The NFTC Tax Treaty Project:

TOWARDS A U.S. TAX TREATY POLICY FOR THE FUTURE: ISSUES AND RECOMMENDATIONS

PART ONE
Chapters 1 – 7

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The NFTC Tax Treaty Project:

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Preface

The increasing globalization of business has heightened the importance of tax treaties as a crucial mechanism for avoiding double taxation and preventing barriers to international trade and investment. The pace of developments in tax treaty policy has quickened in recent years, as evidenced by the U.S. Treasury’s recent decision to revise the 1996 U.S. Model Tax Treaty, its introduction of significant changes to U.S. treaty provisions, the increased frequency of U.S. Senate consideration of pending treaties, and the number of ongoing projects at the Organisation for Economic Co-operation and Development (OECD) addressing important issues of treaty interpretation and implementation. Earlier this year, the NFTC launched a tax treaty project in order to examine and make recommendations on a number of significant issues of U.S. tax treaty policy. The project is divided into two parts, with the first part divided into two phases. The current document represents the first two phases (Chapters 1 through 7) of Part One of the project. The NFTC anticipates releasing Part Two in early 2005.
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Drafters

Mary C. Bennett  
Partner, Baker & McKenzie LLP  
Former Deputy International Tax Counsel, U.S. Treasury Department

Carol A. Dunahoo  
Partner, Baker & McKenzie LLP  
Former Director, International, Internal Revenue Service  
Former Associate International Tax Counsel, U.S. Treasury Department
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INTRODUCTION

The National Foreign Trade Council, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Its membership covers the full spectrum of industrial, commercial, financial, and service activities. The NFTC therefore seeks to foster an environment in which U.S. companies, like their foreign counterparts, can be dynamic and effective competitors in the international business arena. To achieve this goal, businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital that global enterprises be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of such companies.

Tax treaties are a crucial component of the framework that is necessary to allow that growth and to promote balanced competition. This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why it has undertaken this study of U.S. tax treaty policy, with a view to considering issues and making recommendations for the future.

Tax treaties are bilateral agreements that serve to harmonize the tax systems of the two countries applicable to companies and other persons involved in cross-border investment and trade. In the absence of a tax treaty, income from cross-border transactions or investment would be subject to potential double taxation, first by the country where the income arises and again by the country of the recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners. Treaties are the mechanism by which these taxes are lowered on a bilateral basis. If enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and non-creditable levels of foreign tax and to be at a competitive disadvantage relative to businesses from other countries that do have such benefits. Tax treaties serve to prevent this barrier to participation in international commerce.

Tax treaties also provide other features that are vital to the competitive position of global businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring tax laws to be applied in a nondiscriminatory manner to nonresident enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit that is available exclusively under tax treaties is the mutual agreement procedure, to resolve disputes in particular cases or reach bilateral agreement on issues of interpretation or application. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States and other governments by providing assistance for the administration of their tax laws and the implementation of their treaty policy. The article that
provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network.

As cross-border trade and investment expand, tax treaties are playing an increasingly important role in preventing the imposition of excessive or inappropriate taxes on global businesses and in ensuring the fairer and more efficient application of the tax laws. To continue to serve their intended purposes, treaties must keep pace with developments in today’s global economy. It is appropriate to revisit periodically both the tax policy positions and priorities reflected in treaties and the interpretation and implementation of treaties in practice. The United States and some of its major trading partners have shown an increased willingness in recent years to reconsider such issues, as demonstrated, for example, by recent treaty agreements to eliminate withholding on certain cross-border dividends and to expand cross-border coordination with respect to pensions and stock options. The United States and many other member countries of the Organisation for Economic Co-operation and Development (OECD) also have recently undertaken to evaluate and improve upon current treaty dispute resolution practices and mechanisms.

The increasing magnitude and reach of cross-border trade and investment is prompting the negotiation of an ever-growing international network of tax treaties. A broad international consensus on the interpretation of common treaty terms and provisions is critical to the effectiveness of treaties in achieving their goals. While these issues could be addressed bilaterally as well, this often would be less efficient than a multilateral approach and would be of limited value in addressing issues, such as the attribution of profits, in cases that involve more than two countries.

Much important multilateral work on tax treaties has been undertaken by countries already under the aegis of the OECD, and several OECD projects of great significance to business are presently underway. The international business community appreciates these efforts, as well as the efforts made by the OECD and its member countries to expand the dialogue with business and to improve the transparency of their deliberations. A number of the topics addressed in this study relate directly to projects currently underway at the OECD. Although the study focuses in particular on U.S. tax treaty policy, the NFTC hopes that it will be of broader interest and relevance.

This study is offered with a view to promoting constructive dialogue. In that spirit, the NFTC would be pleased to discuss its analysis and recommendations with interested governments and organizations.
EXECUTIVE SUMMARY

The National Foreign Trade Council, an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment, has undertaken this study of U.S. tax treaty policy with a view to identifying issues and opportunities for improvement. This project was undertaken in recognition of the growing importance of tax treaties in preventing the imposition of excessive or inappropriate taxes on global businesses and in ensuring the fairer and more efficient application of the tax laws. To continue to serve their intended purposes, treaties must keep pace with developments in today’s global economy. It is appropriate to revisit periodically both the tax policy positions and priorities reflected in treaties and the interpretation and implementation of treaties in practice. The NFTC hopes that this effort will add value to those already underway on a bilateral basis, among the United States and other countries, and on a multilateral basis at the OECD.

The first phase of Part One of the NFTC study was published in September 2004, and addressed issues relating to the attribution of profits to a permanent establishment, practical treaty implementation concerns, and arbitration. The second phase of Part One addresses four additional sets of issues, including issues relating to permanent establishments, withholding rate provisions, pensions and equity-based compensation, and the U.S. Model Treaty. The final portion of this study, to be published in 2005, will address additional policy and implementation issues relating to tax treaties.

Issues Regarding the Attribution of Profits to a Permanent Establishment

Global businesses are encountering increased examination activity on permanent establishment issues in many countries, typically involving the attribution of substantial profits. Their primary concerns regarding the attribution of profits to a permanent establishment are that (1) a consistent approach be applied internationally, (2) adequate certainty be provided in advance regarding the interpretation and implementation of the agreed approach, and (3) associated compliance burdens not exceed an administrable level. Each of these three goals must be satisfied if the primary purpose of tax treaties—the avoidance of double or inappropriate taxation—is to be achieved.

The current OECD project to reexamine the attribution of profits to a permanent establishment represents an important effort to achieve a broad international consensus on key issues. Once finalized and implemented, it could potentially eliminate a number of current disagreements among countries, and between taxpayers and tax authorities, regarding the interpretation of treaty provisions relating to profit attribution. It is not yet clear, however, to what extent that project will succeed in providing the requisite consistency, certainty, and administrability. This is likely to turn in large part on the content of the final report and accompanying guidance, and on how they are implemented in practice by tax authorities around the world. Without clearer guidance, there is a risk that the uncertainties contained in the report could outweigh its benefits.

Significant changes are being proposed under the “authorised OECD approach,” as described in the recently released Report on Part I of the OECD project. Some of these changes are likely to create uncertainty and controversy, because they are not entirely clear and, therefore, leave too much latitude for differing interpretations. Many of these difficulties might be avoided with the
provision of additional details and examples. Clarifications and details are needed, in particular, on technical issues relating to (1) the functional analysis, including the determination of assets used and conditions of use and risks assumed; (2) the attribution of capital; (3) the comparability analysis; (4) the application of transfer pricing methods; and (5) the treatment of dependent agent permanent establishments and “fixed place of business” permanent establishments. It is also critical that U.S. tax authorities and their counterparts in other countries clarify in advance their positions regarding the legal effect of the final Report or of changes to the OECD Commentary on Article 7 (Business Profits) of the OECD Model Treaty on existing and future treaties.

The proposed changes also raise a host of practical implementation issues that need to be addressed before the authorised OECD approach is implemented. Apart from the general need for additional guidance to enable compliance, the primary implementation issues relate to the new taxpayer documentation requirements envisaged by the Report, particularly for deemed permanent establishments that may not have been anticipated by the taxpayer, such as dependent agent permanent establishments. The Report should address more forthrightly the specific difficulties that arise from trying to apply transfer pricing guidelines developed for separate legal enterprises “by analogy” to a single enterprise, where the “separateness” of the permanent establishment from other parts of the enterprise will not be so obviously demarcated through documentation or conduct. In recognition of these difficulties and their potential to give rise to subjective disputes among countries and between taxpayers and tax authorities, the Report should propose much greater deference towards reasonable taxpayer efforts to document and characterize the activities of their permanent establishments. Likewise, more could be done to minimize other administrative burdens, and transition issues need to be resolved prior to implementation of the new approach.

**Practical Issues Regarding Treaty Implementation**

To fulfill their intended purposes, treaties must be properly implemented by both countries. This involves three essential aspects. First, treaties must be implemented in a manner that provides adequate guidance in advance regarding their interpretation, as a legal matter. Second, there also must be adequate certainty in advance regarding the manner in which the treaties will be applied in practice. Finally, mechanisms must be provided to ensure the effective and efficient application of the treaty and the resolution of any disputes that may arise regarding its interpretation or application.

