the following;

- the capital allocation approach,
- the economic allocation approach,
- the thin capitalisation approach, and

¹⁰⁰ OECD Report, para. 136.

¹⁰¹ Ibid.

¹⁰² Ibid., para. 184.

¹⁰³ Ibid., para. 141.

- the safe harbour approach.¹⁰⁴

In short the *capital allocation approach* is trying to allocate an enterprise's actual "free" capital to a PE in accordance with the attribution of assets owned and risks assumed. The allocation in this approach is based on the proportion of assets and risks attributed to the PE by the functional analysis. Consequently, if 20 % of the assets and/or risks are attributed to the PE, it will also be attributed 20 % of the enterprise's "free" capital. Problems can arise if the PE is engaged in a different type of business from the rest of the enterprise.¹⁰⁵

The *economic allocation approach* is measuring the risks with sophisticated risk measurement tools. This approach is based on economic capital, instead of regulatory measurement of capital and is foremost used in a banking context.¹⁰⁶

In the *thin capitalisation approach* the attribution of capital is based on the capital structure of a comparable uncontrolled enterprise performing the same or similar activities under the same or similar conditions, i.e. engaged in similar activities. The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding that would be required by the PE. The next step would be to determine the allocation of the funding into interest-bearing debt and "free" capital.¹⁰⁷

The *safe harbour approach* requires the PE have at least the same amount of "free" capital as required for an independent banking enterprise. This is not an authorized OECD approach, though it can be acceptable if it does not result in the attribution of more profits to the PE than would be attributed by an authorised OECD approach.¹⁰⁸

The attribution of "free" capital between the PE and the rest of the enterprise is an essential step in the process of attributing profits to the PE. The general principle is that the PE should have sufficient "free" capital to support the functions, assets and risks attributed to the PE. Consequently, the method by which capital is attributed is an important step in avoiding or minimising double taxation or less than single taxation. Even if the general principle has a broad international consensus it has not been possible to develop an internationally acceptable approach for attributing "free" capital. For this reason the Mutual Agreement Procedure (MAP) is available to resolve cases when different countries tax administrations disagree over the results.¹⁰⁹

¹⁰⁴ OECD Report, paras. 155 to 172.

¹⁰⁵ Ibid., paras. 155 et seq.

¹⁰⁶ Ibid., para. 162.

¹⁰⁷ Ibid., para. 163.

¹⁰⁸ Ibid., para. 169.

¹⁰⁹ Ibid., paras. 180 et seq.

To sum up, capital must be regarded as following risks. Therefore, the attribution of capital is made by reference to the risks arising from the PEs activities.

3.3.2.3.3 Attribution of Interest

As mentioned above, the authorised OECD approach recognizes that the PE needs a certain amount of funding. Interest-bearing debts may consist of external interest expense or internal interest dealings. Similar to the attribution of “free” capital, there is more than one authorised OECD approach for attributing interest-bearing debt and to determine the rate of interest to be applied to that debt. Regarding the external interest expenses there are two acceptable approaches, *the tracing approach* and *the fungibility approach*.¹¹⁰

The *tracing approach* attributes interest by tracing down any capital borrowed from third parties and attributes the deductible interest to the part of the enterprise that was allocated the capital. The *fungibility approach* does not recognize specific transactions, instead it distributes the entire enterprise’s borrowed interest-bearing capital on a pre-determined basis. Both approaches have problems and several countries are using a modified version of one of these approaches. There is a lack of consensus concerning which approach that should be used. Some countries favour one of the existing approaches, while others want a more flexible approach. The OECD recognizes the problem, but stresses the point that all approaches have the same goal and therefore should be regarded as authorised approaches.¹¹¹

Movements of funds within an enterprise do not automatically give rise to dealings, but under some circumstances such dealings can be recognized as internal interest dealings. Internal interest dealings can only be recognized if they can be referred to as “treasury dealings” for the purpose of rewarding any treasury functions made by parts of the same enterprise.¹¹² Whether the dealing would be recognized as a “treasury dealing” or not depend on a functional and factual analysis of the “dealing” and the conditions under which it was performed. The functional and factual analysis requires that all facts and circumstances surrounding the dealing are to be taken into account. It is important to identify one part of the enterprise as the owner of the cash or financial asset as the owner is entitled to an arm’s length return from the cash or assets under an internal “treasury dealing”. The identification of the ownership depends on who is performing the SPF relevant for the cash or financial assets. In absence of such SPF it would be impossible to recognize any internal “treasury dealing” at arm’s length price.¹¹³

¹¹⁰ OECD Report, para. 189.