Current experience indicates that treaties are properly implemented in most cases. However, where treaty provisions are not properly implemented, there are serious consequences. Both business and government incur increased administrative and compliance costs because of resulting disputes. Double taxation or inappropriate taxation may result, and may remain unrelieved. Finally, business confidence in treaties is undermined, which may cause distortions in cross-border trade and investment.

Failures to implement treaty provisions properly generally stem from a limited number of commonly recurring concerns. One group of concerns relates to problems involving the operation of treaties’ Mutual Agreement Procedure (MAP) provisions for dispute resolution. A
second group of concerns relates to difficulties associated with the procedures for claiming treaty benefits and for obtaining advance determinations of the availability of those benefits.

Among the first group of concerns are problems that arise where access to consideration under the treaty’s MAP provisions is either explicitly or effectively restricted, often because of inadequate transparency or through the unclear or unfair application of deadlines. Access problems can also arise from inflexibility regarding the parties to the MAP process, its unanticipated or undesirable interaction with domestic proceedings, failure to suspend the collection of asserted tax liabilities during MAP consideration, the improper assertion of anti-abuse exclusions, and the unwillingness or inability of some competent authorities to consider double taxation cases not explicitly provided for by the treaty.

Problems also arise from structural issues relating to the MAP process. These include situations in which the competent authority has inadequate legal or organizational authority, lacks adequate independence, is not adequately coordinated with other governmental functions, is not adequately centralized, or lacks adequate resources.

Another type of concern relates to MAP operational issues, typically involving insufficient communication, inordinate case processing delays, or inappropriate case resolutions that are unprincipled, non-neutral, or inconsistent.

This report outlines a series of specific recommendations to address concerns regarding restricted access to MAP consideration, its interaction with domestic proceedings, structural and operational issues regarding the MAP process, and other treaty implementation concerns. In addition to these specific recommendations, a number of general improvements are needed. First, a much broader international consensus on key MAP process issues is needed to reduce compliance costs and eliminate procedural “traps for the unwary.” The Manual on Effective Mutual Agreement Procedures proposed by the OECD Dispute Resolution Report should help, but its non-binding nature will limit its utility. On key issues that can preclude MAP consideration, such as the definition of when “notification” of the taxpayer occurs for purposes of treaty MAP deadlines and the application of those deadlines in the withholding tax context, changes to the OECD Model Convention or Commentary, and to the U.S. Model Convention and Model Technical Explanation, are advisable. Certain issues, such as the applicability or non-applicability of domestic statutes of limitations, also should be addressed via bilateral treaty, to ensure binding and reciprocal effect. The conclusion of a bilateral agreement interpreting an existing bilateral treaty may be an alternative means of addressing other issues, such as the suspension of collection during MAP consideration.

Second, the role of the competent authorities should be expanded to address additional issues where appropriate and feasible. For example, MAP agreements on particular cases should generally cover future years as well as past years, as is currently the case for transfer pricing issues addressed in APAs. The competent authorities should devote more attention to addressing general issues of process. They should also exercise more frequently their authority to resolve interpretive issues of general application, where appropriate.
Finally, as discussed in Chapter 3 of this study, recourse to mandatory, binding arbitration is urgently needed as an additional safeguard to ensure the appropriate functioning of the MAP process and the successful resolution of cases in instances where that process fails.

In the area of procedural requirements for claiming treaty benefits, problems can arise where countries are unwilling to grant treaty relief except through refund claims, or where the procedures for taxpayers to certify their entitlement to treaty benefits or to obtain certification of their residency status from their home country tax officials are unduly onerous, time-consuming, or expensive. This Report recommends significantly enhanced coordination between treaty partners to simplify and streamline their procedures. It also recommends the institution of efforts by the United States and the OECD to establish, with input from the business community, an international consensus for more standardized and modernized procedures, as well as a “peer review” process to monitor treaty countries’ adherence to international standards.

Taxpayers should be able to obtain advance rulings on a timely basis on issues of treaty interpretation relevant to their situations. In the United States, this may require a more robust administration of the private letter ruling process, as well as an expansion of the Pre-Filing Agreement program. Greater use should also be made of the ability granted by treaties to competent authorities to enter into mutual agreements to resolve generic issues of interpretation and to improve the procedural mechanisms for claiming treaty benefits.

Finally, a note of caution is included about the increasingly prevalent and complicated anti-treaty shopping (“Limitation on Benefits”) provisions found in U.S. tax treaties, to ensure that appropriate attention is paid to their administrability, so that they do not become unduly restrictive in operation.

**Arbitration**

Tax treaty disputes are growing in number and difficulty. Many taxpayers and tax administrations have growing concerns regarding the current and future ability of existing competent authority processes to address disputes in an effective and timely manner. Although they generally work well, the voluntary dispute resolution processes currently provided by U.S. treaties are not adequate to address the most problematic cases and relationships. Relevant experience suggests that the operation and effectiveness of the competent authority process, and the implementation of treaties generally, could be improved with the addition of arbitration as a mechanism to “back-stop” the competent authority process. The U.S. competent authority office has acknowledged this by reversing its prior opposition to arbitration. Mandatory, binding arbitration provisions should be added without delay to U.S. treaties.

Business strongly supports the universal inclusion of mandatory, binding arbitration provisions in treaties to supplement the competent authority procedures. From the taxpayer’s perspective, such provisions would offer four key benefits. First, they would set an effective deadline for the conclusion of the competent authority process, thus improving its efficiency. Second, they would encourage competent authorities, and presumably examiners as well, to moderate any extreme positions they might otherwise be inclined to adopt. Third, arbitration provisions would provide assurance that treaty disputes ultimately will be resolved. Finally, they could have the
additional benefit of providing book and accounting benefits by reducing contingent reserve requirements, as taxpayers could be assured of ultimate relief from double taxation even where the relationship between the competent authorities is not functioning smoothly.

Governments also stand to derive a number of benefits from the addition of arbitration provisions. First, such provisions would provide all treaty partners with a strong incentive to deal in good faith in the MAP process, and could have similar effects on the examination process. Second, arbitration would operate to ensure a resolution even where the treaty partner fails to participate in good faith in MAP cases. Third, arbitration would conserve government resources by setting an effective deadline for the resolution of MAP cases, thus eliminating lingering disputes.

**Permanent Establishment Issues**

Global businesses are experiencing a significant increase in examination activity relating to permanent establishment issues, in more than two dozen countries around the world. Permanent establishment issues were identified as a leading concern in the National Foreign Trade Council’s 2004 Tax Treaty Survey of its member companies, with more than 80 percent of respondents naming permanent establishment issues as one of their top two treaty concerns in at least one jurisdiction. Permanent establishment cases are being referred to the competent authorities in greater numbers, and they already are encountering difficulty in resolving many of them. Business is concerned about the increased risk of multiple or unanticipated taxation, the exposures associated with unexpected permanent establishment challenges, the difficulty of resolving cross-border controversies on these issues, and the associated compliance burdens. The current lack of clear, internationally agreed rules regarding the amount of profit attributable to various types of permanent establishments, addressed in Chapter 1 of this Study, contributes greatly to the risk of multiple or unanticipated taxation.

The recent efforts at the OECD to achieve a broad international consensus on certain permanent establishment issues represent a potentially positive step. A number of amendments have recently been made to the OECD Commentary on Article 5, and additional changes are currently under consideration. These steps generally represent a positive effort to confirm a broad international consensus on certain permanent establishment issues. However, they have raised some new concerns and ambiguities that may exacerbate current trends.

These and other issues are in need of further clarification and should be addressed through additional amendments to the Commentary as soon as possible. These include issues as to when the conduct of activities other than the conclusion of contracts by one company for another will create a permanent establishment on a “dependent agent” basis. Much greater clarification also is needed regarding the meaning of the term “at its disposal,” as used in the Article 5 Commentary to refer to circumstances in which an enterprise may be deemed to have a “place of business” based on premises other than its own. There also are a number of interpretive issues regarding the general “fixed place of business” requirement for finding a permanent establishment, the meaning of the term “place of management,” the meaning of “authority to conclude contracts,” and the concept of an “independent agent” acting “in the ordinary course of business.” Additional guidance on these issues would assist both taxpayers and tax authorities...
attempting to apply treaty permanent establishment provisions and to minimize the risks of multiple or unanticipated taxation that the competent authorities may be unable to resolve. The NFTC generally opposes time thresholds above which permanent establishments are irrebuttably presumed to exist. However, serious consideration should be given to the adoption of a clear, internationally agreed time floor for permanent establishments, which could further these goals if properly designed and applied.

**Withholding Rate Provisions**

The NFTC strongly supports the reciprocal elimination by treaty of withholding taxes on cross-border payments of dividends, interest, royalties, and service fees. Situations in which this goal has not yet been accomplished in its entirety, despite the best efforts of U.S. treaty negotiators, leave U.S. resident companies with an excessive tax burden that hampers international trade and investment and put them at a competitive disadvantage relative to companies resident in EU Member States or other jurisdictions that have achieved this on a broader scale. Businesses and withholding agents also encounter interpretive difficulties in situations where the intended scope of a withholding tax exemption is not entirely clear from the treaty text.

The NFTC applauds the recent efforts and successes of the U.S. Treasury Department in eliminating withholding taxes by treaty on significant cross-border flows of direct dividends, interest, and royalties. It encourages U.S. treaty negotiators to continue to press for the broadest possible elimination or exemptions from withholding taxes on such amounts, as well as on service fees.

Treasury should confirm that it supports the reciprocal elimination of withholding on direct dividends as a matter of general policy, within the context of otherwise acceptable treaty agreements. If exceptions to this policy are considered necessary, the U.S. Treasury Department should, following Congressional consultations as appropriate, articulate the circumstances in which it generally will not be prepared to agree to a zero rate. Given the strong policy justifications for a zero rate, however, such exceptions should be limited to circumstances in which the treaty partner is unwilling to agree to a reciprocal zero rate provision or to include adequate limitation on benefits and exchange of information provisions in the treaty. Treasury also should take the opportunity now to reevaluate the need for some of the limitations on the zero dividend rate that have been provided by treaties thus far. Specifically, future U.S. treaties should provide an ownership threshold of 10 percent for the zero rate on direct dividends, should specify that the ownership threshold may be satisfied through either direct or indirect ownership, and should eliminate the requirement that the requisite ownership interest be held for a period of at least 12 months prior to declaration of the dividend.

U.S. treaty negotiators should continue to vigorously pursue the complete elimination of withholding taxes on royalties, service fees, and interest. In addition to representing sound tax policy, the elimination of withholding on such amounts has the additional benefit of eliminating disputes with tax authorities about the characterization of transactions, source of payments, and treatment of bundled payments, and about cascading royalty taxes.
Where it is not possible to eliminate such withholding taxes in their entirety, U.S. treaty negotiators should seek partial exemptions that are as broad as possible. It is important that the scope of these and other withholding tax exemptions or reductions for certain categories of income be defined as precisely as possible, to ensure that they operate as intended. A number of the interpretive difficulties that have arisen over the years regarding the application of treaty withholding tax exemptions might have been avoided, for example, through the inclusion of additional definitions or details in the treaty or in accompanying bilateral documents, to provide adequate guidance to taxpayers and withholding agents. Treaties should take particular care to define precisely key terms used in connection with such exemptions, such as the terms “bank,” “investment bank,” “financial institution,” “captive financing companies,” “commercial finance companies,” “consumer credit companies,” “wholly independently,” and interest paid “in connection with” sales on credit. Treaties should also provide appropriate guidance, where needed, regarding the treatment of multiple entity groups, which is of particular importance where financial services functions are divided among members of a corporate group.

A variety of other issues relating to withholding taxes should be addressed by U.S. treaties. For example, they should routinely provide for a zero rate of withholding on interest and dividends received by a qualified pension plan or arrangement. They also should continue to include language that specifically confirms the availability of treaty rates of withholding for amounts derived by U.S. residents through flow-through entities. The inclusion of anti-conduit provisions, however, should be avoided if at all possible, because they can give rise to undesirable uncertainty about the availability of treaty benefits in ordinary business transactions and create confusion about their interaction with U.S. domestic law anti-conduit rules. Where they are necessary, their scope and manner of application and the meaning of their key terms should be clarified. The sourcing provisions of U.S. treaties should also be clarified. Every U.S. treaty should include a sourcing rule which recognizes the foreign source character of income items the treaty authorizes the treaty partner to tax, in order to avoid double taxation. Interpretive issues that have sometimes limited the ability of U.S. treaties to achieve this goal should be addressed clearly. Finally, Treasury should refrain from including references to an “anti-cherry-picking” principle in its Technical Explanations of treaties, unless appropriate legal grounds for, and parameters of, such a principle are clearly established.

**Issues Regarding Pensions and Equity-Based Compensation**

Most U.S. bilateral treaties contain either limited provisions relating to pensions, stock options, and equity-based compensation, or no specific provisions at all. Business is concerned about the relative lack of international coordination on the taxation of pensions, stock options, and other forms of equity-based compensation. The current multiplicity of taxing regimes and relative lack of cross-border coordination increase both the risk of double or multiple taxation and the costs of global tax compliance. This is a significant concern for businesses because it hampers employee mobility and hinders their ability to operate globally in an efficient manner.

U.S. treaty negotiators have made important advances in a couple of recent treaties towards providing broader cross-border coordination on certain pensions and stock options issues. They are to be applauded for these efforts and should be encouraged to expand such coordination to
cover additional issues, including issues relating to equity-based compensation other than stock options (such as restricted stock, stock appreciation rights, and phantom stock). Wherever possible, this coordination should occur on a multilateral basis. The recent OECD report on Cross-border Income Tax Issues Arising from Employee Stock Option Plans represents a positive initial step. Bilateral treaty efforts should be pursued as an interim measure, however, where no multilateral consensus appears likely.

Attempts to develop consistent approaches to the taxation of pensions and equity-based compensation in the cross-border context should be kept as simple as possible, to facilitate administration and compliance. U.S. treaties that have attempted to address certain issues in this area have, however, tended to provide specific rules that cover particular bilateral cases, rather than general principles. This has resulted in a patchwork of tailored, often complex provisions that vary, sometimes significantly, from treaty to treaty. The resulting multiplicity of approaches increases the interpretive difficulties and administrative costs for taxpayers and tax administrations of applying treaty pension provisions. They also often fall short in addressing issues that arise in the increasingly common case of peripatetic employees.

Cross-border pension issues have arisen in practice on seven points in particular, each of which should be addressed in future treaties wherever possible. These points include (1) the definition of “pension”; (2) covered forms of distribution; (3) required timing of distributions; (4) characterization of distributions; (5) deductibility of contributions; and (6) the timing of taxation of benefits (including contributions and earnings and benefit accruals); and (7) the treatment of “rollovers.”

Similar concerns have arisen in connection with stock options and other equity-based compensation. Cross-border coordination is particularly needed to avoid double taxation with respect to the following issues relating to equity-based compensation, some but not all of which would be addressed by the recent OECD report on stock options: (1) difference in measurement of taxable income; (2) timing of taxation of benefits; (3) sourcing issues; (4) characterization issues; (5) deductibility of costs; and (6) issues arising as a result of a corporate reorganization.

**Issues Regarding the U.S. Model Treaty**

The United States has long been active in the multilateral drafting and interpretation processes relating to the OECD Model Convention and Commentary, which are widely used in the negotiation and interpretation of bilateral treaties. The United States is virtually unique among major countries in also maintaining a published model income tax treaty of its own, which differs in some respects from the OECD Model. The U.S. Model Treaty and Technical Explanation play an important part in making U.S. treaty policy more transparent, facilitating more efficient bilateral U.S. treaty negotiations, and promoting greater consistency in bilateral U.S. treaty texts. Business supports the continued development and publication of a U.S. Model Treaty and Technical Explanation, because they serve certain useful purposes that cannot be served by the multilateral OECD Model Convention and Commentary. The process of developing and interpreting the U.S. Model Treaty and Technical Explanation, however, could be improved in some respects. For example, issues have arisen regarding their proper role and interpretation in
the treaty negotiation and ratification processes, the frequency of revisions and the process by which such revisions are made, the scope of the U.S. Model Treaty and Technical Explanation, and their use as vehicles for providing interpretive guidance.

The U.S. Model and Technical Explanation should be regarded as a means of identifying and providing standard texts for points on which it is believed necessary and appropriate for the preferred U.S. negotiating position to depart from the OECD Model Convention and Commentary. It should be recognized that the U.S. Model Treaty does not represent an ideal treaty that can be used as a definitive standard to evaluate the acceptability of a proposed bilateral U.S. treaty, or a series of positions subject to “cherry-picking” by prospective treaty partners regardless of overall balance.

The U.S. Model Treaty and Technical Explanation should be updated with much greater frequency. The U.S. Treasury Department should be encouraged to undertake partial revisions if resource constraints require, as it is now in the process of doing for the first time. Changes should be issued in draft form with an opportunity for public comment before finalization. New U.S. negotiating positions should be proposed first as revisions to the U.S. Model Treaty rather than in bilateral treaties, wherever possible.

The scope of the U.S. Model Treaty should be expanded to include texts for provisions that U.S. negotiators may not be willing to include in all bilateral treaties, as well as new provisions not yet included in any bilateral U.S. treaty.

Taxpayers and practitioners need additional guidance on issues of treaty interpretation, but caution should be taken in using the U.S. Model Treaty or Technical Explanation for this purpose. In most circumstances, the issuance of general published guidance is preferable on issues subject to unilateral U.S. interpretation, while issues on which reciprocal treatment is sought should be addressed in bilateral documents with binding effect under international law.

The U.S. Treasury Department and Internal Revenue Service should clarify their position regarding the effect of changes in U.S. or OECD Model documents on their interpretation of bilateral U.S. treaties and regarding the interaction, if any, between the U.S. and OECD Model documents. They also should confirm that they will not seek to apply changes in treaty interpretation to the retrospective disadvantage of taxpayers.