¹¹¹ Ibid., paras. 189 et seq.

¹¹² Ibid., para. 187.

¹¹³ Ibid., para. 188.

If the amount of “free capital attributed to the PE is less than the arm’s length amount as determined by one of the authorised OECD approaches, it is necessary to make an appropriate adjustment. The adjustment implies a reduction of any received interest-bearing capital and is performed in order to transform parts of the interest-bearing capital into “free” capital. However, if such adjustments are not made the PE may not be taxing an arm’s length amount of profits in the host country due to excessive interest deductions. It should be noted that the focus of Article 7 is to determine the appropriate taxing rights of the PE host country so it cannot tax in excess of the arm’s length amount of profit.¹¹⁴ In an opposite situation, where an excessive amount of “free” capital is attributed to a PE, the authorised OECD approach allows the home state to make such adjustments.¹¹⁵

3.3.2.4 Recognitions of dealings

There are a number of aspects to the recognition of dealings between a PE and the enterprise to which it belongs. Firstly, the PE is different from a subsidiary, it is not legally or economically separate from the rest of the enterprise of which it is a part. Secondly, dealings between the PE and its head office normally have no legal consequences for the enterprise as a whole.¹¹⁶

The functional and factual analysis is aiming at constructing the PE as a hypothetical “distinct and separate” enterprise. The functions, assets, risks and “free” capital are attributed to the PE. Also the income and expenses arising from transactions with both associated and independent enterprises are attributed to the PE. The wording of Article 7(2) of the OECD Model states that a PE shall be “...*dealing wholly independently with the enterprise of which it is a permanent establishment*”. This implies that it is not only the PE that has to be hypothesised as “distinct and separate”, but also the profits to be attributed to the PE. Thus, it is necessary to identify and determine the nature of the internal dealings between the PE and the rest of the enterprise of which it is a part.¹¹⁷

For associated enterprises the arm’s length price is determined by direct application of the OECD Guidelines.¹¹⁸ The controlled transactions between associated enterprises are compared with comparable uncontrolled transactions between independent enterprises. One difference between a subsidiary and a PE is that the latter is neither legally nor economically separate from the rest of the enterprise of which it belongs. Therefore, as opposed to associated enterprises the OECD Guidelines cannot be directly applicable in a PE situation.¹¹⁹

¹¹⁴ OECD Report, paras 197 et seq.

¹¹⁵ Ibid., para. 201.

¹¹⁶ Ibid., para. 210.

¹¹⁷ Ibid., para. 207.

¹¹⁸ Ibid., para. 207

¹¹⁹ Ibid., para. 210.

In a PE situation the dealings govern the economic and financial relationship between the PE and another part of the enterprise. If the dealings pass the threshold test they will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other part of the enterprise. Under the authorised OECD approach, internal dealings should have the same effect on the attribution of profits in a PE situation as it would have in the case of comparable provision of services and goods between independent enterprises. However, internal dealings are assumed under the authorised OECD approach only for the purpose of attributing an appropriate amount of profit to the PE.¹²⁰

The examination of a potential “dealing” is normally started with a revision of accounting records and other internal documentation of the PE that are supporting the alleged dealing. For associated enterprises it is normally self-evident that a transaction has occurred. Regarding internal dealings, there are a need for a greater scrutiny due to the lack of legally binding contracts between the PE and the rest of its enterprise. This greater scrutiny means that a threshold needs to be passed before the dealing is accepted as equivalent to a transaction between independents at arm’s length. Under the authorised OECD approach, the “dealing” will be recognised for the purposes of attributing profits if it relates to a real and identifiable event.¹²¹ The functional and factual analysis is used to determine whether such an event actually has occurred. Furthermore, the analysis should determine if the internal dealing has any economic significance. It should be noted that it is the functional and factual analysis that determines the existence of a “dealing”, not the accounting records or other documentation provided by the enterprise.¹²²