Finally, in developing the U.S. Model Treaty and Technical Explanation and determining when it is appropriate to depart from their provisions in bilateral negotiations, it is necessary to strike a proper balance between the need for adequate recognition of particular U.S. policy or interpretive concerns on the one hand, and the desirability of maximizing consistency with the OECD Model Convention and Commentary on the other. While it is sometimes preferable to depart from the general international consensus in order to address particular U.S. concerns, such departures must be carefully weighed, as they increase the risk of international disputes that can result in unrelieved double taxation and additional administrative costs for both taxpayers and governments.
CHAPTER 1

ISSUES REGARDING THE ATTRIBUTION OF PROFITS
TO A PERMANENT ESTABLISHMENT

I. Introduction

A. Overview of Historical U.S. Treaty Policy

The United States, together with most other OECD member countries, historically has supported
the application of a permanent establishment threshold designed to strike a certain balance
between the revenue claims of source (or “host”) countries and residence countries, by
precluding host country taxation of the business profits of a non-resident enterprise where that
enterprise’s participation in the economic life of the host country does not exceed a certain
threshold. Like other OECD member countries, it has also traditionally included in its treaties
provisions that limit the profits the host country may attribute to a permanent establishment, in
general by providing that the host country may tax the non-resident enterprise’s permanent
establishment only on those profits “which it might be expected to make if it were a distinct and
separate enterprise engaged in the same or similar activities under the same or similar conditions
and dealing wholly independently with the enterprise of which it is a permanent establishment.”
This so-called “arm’s length” approach reflects both policy and administrative concerns.

In recent years, an increasing focus on permanent establishment issues at the OECD (e.g.,
because of the growth of electronic commerce and global trading of financial products) led to the
conclusion that the OECD member countries needed to reach a greater consensus on the
principles to be applied in attributing profits to permanent establishments. Accordingly,
beginning in 1998, the OECD undertook an effort to reconsider the interpretation of Article 7
with a view towards achieving consensus among the member countries on its correct
interpretation.

During the same time period, attempts by the U.S. Internal Revenue Service to defend certain
formulary provisions of U.S. domestic law as consistent with Article 7 have been rejected in two
sweeping court decisions. See North West Life Assurance Co. of Canada v. Commissioner, 107
Citing the OECD Commentary on Article 7 (Business Profits) of the OECD Model Convention,¹
these decisions have deferred largely to the taxpayer’s books and records to determine the profit
attributable to its U.S. permanent establishment. These cases presumably have provided at least
part of the motivation for the active participation of the U.S. Treasury Department and Internal
Revenue Service in the effort underway at the OECD to determine the appropriate principles for
attributing profits to permanent establishments under Article 7.

¹ See Commentaries of the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and
Development on the OECD Model Tax Convention on Income and on Capital.
B. Summary of Current Concerns

Global businesses are encountering increased examination activity on permanent establishment issues in many countries, typically involving the attribution of substantial profits. Their primary concerns regarding the attribution of profits to a permanent establishment are that—

(1) A consistent approach be applied internationally,

(2) Adequate certainty be provided in advance regarding the interpretation and implementation of the agreed approach, and

(3) Associated compliance burdens not exceed an administrable level.

Each of these three goals must be satisfied if the primary purpose of tax treaties—the avoidance of double or inappropriate taxation—is to be achieved.

The avoidance of double taxation clearly is a major aim of the current OECD project on the attribution of profits to permanent establishments. It is not yet clear, however, to what extent that project will succeed in providing the requisite consistency, certainty, and administrability. This is likely to turn in large part on the content of the final report and accompanying guidance, and on how they are implemented in practice by tax authorities around the world.

C. Summary of Conclusions and Recommendations

The current OECD project to reexamine the attribution of profits to a permanent establishment represents an important effort to achieve a broad international consensus on key issues. Once finalized and implemented, it seems likely to eliminate a number of current disagreements among countries, and between taxpayers and tax authorities, regarding the interpretation of treaty provisions relating to profit attribution.

Significant changes are being proposed, however, under the “authorised OECD approach,” as described in the recently released Report on Part I of the OECD project. Some of these changes are likely to create uncertainty and controversy, because they are not entirely clear and, therefore, leave too much latitude for differing interpretations. Many of these difficulties might be avoided with the provision of additional details and examples.

As discussed below, clarifications and details are needed, in particular, on technical issues relating to (1) the functional analysis, including the determination of assets used and conditions of use and risks assumed; (2) the attribution of capital; (3) the comparability analysis; (4) the application of transfer pricing methods; and (5) the treatment of dependent agent permanent establishments and “fixed place of business” permanent establishments. It is also critical that U.S. tax authorities and their counterparts in other countries clarify in advance their positions regarding the legal effect of the final Report or of changes to the OECD Commentary on Article 7 on existing and future treaties.

Finally, the proposed changes raise a host of practical implementation issues that need to be addressed before the authorised OECD approach is implemented. Apart from the general need
for additional guidance to enable compliance, the primary implementation issues relate to the new taxpayer documentation requirements envisaged by the Report, particularly for deemed permanent establishments that may not have been anticipated by the taxpayer, such as dependent agent permanent establishments. The Report should address more forthrightly the specific difficulties that arise from trying to apply transfer pricing guidelines developed for separate legal enterprises “by analogy” to a single enterprise, where the “separateness” of the permanent establishment from other parts of the enterprise will not be so obviously demarcated through documentation or conduct. In recognition of these difficulties and their potential to give rise to subjective disputes among countries and between taxpayers and tax authorities, the Report should propose much greater deference towards reasonable taxpayer efforts to document and characterize the activities of their permanent establishments. Likewise, more could be done to minimize other administrative burdens, and transition issues need to be resolved prior to implementation of the new approach.

II. Purpose of Profit Attribution Provisions

A. Limitation of Source-Based Taxation

The provisions of Article 7 have long been viewed as designed to prevent taxation of the profits of a non-resident enterprise, except to the extent that they are attributable to a permanent establishment of the enterprise. The OECD Commentary on Article 7, for example, endorses—

the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. … The second and more important point is that … when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment, in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.2

The approach historically taken by Article 7 reflects both policy and administrative considerations. As a policy matter, the limitations provided by Article 7 reflect the view that the host country should be permitted to tax the profits of a non-resident enterprise only if it has a substantial connection with that country. In this respect, the business profits provisions have

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2 OECD Commentary on Article 7, ¶¶ 3, 5. See also 1996 U.S. Model Technical Explanation of Article 7, Paragraph 1 (referring to “the general rule that business profits … of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on business in that other Contracting State through a permanent establishment … situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise, but only on a net basis and only on the income that is attributable to the permanent establishment”).
played a central role in maintaining the longstanding balance between residence-based taxation and the taxation at source permitted by other treaty provisions.

The limitations imposed by Article 7 also reflect the practical difficulties associated with the net-basis taxation of non-resident enterprises, particularly the host country’s inadequate access to the information necessary to compute net profits properly in such cases. Even where it is agreed that the enterprise has a local permanent establishment, for example, the determination, allocation, and verification of income and expenses attributable to the permanent establishment often normally are more difficult for the host country to ascertain than for the residence country.

**B. Minimization of Double or Inappropriate Taxation**

By minimizing the exposure of non-resident enterprises to taxation in jurisdictions with which they have limited contact, the provisions of Article 7 have helped to avoid overlapping claims of jurisdiction to tax. Such overlapping claims otherwise would arise with greater frequency, both as between host and residence countries, and between host countries asserting conflicting permanent establishment claims. Overlapping claims of taxing jurisdiction lead not only to lengthy competent authority disputes among treaty partners, but also to unrelieved double taxation in unresolved cases or in cases not covered by treaty.

The provisions of Article 7 also avoid the inappropriate attribution of profits where a permanent establishment exists. By limiting the profits that are attributable to a permanent establishment to those which it might earn at arm’s length, Article 7 prevents the application of “force of attraction” provisions that some jurisdictions would otherwise apply to tax additional profits of the enterprise.

Article 7, therefore, plays a central role in facilitating cross-border trade and investment through the minimization of double or inappropriate taxation. The ability of Article 7 to prevent this turns, however, on broad international application of clearly defined rules.

**C. Avoidance of Duplicative Compliance Burdens**

By limiting net-basis taxation to situations in which profits are attributable to a permanent establishment, Article 7 prevents global enterprises from being required to file income tax returns and manage associated compliance processes in every jurisdiction with which they have contact. This eliminates the need to perform complex income and expense computations for jurisdictions in which such enterprises have a limited presence. It also avoids the unnecessary imposition of other duplicative compliance burdens that could otherwise impede the global conduct of business.

**III. Implications for Business**

**A. International Consistency**

A consistent international approach to the attribution of profits is essential if double or inappropriate taxation is to be avoided. This includes the application by treaty partners of a symmetrical approach to the attribution of profits where one is the residence country and the
other the host country. However, to avoid conflicting claims by or among other putative host countries, broader international consistency is also required.