So, when dealing is made within a single legal entity there are no “contractual terms”, as opposed to an associated enterprise, that can be analysed. However, under the authorised OECD approach the “dealings” are treated analogous to transactions between associated enterprises, thus the guidance in paragraphs 1.28 and 1.29 of the OECD Guidelines are applied in a PE situation by analogy. Consequently, the accounting records and any contemporaneous internal documentation supporting transfer of risks, responsibilities and benefits from one part of the enterprise to another is recognized as “contractual terms”.¹²³ Furthermore, an analysis of the “contractual terms” is used to examine whether the actual conduct of the parties conform to the terms of the contract and if it is consistent with the economic principles governing the relationship between the independent enterprises. The OECD Guidelines paragraph 1.29 is modified to suit “dealings” in a PE situation. Therefore, it is necessary, especially in a PE situation where no contractually binding terms exist, to examine if the

¹²⁰ OECD Report, para. 208.

¹²¹ Ibid., para. 212.

¹²² Ibid., paras. 210 et seq.

¹²³ Ibid., para. 214.

parties actually conform to the terms of the dealing, so the terms are not a sham.¹²⁴

So, once the threshold has been passed and the dealing has been recognized as real and identifiable, the authorised OECD approach applies the OECD Guidelines by analogy. The OECD Guidelines are only applicable to dealings between the PE and the rest of the enterprise, thus not to other transactions within the enterprise.¹²⁵

3.3.3 Step Two – Determining the Profits of the Permanent Establishment

Under the authorised OECD approach the dealings between the PE and the rest of the enterprise is compared with transactions between independent enterprises. The comparison is following the comparability analysis in the OECD Guidelines, but is made by analogy. In a PE context the comparability means that none of the differences (if any) between the dealing and the transaction between independent enterprises materially affects the measure used to attribute profits to the PE. Reasonably accurate adjustments can be made in order to eliminate such material differences that affect the material effects.¹²⁶

For associated enterprises the arm's length principle is based on comparisons of the conditions of controlled and uncontrolled transactions. The OECD recommends several methods, which all are based on establishing an arm's length price for a transaction. The transfer pricing methods are divided into *traditional transaction methods* and *transactional profit methods*. The traditional transaction methods consist of the comparable uncontrolled price method (hereinafter: CUP), the resale price method and the cost plus method, while the transactional profit methods consist of the profit split method and the transactional net marginal method (hereinafter: TNMM). Concerning the profits that should be attributed to a PE the OECD Guidelines are once again applied by analogy.¹²⁷

The traditional transactional methods are the most preferable methods in establishing whether conditions in the commercial and financial relations between associated enterprises are at arm's length. As regards to internal dealings the traditional transaction methods are followed by analogy. Nevertheless, other methods have been developed in order to solve the practical difficulties in the traditional transactional methods. The other methods are referred to as the transactional profit methods and include the profit split method and TNMM described above.¹²⁸

¹²⁴ OECD Report, para. 215.

¹²⁵ Ibid., para. 217.

¹²⁶ Ibid., para. 218.

¹²⁷ Ibid., para. 219.

¹²⁸ OECD Guidelines, para. 2.49.

The methods used for determining the arm's length price, i.e. the methods for controlling if the price set is corresponding with the market prices, will be presented below. The presentation of the traditional transaction methods will be followed by the transactional profit methods.

3.3.3.1 Methods of Valuation

3.3.3.1.1 The Comparable Uncontrolled Price Method

The CUP method is a traditional transaction method, which compares the actual transfer prices with comparable prices applied between unrelated enterprises, i.e. comparing the price for property or services transferred in a controlled transaction to the price charged for property and services transferred in a comparable uncontrolled transaction in comparable circumstances. Differences in the compared prices may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length. Furthermore, the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.¹²⁹ Two conditions need to be fulfilled for an uncontrolled transaction to be comparable to a controlled transaction. The first condition requires that the differences (if any) do not materially affect the price in the open market. The second condition requires that reasonably accurate adjustment can be made to eliminate the material effects of such differences.¹³⁰