**B. Certainty**

Businesses need adequate certainty regarding the rules that will apply to attribute profits to their permanent establishments and the manner in which these rules actually will be applied in practice by the jurisdictions concerned. This certainty must be provided in advance, rather than after the fact, to prevent unanticipated tax results from inhibiting the conduct of cross-border business.

**C. Compliance Burden**

From a business perspective, it is also imperative that compliance burdens be minimized wherever possible. If the burdens associated with tax compliance become unmanageable, they can have a negative effect on international trade and investment, regardless of the magnitude of the tax liability itself. As the number of asserted permanent establishments increases, so, too, does the risk that the cumulative compliance burden will exceed an acceptable level.

**IV. Implications for Governments**

**A. Allocation of Tax Revenues**

For governments, the manner in which profits are attributed to a permanent establishment has a direct effect on the allocation of tax revenues among jurisdictions. The historical approach to profit attribution has favored residence-based taxation except in cases where the enterprise’s host country presence has exceeded a specified permanent establishment threshold, and then only to the extent that profits were attributable to the permanent establishment. To the extent that the current approach changes as a result of the project underway at the OECD, tax revenues inevitably will shift among countries, with the direction and extent depending upon the particular approach adopted. There is a general belief in the business community that the OECD project will tend to cause something of a shift in tax revenues away from residence countries toward source countries. That being said, there is also a concern that the compliance costs and uncertainties created for businesses as a result of the need to apply the very subjective rules of the OECD’s approach could significantly outweigh the amount of tax revenue that may shift to source countries.

**B. Ability to Administer**

As for treaty provisions generally, the successful operation of the profit attribution rules will turn in part on the ability of national tax administrations to apply them properly and consistently. This becomes more difficult, for governments as well as for taxpayers, as those rules grow in complexity and subjectivity.

**V. OECD Project on the Attribution of Profits to a Permanent Establishment**

**A. Background**
Beginning in 1998, OECD Working Party No. 6 launched a project to reexamine Article 7, without reference to past practice or interpretation. The Working Party published an initial Discussion Draft in February 2001 (the “2001 Draft”) that focused on both general issues (Part I) and issues relating to the banking sector (Part II). This has been followed by drafts relating exclusively to banking and global dealing issues (Parts II and III) and, in August 2004, by a significantly revised and expanded Report on Part I (General Considerations) (the “2004 Report”).

This project has entailed a substantial rethinking of Article 7. As explained in the 2004 Report:

The development of the WH [Working Hypothesis] was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention was to formulate the preferred approach to attributing profits to a PE under Article 7, given modern-day multinational operations and trade.

With the publication of the 2004 Report, the Working Hypothesis proposed in 2001 has been adopted by Working Party No. 6 as the “authorised OECD approach.” The Working Hypothesis had encountered criticism but, with the publication of the 2004 Report, the OECD has announced that “the principles are now finalised” and that the Report will be finalized in 2004 and approved by the OECD in early 2005.

The authorised OECD approach seeks to attribute to a permanent establishment the profits that it 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. The authorised OECD approach begins by “hypothesizing” the permanent establishment as a distinct and separate enterprise, to which it attributes functions, assets, and risks, based on factual and functional analysis focusing on “key entrepreneurial risk taking functions.” Capital and funding costs are attributed to the permanent establishment based on its functions, assets, and risks. A comparability analysis is then performed, and, finally, transfer pricing methods used for attributing profits between related legal enterprises are applied “by analogy” to determine the portion of the profits of a single legal enterprise attributable to its permanent establishment.

This section V focuses on key issues raised by the 2004 Report’s discussion of the authorised OECD approach and associated issues. Its scope is, accordingly, limited to a consideration of Part I (General Considerations) of the OECD project.

B. Policy Issues

3 The “Working Hypothesis” was the preferred approach for attributing profits to permanent establishments proposed by the 2001 Draft.

4 See 2004 Report, Preface ¶ 3.

5 See OECD press release accompanying the 2004 Report, at http://www.oecd.org/document/29/0,2340,en_2649_33753_33640797_1_1_1,00.html.
The 2001 Draft did not discuss the policy goals of the OECD project in any detail. It acknowledged three goals, which the 2004 Report continues to endorse—“simplicity, administerability [sic], and sound tax policy”—but noted policy concerns only briefly.\textsuperscript{6}

The 2004 Report, in contrast, contains numerous passages that appear designed to express a clear policy preference for increased host-country taxation. For example, the 2004 Report acknowledges, as did the 2001 Draft, that the “functionally separate entity” approach incorporated in the authorised OECD approach “is more likely [than the alternative “relevant business activity approach”] to produce a profit attribution in respect of a particular business activity.”\textsuperscript{7} Elsewhere, the 2004 Report emphasizes that it is inappropriate to seek the same treatment for permanent establishments and subsidiaries, stating that “it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilisation, risk diversification, economies of scale etc.”\textsuperscript{8}

Similarly, in rejecting the “single taxpayer” approach requested by many commentators, under which profits would not be attributed to a dependent agent PE where an arm’s length reward has been paid to the dependent agent itself, the 2004 Report expresses the view that “this approach would not result in a fair division of taxing rights between host and home jurisdictions as it ignores assets and risks that relate to the activity being carried on in the source jurisdiction simply because those assets and risk [sic] legally belong to the non-resident enterprise.”\textsuperscript{9} Indeed, the 2004 Report goes on to describe the purpose of the permanent establishment concept broadly, as one of permitting—rather than generally prohibiting—source-based taxation of non-resident enterprises:

Indeed, [a “single taxpayer” approach for dependent agents] would go against one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source jurisdiction.\textsuperscript{10}

These arguments in support of increased source-based taxation are somewhat surprising, given the historical preference of the United States and most other OECD member countries for residence-based taxation of business profits. If increased source-basis taxation is not an intended result of the OECD project, the 2004 Report should be amended to clarify and avoid this implication.

\textbf{C. Technical Issues}

\begin{itemize}
  \item \textsuperscript{6} See 2001 Draft, ¶ 4.
  \item \textsuperscript{7} See 2004 Report, ¶ 27.
  \item \textsuperscript{8} Id. ¶ 55.
  \item \textsuperscript{9} Id. ¶ 275.
  \item \textsuperscript{10} Id.
\end{itemize}
The 2004 Report attempts to address a series of difficult and conceptually challenging technical issues. As discussed below, however, the intended result is not always clear, at least as currently articulated. To the extent that this is due to the need for additional details and examples, the relevant portions should be clarified. Where the ambiguity reflects a lack of consensus among OECD member countries, however, those differences of view should be addressed and resolved prior to finalization of the Report.

1. Symmetrical Application

The 2004 Report attempts to resolve this issue by establishing broad consensus on the authorised OECD approach and by confirming that Article 23 will require the residence country to grant double taxation relief (subject to limitations in its domestic law) for source country taxes imposed on a permanent establishment in accordance with the authorised OECD approach. This approach seems generally correct in principle. Its success ultimately will depend, however, upon successful implementation in practice. It should be noted, for example, that the proper operation of Article 23 is heavily dependent upon the provision of appropriate treaty source rules, the operation of which has been ambiguous in some treaties, including certain U.S. treaties. Care will need to be taken as well to ensure that the authorised OECD approach is applied correctly in practice and, conversely, that unfounded disputes regarding facts or methodology are not used to avoid the obligation to provide relief under Article 23 in appropriate cases.

A related issue, also acknowledged by the 2004 Report, is the lack of symmetry among jurisdictions in the definition of “profits.” These and other similar differences may create double taxation because of the mismatch between the amount of profits attributed to a permanent establishment by the source jurisdiction under Article 7 and the amount of double tax relief allowed by the residence jurisdiction under Article 23. The 2004 Report notes that such mismatches predate and are not affected by the authorised OECD approach, and, therefore, fall outside of its scope. This may be a fair point in the isolated context of the Report. Any material lack of symmetry that creates a mismatch between Articles 7 and 23 is of concern to business, because of the associated disputes and double taxation risks. The incidence of these issues seems

11 See 2001 Draft, ¶ 33.
likely to increase with the number and complexity of permanent establishment and profit attribution controversies. The 2004 Report, together with the pending and recent changes to the OECD Commentary on Article 5 (Permanent Establishment), may assist in resolving many of these disputes. However, these changes also are likely to prompt additional examination activity and disputes, including disputes between countries regarding their proper interpretation. To minimize these new problems, future attention should also be devoted to resolving other mismatches between Articles 7 and 23 that are identified by the 2004 Report.

2. Functional Analysis in General

The proposed process of hypothesizing a distinct and separate enterprise, its functions, and the “conditions” under which they are performed requires both the taxpayer and the tax authorities to make a series of difficult subjective judgments. Although the 2004 Report provides more detail on some points than did the 2001 Draft, the guidance furnished remains generally inadequate.

Too much reliance is placed, for example, on general references to the OECD Transfer Pricing Guidelines, given that the 2004 Report itself cautions that the Guidelines must be applied “by analogy” to permanent establishments. Although the 2004 Report contemplates that the Guidelines must be adapted and supplemented to take into account unspecified “factual differences” between a permanent establishment and a legally distinct and separate enterprise, it does not specify when and how this will occur.