The CUP method is the most reliable and direct method to determine the arm's length price if it is possible to locate a comparable uncontrolled transaction. The main problem with this method is to find a transaction between unrelated parties that is similar to an internal transaction due to the fact that minor differences may have a material effect on the price. Although, this can be solved by appropriate adjustments it can be difficult to determine the appropriate adjustments.¹³¹

3.3.3.1.2 The Resale Price Method

The resale price method is a traditional transaction method, which determines the arm's length price by comparing the price at which a product has been purchased with the resale price. The resale price is reduced with the resale price margin, which is the margin out of which the reseller is trying to make an appropriate profit. The amount after the subtracting of the resale price margin and after adjustments for other costs associated with the purchase of the product is the arm's length price of the original transfer of property. This method is mostly used in marketing operations.¹³²

¹²⁹ OECD Guidelines, G-3.

¹³⁰ Ibid., para. 2.6-7.

¹³¹ Ibid., para. 2.8.

¹³² Ibid., para. 2.14-15.

In determining the resale price margin of the reseller reference can be made to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. Even, the resale price margin earned by an independent enterprise may serve as a guide under the condition that it is a comparable uncontrolled transaction. This method has the same conditions as the CUP method, one difference is that it does normally not require as many adjustments as the CUP method.¹³³ The fact that gross profit margins represent gross compensation the differences in product are less significant. Therefore, this method allows a broader product difference than the CUP method. So, if an uncontrolled and a controlled transaction are comparable in all aspects than the product itself the resale price would probably generate a more reliable arm's length price than the CUP method.¹³⁴

3.3.3.1.3 The Cost Plus Method

The cost plus method is a traditional transaction method, which determines the arm's length price by marking up the costs incurred by the supplier of property or services in a controlled transaction. The mark-up must be appropriate to make an appropriate profit relating to the functions performed and to the market conditions. The amount after the cost plus mark-up is considered as an arm's length price of the original controlled transaction. This method is mostly used in situations where partly finished goods are sold between related parties.¹³⁵

Preferably the cost plus mark-up should be determined by reference to the cost plus mark-up earned in a comparable uncontrolled transaction. So, the cost plus mark-up in a comparable transaction performed by an independent enterprise can serve as a guide. When determining if a transaction is a comparable uncontrolled transaction, the same principle as described for the methods above applies.¹³⁶ Generally, the cost and expenses can be divided into three broad categories;

1. *direct costs* of producing a product or service, such as the cost of raw materials,
2. *indirect costs* of productions, which are closely linked to the production process but attributable to several products and services, and,
3. *operating costs* such as supervisory, general and administrative expenses.¹³⁷

This method has problems with the proper application of the determination of costs. Therefore, attention should be paid when applying a comparable mark up to a comparable cost basis. For example, the cost basis may not be comparable in a situation where the supplier employs leased assets to a

¹³³ OECD Guidelines, para. 2.15-16.

¹³⁴ Ibid., para. 2.17-19.

¹³⁵ Ibid., para. 2.32.

¹³⁶ Ibid., para. 2.33-34.

¹³⁷ Ibid., para. 2.40.

situation where the supplier owns its business assets.¹³⁸ In a PE situation, it can be problematic in determining whether a service provided within the single enterprise should be charged at its actual cost or at a cost plus mark-up. In cases where the trade of the enterprise consists of providing services to third parties it is usually acceptable to charge a service at the same rate as it is charged to the outside customer.¹³⁹ If the main activity of a PE is to provide certain services that provide a real advantage to the rest of its enterprise and the costs represent a major part of the expenses of the enterprise, the host country may require that a profit margin shall be included in the amount of the costs.¹⁴⁰

3.3.3.1.4 The Profit Split Method

The profit split method is a transactional profit method that determines the arm's length price by identifying the combined profit of the associated enterprises and then split those profits between them on an economically valid basis. The purpose of this method is to eliminate special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have anticipated in an agreement made at arm's length.¹⁴¹