The required determination, of which functions (i.e., activities) of the enterprise are associated with the permanent establishment, and to what extent, raises similar concerns. The 2004 Report does not provide adequate guidance regarding the manner in which activities are to be taken into account in attributing profits to the permanent establishment. It focuses heavily on where the “key entrepreneurial risk-taking functions” are performed and what their relative importance is. It notes, however, that these key functions will vary from sector to sector and even from enterprise to enterprise and concludes that the determination must be made on a case-by-case basis because it “will depend on the particular facts and circumstances.” As discussed below, the 2004 Report thus fails to clarify certain key issues, such as the question of whether the functions and risks associated with the acquisition of an asset or those associated with its use constitute the “key entrepreneurial risk-taking functions.”

In addition, the 2004 Report requires an analysis of all activities performed on behalf of the permanent establishment, and of all activities performed by the permanent establishment on behalf of other parts of the enterprise. It fails to give practical guidance on how to deal with

12 Id. ¶ 55.
13 Id.
14 Id. ¶ 56.
15 Id.
situations where key functions that are closely related are carried out partly within and partly outside the host country, or to acknowledge that, where some or all of the relevant activities occur outside of the host country, the necessary information may not be readily available.

For example, suppose an enterprise resident in Country A sells its products to customers in Country B through a permanent establishment located in Country B where the enterprise has a dependent agent who regularly negotiates and concludes contracts on behalf of the enterprise. Suppose further that the result of such sales is that the enterprise holds receivables from its customers. In that case, the enterprise would have to determine where the “key entrepreneurial risk-taking functions” are performed that relate to the holding of those receivables (in order ultimately to determine where the profit allocable to the holding of that credit risk should be attributed). Should these functions be viewed as attributable to Country B, because that is where the sales are concluded that give rise to the receivables? Should they be viewed as attributable to Country A, on the grounds that the enterprise’s head office personnel there set the criteria for extending credit to customers in Country B? Or back in Country B, because that is where the collection activities on the receivables will take place? Or back in Country A, because that is where the enterprise’s treasury function is headquartered which allows the enterprise to be in a position to extend credit to its customers? Should it matter whether the enterprise records bad debts on the books of its Country A head office or its Country B permanent establishment? Should the functions be viewed as split between Country A and Country B, and if so, how much weight should be given to the functions performed in each country?

Unfortunately, the 2004 Report does not provide much in the way of guidance for resolving these very practical issues. Note that these issues would tend not to arise between separate legal entities (at least, not to the same extent), because the allocation of functional responsibilities between such entities would tend to be reflected in explicit legal or contractual relationships (e.g., through a sales subsidiary’s retained legal ownership of customer receivables, or through a parent company’s acquisition of the receivables pursuant to a factoring agreement). This is merely one example of the myriad of issues that could arise in attempting to identify the “key entrepreneurial risk-taking functions” associated with the activities of a permanent establishment.

These and other similar gaps simply leave too much latitude for disagreement between taxpayers and tax authorities, and among jurisdictions. Far more detail regarding the intended operation of the authorised OECD approach is needed to ensure its proper and consistent implementation and to avoid the creation of new disputes. For the sake of clarity, the general principles set forth in the Report also need to be illustrated with realistic examples, which are conspicuously absent from the current draft. The need for such examples is particularly acute with respect to the identification of “key entrepreneurial risk-taking functions” for various common activities, because without such guidance the potential for disputes is enormous.

3. Assets Used and Conditions of Use

Determining the assets used by the permanent establishment and the “conditions” under which they are used will also pose a series of technical and practical challenges. The 2004 Report acknowledges that “[d]etermining ownership of the assets used by a PE can present problems not
found in separate enterprises where legal agreements can be relied upon to determine ownership” and concludes that “it is the economic (rather than legal) conditions that are most important.”

The difficulties associated with this determination even in the case of an actual branch will be further compounded in the dependent agent context, where the taxpayer is deemed to have a permanent establishment that it did not necessarily anticipate.

A “facts and circumstances” approach is prescribed to determine which assets are used by the permanent establishment and to what extent. The 2004 Report first requires a determination of what assets are used in the functions performed by the PE, in order to take that use into account:

To the extent that assets are used in the functions performed by the PE, the use of those assets should be taken into account in attributing profit to the functions performed by the PE.17

It then requires a determination of the “conditions” under which the PE uses the assets (e.g., as owner, lessee/licensee, or member of a Cost Contribution Arrangement).18 Where a physical asset is owned by the enterprise and used exclusively by the permanent establishment from the time of its acquisition, the 2004 Report appears to attribute economic ownership of the asset to the permanent establishment, without regard to which part of the enterprise funded or arranged the acquisition. It states that the economic ownership of an asset “belongs with the part or parts of the enterprise performing in particular the key entrepreneurial risk-taking functions in respect of that asset,” and that “the actual acquisition of an asset by one part of the enterprise is not determinative in assigning its economic ownership within the enterprise.”19 What is not clear from this language is whether the focus is intended to be on the key entrepreneurial risk-taking functions in respect of the acquisition of the asset or in respect of its use, although the more likely reading seems to be the latter. If that is the intended approach, this would appear to represent another instance in which the 2004 Report often will have the effect of systematically shifting profits from the head offices of enterprises to their permanent establishments. It is essential that this point be clarified before the Report is finalized.

For reasons that are not explained, the 2004 Report appears to adopt a somewhat different approach to determining the economic ownership of intangible assets. Where the asset is developed by the enterprise, it states that the “key factor is whether the PE undertakes the active decision-making with regard to the taking on and day-to-day management of the risks related to the creation of the intangible.”20 It does, however, focus on the user of an intangible acquired

16 Id. ¶ 86.
17 Id. ¶ 84.
18 Id. ¶ 85.
19 Id. ¶ 199.
20 Id. ¶ 234.
The intended treatment of intangibles in this connection is, therefore, also in need of further clarification.

Where use of a capital asset changes from one location to another within the enterprise, the 2004 Report notes the difficulty of accounting for the manner of the transfer (e.g., whether a sale, rental/license, or Cost Contribution Arrangement) and suggests a focus on “accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part” to resolve that question. In a theme that is repeated throughout the 2004 Report, taxpayers are urged as part of their “compliance obligation” to create internal documentation that will mimic contractual arrangements between associated enterprises by “purporting” to transfer risks, responsibilities, and benefits. They are continually warned, however, that their documentation will be respected only if the “actual conduct of the PE and the rest of the enterprise” is viewed by tax authorities as consistent with the documentation’s purported characterization.

For example, the 2004 Report says the transfer of a physical asset from one part of the enterprise to the permanent establishment might be documented as a “rental,” but that characterization will not necessarily be respected if the circumstances suggest that the “true nature” of the arrangement is effectively a sale (i.e., a transfer of economic ownership to the permanent establishment). As examples of factors that could suggest a sale, the 2004 Report cites the permanent establishment’s assumption of the responsibility for maintaining the asset and deciding when to replace it.

The 2004 Report does not indicate how factual disputes between the taxpayer and the tax examiner on this point are to be resolved. In particular, the 2004 Report provides little practical guidance to taxpayers or tax authorities on the types of evidence that would be sufficient to demonstrate that assets (including, e.g., financial assets and intangible assets) used by a permanent establishment are properly considered leased, loaned, or licensed to the permanent establishment, rather than owned by it, for purposes of determining the amount of profits attributable to the permanent establishment. In a change from the 2001 Draft, the 2004 Report appears to give no weight to the “intent” of the enterprise in determining economic ownership. It contains some statements that might inappropriately call into question the accuracy of the taxpayer’s own characterization (e.g., by suggesting that the fact that a permanent establishment conducts regular maintenance of an asset it is using may detract from characterization of its use

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21 Id. ¶ 237.
22 Id. ¶ 201.
23 Id. ¶¶ 201, 206.
24 Id. ¶ 205.
25 See 2004 Report, ¶ 204.
26 See 2001 Draft, ¶ 96.
as that of a lessee under a rental arrangement). The 2004 Report raises a number of other similar issues without providing any concrete guidance on how to resolve them. For example, it states, without explanation, that the reward attributable to the assumption of credit risk with respect to customer receivables created by a dependent agent “will be determined by reference to the identification of where the key entrepreneurial risk-taking functions are undertaken.”

The 2004 Report appears, therefore, to reflect a general presumption in favor of allocating profits attributable to assets used by a permanent establishment to the permanent establishment rather than to the head office. It fails to provide taxpayers with a reliable framework for rebutting those presumptions, which presumably will be applied by source countries as a matter of course. This will result in a very different treatment from that accorded to truly separate enterprises, which are allowed to allocate asset ownership (and, hence, profit potential) through contractual arrangements establishing legal ownership. The 2004 Report thus seems to depart substantially from the result that would follow from applying the transfer pricing principles, as it generally purports to do.

4. Risks Assumed

Determination of the risks assumed by the permanent establishment can also be expected to raise difficult interpretive issues. The 2004 Report indicates that the permanent establishment should be considered to assume any risks “inherent in, or created by, the PE’s own functions (i.e., for the purpose of the PE),” as well as any risks that “relate directly” to those activities. It acknowledges that this determination “will have to be highly fact specific” but suggests that the appropriate division within the enterprise can be deduced from the parties’ conduct and by comparison with what similar independent enterprises would do. This approach is likely to prove unworkable in practice, however, because a determination of the parties’ actual conduct turns on facts that may not be well-documented, while the comparability analysis involves subjective determinations.