Generally, this method does not rely directly on closely comparable transactions. Thus it can be used in cases when no comparable situation can be identified. The allocation of profit is based on the division of functions between the associated enterprises involved. The functional analysis examines the functions performed by each enterprise and separates them.¹⁴² This method uses external data from uncontrolled transactions for valuating the different functions performed.¹⁴³ It should be noted that both parties to the transaction in question will be evaluated.¹⁴⁴ The OECD Guidelines provide two approaches of attributing the profits within this method. These two approaches are *the contribution analysis* and *the residual analysis*.¹⁴⁵

3.3.3.1.5 The Transactional Net Margin Method

The TNMM is a transactional profit method that determines an arm's length price by relating the net profit margin to an appropriate base such as costs, sales or assets. The net profit obtained from a transaction is compared with the same profit that a taxpayer would obtain in a comparable uncontrolled transaction, using the same base.¹⁴⁶

¹³⁸ OECD Guidelines, para. 2.36-37.

¹³⁹ OECD Model, Commentary on Article 7, para. 35.

¹⁴⁰ Ibid., para. 36.

¹⁴¹ OECD Guidelines, para. 3.5.

¹⁴² Ibid., para. 3.5.

¹⁴³ Ibid., para. 3.6.

¹⁴⁴ Ibid., para. 3.7.

¹⁴⁵ Ibid., para. 3.15.

¹⁴⁶ Ibid., G-9.

This method is quite similar to the cost plus method and the resale price method in that the same requirements are required for establishing if the uncontrolled and controlled transaction is comparable. A functional analysis is necessary to determine if the transactions actually are comparable and if any adjustments need to be made in order to obtain reliable results.¹⁴⁷

The TNMM is more functional than for example the CUP because the net margins such as operating income on sales and return on assets, is less affected by transactional differences. The tolerance this method provides allow the enterprise to have a wide range of gross profit margins but still earn broadly similar levels of net profit.¹⁴⁸

Despite the positive aspects of this method, it can still be quite difficult to determine the arm's length net margins in an accurate and reliable way. This is due to that the net margin can be influenced by factors having no effect, or a less substantial effect on the price or gross margins.¹⁴⁹ This method is normally only applied to one of the associated enterprises. Thus, it provides a one-sided analysis.¹⁵⁰

3.3.3.2 The Comparability Analysis

In the OECD Guidelines the comparability analysis is explained as being:

“A comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.”¹⁵¹

To establish the arm's length price of an internal dealing or a controlled transaction, a comparison to the price of an uncontrolled comparable transaction must be made. This comparison is provided by the comparability analysis. If two situations should be considered to be comparable it is essential that their potential differences not affect the open market price, or that potential adjustments may be made to eliminate such differences. To determine the degree of comparability and the potential adjustments necessary for establishing it, it is vital to understand how unrelated enterprises evaluate their potential transactions. Generally, an independent enterprise enter into business with the enterprise who offers the most attractive alternative in relation to the functions performed, assets used and risks assumed.¹⁵²

¹⁴⁷ OECD Guidelines, para. 2. 26.

¹⁴⁸ Ibid., para. 3.27.

¹⁴⁹ Ibid., para. 3.29.

¹⁵⁰ Ibid., para. 3.31.

¹⁵¹ Ibid., p. G-3.

¹⁵² Ibid., para. 1.15.

There are five factors that might have an impact when determining the comparability. These factors are the following;

1. the characteristics of property or services,
2. functional analysis,
3. contractual terms,
4. economic circumstances, and,
5. business strategies.¹⁵³

The differences in the characteristics of property of services often result in differences in the open market price. Therefore, it is essential to determine the comparability regarding these features. However, the differences do not necessarily have an effect on the profit margins. When examining the transfers of tangible property, it is essential for the comparability analysis to consider the physical features, quality, reliability, availability and volume of supply. Regarding the provision of services it is the nature and extent of the service that are important for determining the comparability. In the case of intangible property, however, it is the duration and degree of protection, and the anticipated benefits from the usage of the property.¹⁵⁴

The purpose of the functional analysis is to identify and to compare the economically significant activities and responsibilities undertaken (or to be) by independent enterprises. Therefore, it is relevant to examine the structure and organisation of the enterprise. It is also relevant to determine in what juridical capacity the taxpayer performs its functions.¹⁵⁵