The 2004 Report discusses only two types of risks specifically: inventory risks and credit and collection risks, both in the context of permanent establishments in the form of dependent sales agents. With respect to inventory risk, it says only that the risk will be allocated to the jurisdiction where the key entrepreneurial risk-taking functions are undertaken with respect to that risk. It notes that this analysis must be undertaken “on a case-by-case basis given the wide variety of risk management strategies used by different types of businesses,” and it says that the “creation and management of inventory risks may involve different entrepreneurial risk taking

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27 See 2004 Report, ¶ 204.
28 Id. ¶ 284.
29 Id. ¶ 87.
30 Id. ¶ 88.
functions in different business sectors, and even different businesses within the same sector.” 31

Beyond those very general statements, the 2004 Report provides no specific guidance.

On the subject of credit and collection risks, the 2004 Report similarly suggests only that their attribution will turn on which part of the enterprise performs the “key entrepreneurial risk taking” functions. 32 However, there is no indication of which functions will be considered relevant for this purpose. It would seem appropriate to attribute credit and collection risks to a permanent establishment only if it had and exercised the authority to select customers and only to the extent that the home office did not provide relevant support from outside the source jurisdiction. However, the Report should confirm this.

There are many other kinds of risks for which taxpayers and tax authorities will have to make determinations on whether they are attributable to permanent establishments (e.g., currency risks, interest rate risks, general market risks, product liability and warranty risks, regulatory risks, etc.). It is not entirely clear how such other categories of risks would be attributed under the authorised OECD approach. For example, general market risks ordinarily would be incurred in development and production, which do not normally occur within a permanent establishment. Presumably, such risks generally should not be attributed to the permanent establishment. Similarly, it would seem that product liability and warranty risks generally should not be attributed to a permanent establishment because they are associated with product quality, which is not normally attributable to a function performed by the permanent establishment. However, the 2004 Report does not provide any specific guidance regarding the attribution of these or other risks.

In the OECD Transfer Pricing Guidelines applicable to separate legal enterprises, it is noted that “the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties.” 33 Tax authorities are directed to take those contractual arrangements into account in determining which party should be deemed to incur a specific risk, unless the parties’ conduct indicates that the contractual terms have not been followed or are a sham. 34 Given the very substantial potential for disputes between taxpayers and tax authorities in the much more subjective determination necessary to allocate risks between different parts of a single enterprise in the absence of such legally binding contracts, the OECD should, before finally adopting the authorised OECD approach, amend the 2004 Report to give much greater deference to taxpayers’ efforts to document their internal allocation of risks.

31 Id. ¶ 281.

32 Id. ¶ 284.


34 Id. ¶ 1.29.
The OECD Transfer Pricing Guidelines also indicate that the determination of which party incurs the risk associated with a particular function may depend on the extent to which the party takes on responsibility for the function by “risking its own resources” in the relevant activities. In the case of dealings between separate legal enterprises, it is relatively easy to determine which party’s “resources” are put at risk in connection with a particular activity, merely by looking to which party pays for that activity out of its own funds. Where the same question arises for activities undertaken by a single enterprise, the 2004 Report does not clearly indicate how to determine which part of an enterprise (e.g., head office or permanent establishment) may be the source of funding for a particular activity, nor even whether it is relevant to attempt that determination.

For example, if the enterprise hires an independent agency to mount an advertising campaign on its behalf in the permanent establishment’s host country, does it matter whether the funding for that effort comes from the head office bank account or a local bank account that may be maintained by the permanent establishment? Does it matter whether the permanent establishment is a start-up operation and the enterprise’s funding for the campaign comes out of pre-existing profits generated by other parts of the enterprise? Is the source of funding totally irrelevant, and is the only relevant inquiry where the enterprise’s decision-makers are located who make the decision to undertake the campaign (or to select the particular independent agency, or to determine the scope and thrust of the campaign)? If the funding is relevant and is traceable to a part of the enterprise other than the permanent establishment, should that suggest that the risk has been borne by that part of the enterprise? Or does it instead suggest that that part of the enterprise has effectively made a capital contribution or loan to the PE, or has performed a service for the PE?

Another example would be the common situation in which head office personnel set the bad debt exposure limitation policies for the enterprise, produce a written manual, and provide training to branch personnel. The branch personnel responsible for accounts receivable then apply those policies. Where are the enterprise’s credit and collection risks considered to be managed? Are they managed where the policies for limiting those risks are developed, or where those policies are implemented? The Report does not indicate which of these functions would be considered determinative, or what their relative importance would be if both were taken into account.

A variety of different approaches to characterizing common business arrangements could be reasonable in the context of separate enterprises. More needs to be done to give greater certainty to taxpayers acting as single enterprises on how they will have to arrange their affairs to be confident that tax authorities will respect their characterization of the arrangement.

Additional guidance is also needed on how the taxpayer can demonstrate that risks (or assets) are properly attributed to its head office or other parts of the enterprise, rather than to the permanent establishment in question. The 2004 Report does acknowledge that a “just in time” manufacturing program administered by the head office may eliminate inventory risk attributable

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35 Id. ¶ 1.25.
to the permanent establishment. However, it fails to address the treatment of other activities normally conducted by the head office, including participation in risk management (insurance) activities, in the development or oversight of standards for extending credit, in carrying out the financing function for the enterprise as a whole, in market research or development of marketing strategy or advertising content, and in development or funding of trademarks, customer lists, and the like. As currently drafted, the Report does not indicate how a determination will be made as to whether head office activities attract risk and corresponding return (as opposed to only a service fee). Additional guidance is needed on these issues.

Nor is it clear, as an evidentiary matter, how much weight will be accorded to accounting records or other internal documentation reflecting the transfer of risks (e.g., the “factoring” of receivables) to the head office. Will evidence of how independent manufacturing and distribution enterprises typically allocate product liability and foreign exchange risks be regarded as relevant, and, if so, will it be required? These points should be clarified.

Finally, it is noted that the 2001 Draft acknowledged disagreement among OECD member countries about the extent, if any, to which the risk analysis should take into account as an internal condition of the enterprise the mitigating factors resulting from the fact that the permanent establishment belongs to a wider enterprise. The 2004 Report removed this discussion without indicating whether or how this disagreement has been resolved. Any remaining disagreement on this issue would create uncertainty and potential controversy and should, therefore, be resolved.

5. Attribution of Capital

The 2004 Report continues to espouse the basic principles that capital follows risks and that a permanent establishment must have attributed to it sufficient capital to support the functions it undertakes, the assets it uses, and the risks it assumes. However, it significantly modifies and expands the 2001 discussion regarding capital attribution and addresses a number of ancillary issues. It is obvious that the 2004 Report drew heavily on the analysis developed in connection with the OECD’s publication of the 2001 and 2003 versions of Part II of the Permanent Establishment Profit Attribution project, relating to the banking sector. One could reasonably ask whether the influence of that financial sector analysis hasn’t unduly tainted the analysis in the 2004 Report. For example, one might even question whether it is appropriate to apply the “capital follows risk” principle outside the relatively non-capital-intensive financial sector, and whether it might not be more appropriate to recognize that risk can follow capital in capital-intensive industries.

In any event, the 2004 Report rejects the preference stated in the 2001 Draft for a single method of allocation and provides several alternative methods for attributing an arm’s length amount of capital to a permanent establishment. It indicates that this was done because it was not possible.

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36 See 2004 Report, ¶ 281.

37 See 2001 Draft, ¶ 59.
to achieve an international consensus on a single allocation method, which it suggests was due to the fact that “there is no single approach which is capable of dealing with all circumstances.”

The 2004 Report accordingly endorses four alternative approaches, which differ substantially:

1. The **Capital Allocation Approach**, which involves allocating an enterprise’s actual “free” capital in accordance with the attribution of assets owned and risks assumed, but does not indicate how those two bases are weighted;

2. The **Economic Capital Allocation Approach**, which involves allocating economic capital based on all economic risks;

3. The **Thin Capitalization Approach**, which requires the permanent establishment to have the same amount of “free” capital as would an independent enterprise carrying on the same or similar activities under the same or similar conditions in the host country; and

4. The **Safe Harbour Approach**, a quasi-thin capitalization or regulatory minimum capital approach, which requires the permanent establishment to have at least the same amount of “free” capital required for regulatory purposes as would an independent enterprise operating in its sector in the host country, potentially combined with a safe harbour.

The 2004 Report states that each alternative approach has strengths and weaknesses that will become more or less material depending on the facts and circumstances of the case. Its discussion of the four alternative approaches notes significant issues and difficulties with each, including but not limited to: likely double taxation under the first and the third alternatives; the likely unavailability under the second alternative of the necessary risk measurement systems in non-financial institutions; and the difficulty under the fourth alternative in finding objective sector benchmarks outside the regulated financial sector that are suitable even as safe harbors.