For transactions to be comparable, the contractual terms need to be comparable. Generally, the contractual terms of a transaction specifies how the responsibilities, risks and benefits should be divided between the parties. This part of the comparability analysis has a close connection to the functional analysis and it is important to examine the conduct of the involved parties to see whether the parties' conduct conforms to the contractual terms.¹⁵⁶

Different profit margins are possible in different countries or markets and at different times. The arm's length price may vary for transactions involving the same property or services due to the fact that they are performed in different markets. It is necessary that the markets in which the independent and associated enterprises operated is comparable. Therefore, it is vital to identify the relevant market and the economic circumstances that can be relevant in determining the comparability. The relevant factors may consist of the geographic location; the size of the markets; the extent of competition and the relative competitive positions of the buyers and sellers; the availability of substituted goods and services; the level of supply and demand in the market as a whole etc.¹⁵⁷

¹⁵³ OECD Guidelines, p. I-9-13.

¹⁵⁴ Ibid., para. 1.19.

¹⁵⁵ Ibid., para. 1.20.

¹⁵⁶ Ibid., para. 1.28-29.

¹⁵⁷ Ibid., para. 1-30.

Business strategies consider many aspects of an enterprise when determining comparability. The relevant aspects consist of factors relevant for the daily operations of the business. For example, these can consist of innovation, development of new products, the degree of diversification, risk aversion, and input of existing and planned labour law.¹⁵⁸

It is important to understand that different business strategies may result in different prices. For example, a business strategy can include a market penetration scheme, which temporarily may charge a lower price for its product than normally charged for comparable products.¹⁵⁹

3.4 Concluding Remarks

So, we know for a fact that the PE concept has a long history and the work of creating a better and broader consensus of application and interpretation amongst the member states are still in progress. The scholars seem to believe that the project is coming closer to its end and that the focus instead should be turned to how the principles should be applied in practice in order to implement the authorised OECD approach in full.¹⁶⁰ The variation in application and interpretation has led to several reports concerning the attribution of business profits. The most recent report was released in July 2008 – *The Final Report on the Attribution of Profits to Permanent Establishments of the 17 July 2008*. The OECD Report focuses on formulating the most preferred approach of attributing profits to PEs.

The attribution of profits to a PE are based on all its activities, including transactions with related enterprises, transactions with other unrelated enterprises and dealings with other parts of the enterprise to which the PE belong. The two-step process described in this chapter is necessary for the application of the OECD Guidelines by analogy, hence it address the application of the arm's length principle to transaction between associated enterprises under Article 9 of the OECD Model. Therefore, the PE needs to be hypothesized as a legally distinct and separate enterprise, which in fact only is a mere fiction. To achieve that, all the economically significant activities and responsibilities are identified under the functional and factual analysis. Then the remuneration of the recognised dealings can be determined by using the OECD Guidelines by analogy.

Even if the PE is treated as an associated enterprise it is still problematic to prove an alleged dealing between a PE and the rest of its enterprise due to the fact that legally binding contracts does not exist between them. Even the application of the OECD Guidelines by analogy raises the author's attention

¹⁵⁸ OECD Guidelines, para. 1-31.

¹⁵⁹ Ibid., para. 1-32.

¹⁶⁰ Bennett, p. 471; Barnes; Owens & Bennett; Russo, p. 461.

as to whether the approach is providing the taxpayer with the desired legal certainty.

In the author's view the application of the OECD Guidelines are both positive and negative. Positive in that aspect that the OECD Guidelines often are used in the area of international law, thus the guidance it provides should be able to be regarded as quite accessible and therefore give the taxpayers and tax administrations a chance to legal certainty. On the other hand, difficulties in applying the OECD Guidelines by analogy may arise. Another aspect is that the application of the OECD Guidelines by analogy may be in conflict with the principle of legality – "*nullum poena sine lege*", i.e. no penalty without law.¹⁶¹ The principle of legality requires that all law should be clear, ascertainable and non-retrospective. In the case of tax law the principle is expressed as "*nullum tributum sine lege*", i.e. no tax without law.¹⁶² Furthermore, the principle requires that disputes should be resolved by applying rules that have been declared beforehand, i.e. not alter the legal situation retrospectively by discretionary departures from the law. Consequently, in the author's opinion the ambulatory interpretation might be in conflict with the principle of legality.

¹⁶¹ Hultquist, p. 3.

¹⁶² Ibid.

4 Analysis

4.1 Introduction

This thesis has presented a general overview of tax treaty law so the reader will understand which impact, if any, the final *Report on attribution of profits to permanent establishments* have on the interpretation and application of tax treaties. The thesis has also presented the authorised OECD approach as described in the most recent OECD Report. Furthermore, this thesis has also aimed at examining whether the OECD Report fulfils its goal of clarifying, standardizing and confirming the fiscal situation of taxpayers who are engaged in cross-border activities.

4.2 The Implication of the OECD Report

The initial chapter of this thesis is providing the reader with a general overview of tax treaty law. The chapter contains a subchapter dealing with the interpretation of tax treaties, which is vital to the understanding of the OECD Report's implication of the application and interpretation of tax treaties. The interpretation is in principle governed by the VCLT, but the OECD material, such as the OECD Model and Commentary, also play an essential role. The VCLT provides rules of interpretation in Article 31 to 33. Article 32 of the VCLT is dealing with the "supplementary means", i.e. preparatory work accompanying the treaty, which might consist of OECD material, such as the OECD Model and Commentary, existing at the time the tax treaty was signed. This implies that the OECD material existing at the time the tax treaty was concluded, actually is serving as a guide of interpretation. Furthermore, also in line with the worldwide recognition of the OECD material as an overall accepted guideline for interpretation of tax treaties. The question is whether later versions of OECD materials, such as the OECD Model and Commentary, should be taken into account when interpreting a tax treaty provision?

According to Article 31(3) of the VCLT, subsequent agreements and state practices should also be taken into account as long as they do not change the original agreement. The fact that Swedish courts are using the guidance given in OECD materials, at least, show one state's practice and according to Article 31(3) of the VCLT should be taken into account as long as it does not alter the original intent. Thus, it should be possible to consider later versions of the OECD Model and Commentary than the ones referred to at the conclusion of the tax treaty. This is also in line with the ambulatory interpretation approach advocated by the OECD.

As mentioned in the section above, subsequent agreements and state practices should only be taken into account as long as they do not change the original intent. The OECD Report might not be able to be regarded as a subsequent agreement in itself. However, the fact that the conclusions of the Report are incorporated in the latest version of the Commentary opens up for a possibility to equalize the OECD Report with subsequent agreements. If not, the conclusions of the OECD Report are still playing a vital role for the interpretation to that extent that it is incorporated in the Commentary.

So, if the conclusions of the OECD Report are incorporated in the latest Commentary, which are to be taken into account, the following question is whether the original intent is changed? The mission of the Report is to clarify, standardize and confirm the fiscal situation of taxpayer engaged in cross-border activities. One may speculate that the fact that the new revised Commentary is taking the conclusions drawn from the OECD Report into account is an indication of a clarification on how to interpret Article 7 of the OECD Model. It can be argued that the clarification consists of a more thorough guidance on how to attribute profits to PEs. The changes in the Commentary are among others intended to encourage the taxpayer to prepare and maintain accounting records and other contemporaneous documentation. This can, in the author's opinion, be seen as an attempt of creating a standard of procedure regarding the attribution of profits to PEs. The conclusions that can be drawn from the above, is that the changes made in the latest Commentary only seeks to clarify the fiscal situation, not changing it. Therefore, the latest version of the Commentary should be taken into account when interpreting a tax treaty.

Different approaches, such as static and ambulatory, concerning the interpretation are also put forward in the scholarly debate. The static approach implies an interpretation based on the circumstances and insights at the time the treaty was concluded. While an ambulatory approach is taking into account the fact that circumstances at the time the tax treaty was concluded and the national law constantly are changing. It can be argued that the Council of OECD is advocating an ambulatory approach, since they recommend the OECD members to bring their practices in line with the most recent Commentary. *Wattel* and *Marres* are of a different opinion; they believe that the starting point should be a static approach since the Commentary, at the time the treaty was concluded, can be considered as having received parliamentary approval.

The author concurs with the Council of OECD and *Skaar's* opinions, that the most recent Commentary should be used when interpreting a tax treaty. Similar to *Skaar*, the author stresses the point that an ambulatory approach should only be used when it does not affect the core and general principles of a treaty. In those cases it actually does affect the core and/or general principles of the treaty, the interpretation should preferably be made with a static approach, since it no longer can be seen as a further development of the authorised OECD approach.

The authorised approach of attribution of profits to PEs is provided in the latest OECD Report released by the OECD in July 2008. In the OECD Report the most preferred way of attributing profits is provided. As mentioned in Chapter 2.3.3.3 the Commentary is accepted as an overall interpretation guide. Furthermore, it is recognised that the conclusions of the OECD Report is included in the latest OECD Commentary. Moreover, OECD members are not legally obliged to follow the recommendations in the OECD Model as it only is considered as “soft law”. But the fact that it expresses the common positions of the member states, they are committed to follow the guidance in the OECD materials.

The OECD material is considered as “soft law” and the OECD is not capable of generating “hard law”. However, the principles and guidelines that they do deliver are followed by states worldwide. One may speculate that the fact that the OECD does not provide “hard law” makes it impossible to obtain a totally harmonized interpretation and application of tax treaties. The fact that it does not exist any formal institutions for observance of the authorised OECD approach makes it, in the author’s view, even harder for attaining a complete harmonized interpretation and application.

The OECD Report is trying to formulate the most preferred approach of attributing profits to PEs. In the past few years even the opinions of non-members and organisations have been taken into account, thus the OECD has given recognition to its worldwide span. In order to achieve a broad consensus in the field of attribution of profits to PEs, the OECD Report has provided principles and guidelines, which are in line with the opinions of the member states, non-member states and other organisations. Even if the OECD Report does not reflect the opinions of all the states in the world, it is for a fact reflecting a broad consensus. Thus, the OECD Report seem to fulfil its goal of clarifying, standardizing and confirming the fiscal situation of taxpayers who are engaged in cross-border activities.

4.3 Conclusions

Even if different approaches are advocated for the interpretation and application of tax treaties, it seems as the ambulatory approach has received most support. The ambulatory approach is advocated by the OECD itself and the author concurs with their opinion. Hence, the implication of the OECD Report seems to be vital in that sense that it actually plays a role in the today’s interpretation and application of tax treaties. If the ambulatory approach is being used, the most recent report will be considered, at least to that extent it is incorporated in the latest Commentary and is not contrary to the existing Commentary. To sum up, the author considers that the OECD Report has an important impact on the future interpretation and application of tax treaties. Consequently, the contents of the OECD Report will play a vital role when interpreting tax treaties.

The fact that the report reflects the opinions of OECD member states, non-member states and other organisations do not confirm its importance as an important guide. However, the actual use of it does. The actual use of the report is more or less constrained to what extent it is included in the Commentary. It may be argued that the worldwide recognition of the OECD material as an overall interpretation guide only confirms its importance.

The answer to the question whether the OECD Report have fulfilled its goal of clarifying, standardizing and confirming the fiscal situation of taxpayers who are engaged in cross-border activities is - yes. Under decades OECD have tried to create a consensus of attribution profits to PEs. Their experiences throughout the years has resulted in a final report, where the earlier authorised approaches has been narrowed down, e.g. the “*functionally entity approach*” had more support than the “*relevant business approach*”. One may speculate that the fact that the OECD Report is seen to reflect the view of the OECD members etc., show on a certain level of consensus, hence the approaches have been narrowed down to one. In the authors opinion the report has achieved its goal due to the fact that it represent the broad consensus of the member states, but also non-member states and other organisations. Also the fact that it has clarified the field of law by providing a more thorough guidance on how to attribute profits to PEs, strengthen the fact that it has reached its goal.

To sum up, the OECD Report has, in the author’s opinion, reached its goal of clarifying, standardizing and confirming the fiscal situation of taxpayers who are engaged in cross-border activities.

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