To the extent that taxpayers are allowed to choose from among the alternative methods, the resulting flexibility may assist them in applying the authorised OECD approach. However, it is not entirely clear from the 2004 Report whether taxpayers are free to make this choice, or whether it is a decision to be made by each OECD member state. In any event, it seems that the differences among the methods and their numerous weaknesses are likely to give rise to numerous disputes between taxpayers and tax authorities or among tax authorities. Although the 2004 Report provides a certain amount of detail and states an intention to “set[] forth a clear principle and provid[e] practical guidance on how to apply that principle in practice,” it does not

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38 See 2004 Report, ¶ 142.

39 Id. ¶ 63.

40 Id. ¶¶ 97-134.
furnish adequate guidance to ensure clear and consistent application.\textsuperscript{41} It correctly notes that, under the current interpretation of Article 7, a mutual agreement may be difficult to achieve because countries take different approaches to attributing the capital of an enterprise to its parts.\textsuperscript{42} The 2004 Report may avoid the current disagreements between the “single entity” and “separate enterprise” approaches under Article 7, but it does not appear to reflect an international consensus adequate to preclude new differences from arising. Such differences seem especially likely, given that the 2004 Report acknowledges that the impact of the capital allocation rules on permanent establishments outside the financial sector may be “significant.”\textsuperscript{43}

As noted above, the 2004 Report concludes that Article 23 requires the home country to give relief for tax on profits calculated in accordance with the approach adopted by the host country, provided that the host country applies an authorised method and produces an arm’s length result.\textsuperscript{44} The 2004 Report notes that the Mutual Agreement Procedure can be applied to resolve any disputes as to whether a particular result is at arm’s length.\textsuperscript{45} If the Article 23 mechanism proves successful, it will represent an improvement in reducing disputes among countries. However, care would need to be taken to ensure that existing disputes regarding capital allocation are not simply transformed into disputes on issues relating to application of the arm’s length principle. In addition, continuing disputes between taxpayers and tax authorities regarding the choice of allocation method and the manner in which each is to be applied would seem to remain likely unless the final Report is able to narrow the potential for disagreement on these points by providing additional guidance.

6. Comparability Analysis

Once the appropriate functions, assets, and risks are attributed to the permanent establishment, the 2004 Report requires the application of traditional transfer pricing methods to determine the arm’s length profit the permanent establishment would earn if it were a comparable independent enterprise. Application of the required comparability analysis to determine the profits of the hypothesized distinct and separate entity will raise additional issues. In addition to the usual challenges encountered in separate entity situations, the absence of contracts in the permanent establishment context, and of documentation more generally in the case of dependent agent permanent establishments, will make the application of a proper comparability analysis very difficult.

\textsuperscript{41} Id., ¶ 101.
\textsuperscript{42} Id.
\textsuperscript{43} Id. ¶ 98.
\textsuperscript{44} Id. ¶¶ 35-43, 144.
\textsuperscript{45} Id. ¶ 145.
As an initial matter, there may be factual disagreements about whether a “dealing” (i.e., a transaction between the permanent establishment and another part of the enterprise) involving an “economically significant” transfer of risks, responsibilities, and benefits has occurred, as required by the 2004 Report.46 “Dealings” include, for example, the use of an intangible asset and the provision of internal services. Such dealings may be difficult, as a practical matter, to ascertain and value in the permanent establishment context.

The 2004 Report calls, first, for an examination of the enterprise’s accounting records, along with any contemporaneous correspondence, communications, or other internal documentation.47 However, it acknowledges that such records and documentation may not exist in the case of a permanent establishment and expresses concern that they may not be reliable. In such a case, the 2004 Report indicates that the identification of dealings will turn on the parties’ conduct, on generally applicable economic principles governing relationships between independent enterprises, and, ultimately, on a factual and functional analysis to determine the economic reality behind any documented dealing. It does not elaborate on what indicia of “conduct” may be relevant. The 2004 Report calls for the imputation of contractual terms to internal dealings within the enterprise, by analogy to the contractual terms of comparable transactions between independent enterprises.48 This will require a series of subjective determinations that presumably will give rise to disagreements in at least some cases.

The 2004 Report also notes that the relationship between a permanent establishment and the other parts of an enterprise with respect to an activity might be analogized to a cost contribution (cost sharing) arrangement, if they are found to be “economic coparticipants” in the activity.49 It confirms that a cost contribution arrangement analogy would “not ordinarily” be applied unless the enterprise intended and documented such an arrangement.50 Conversely, the 2004 Report imposes an especially heavy burden of proof, including a contemporaneous documentation requirement, on a taxpayer seeking to assert a notional cost contribution arrangement. This presumably will make such treatment inapplicable or unavailable in many cases.

Difficult issues also may arise in connection with intangible property. The 2004 Report significantly expands the discussion of intangible property, and explicitly rejects certain positions taken in paragraph 17.4 of the current Article 7 Commentary.51 For example, paragraph 17.4 had generally precluded the possibility of attributing economic ownership of an intangible to a single part of an enterprise which might then charge notional royalties to other

46 Id. ¶ 177.
47 Id. ¶¶ 178-180.
48 Id. ¶ 179.
49 Id. ¶ 191.
50 Id. ¶¶ 192-194.
51 Id. ¶¶ 219-220.
parts of the enterprise using the intangible. The 2004 Report reflects a much greater willingness to attribute economic ownership of an intangible to a particular part (or parts) of an enterprise, and to allow that part (or those parts) to derive a return, including possibly a notional royalty.

The 2004 Report discusses the determination of the “economic owner” of intangible property, both for internally developed and acquired intangibles and for trade and marketing intangibles. The ownership and use of trade intangibles developed by the enterprise are said generally to depend on which part of the enterprise undertakes the “active decision-making” and the “day-to-day management” of the risks associated with its development.\(^{52}\) In contrast, where a trade intangible is acquired by the enterprise, the discussion generally focuses on where the intangible is used but leaves room in some cases for the determination to be based instead on activities relating to its acquisition. The parameters of this exception are left unclear, creating ambiguity as to whether activities relating to acquisition or use will determine economic ownership in a particular case. Moreover, in many cases, the function of acquiring a trade intangible may involve just as much entrepreneurial decision-making (and risk-taking) as the function of developing a trade intangible internally. For this reason, concerns exist that 2004 Report may overstate the significance of where an acquired intangible is used.

In addition, for reasons that are not clear and that have no apparent legal or policy basis, the 2004 Report appears to provide a different approach for marketing intangibles. It asserts that it generally is not possible to identify one part of the enterprise as the owner of global marketing intangibles, although this may sometimes be possible for marketing intangibles specific to the permanent establishment host country.\(^{53}\) This approach appears designed to allow host jurisdictions to tax profits that they attribute to locally developed intangibles, while denying the home jurisdiction any profit with respect to global intangibles, although it may have allowed substantial deductions for the expenses associated with their development. This appears likely to result in a shift of tax revenues to host jurisdictions, absent a change in the fundamental business practices of global companies. Unless the intention of the Report is to achieve one or both of these results, this point should reconsidered and clarified.

The 2004 Report then addresses how to ensure that the economic owner of the intangible is attributed an arm’s length return. For this purpose, it generally applies the OECD Transfer Pricing Guidelines by analogy. It specifically endorses the use of notional internal royalties, profit splits, and cost contribution arrangement-type approaches.\(^{54}\) Although the additional guidance provided by the 2004 Report on these issues is useful, it may remain difficult in practice to determine whether the permanent establishment participated, as a factual matter, in creating the intangible. Other difficult issues include whether the permanent establishment has a notional right to use (or an interest in) the intangible, to what extent the permanent establishment

\(^{52}\) Id. ¶¶ 228-234.

\(^{53}\) Id. ¶¶ 239-242.

\(^{54}\) Id. ¶¶ 244-251.
uses the intangible, and how to address simultaneous use of the intangible by more than one part of the enterprise.

Changes in the use of a capital asset may also raise difficult issues, including how to document such changes, how to determine the nature of the dealing, how to determine the profit to be attributed to the permanent establishment, and how to achieve symmetrical treatment of the transfer in the host and home countries. These issues are not addressed adequately by the 2004 Report.

Finally, issues may arise in connection with the performance of internal services. However, while the 2001 Draft indicated a divergence of views among countries regarding the appropriate treatment of internal services in situations involving a permanent establishment, the 2004 Report indicates broad consensus. The agreed approach is to apply the OECD Transfer Pricing Guidelines by analogy to determine whether and to what extent support functions performed by the permanent establishment for another part of the enterprise, or vice versa, should be rewarded.55 The 2004 Report emphasizes that a tax administration may choose to forgo taxing certain services at arm’s length in some circumstances.56 Based on past experience, however, it would seem likely that disagreements will still arise among countries, or between taxpayers and tax administrations, as to whether and how internal services should be rewarded in particular cases.

7. Application of Transfer Pricing Methods

While the 2004 Report clearly indicates that the OECD Transfer Pricing Guidelines are to be applied “by analogy” under the authorised OECD approach, it contains very little discussion of how the method is to be chosen. Only two paragraphs consider this issue, with the first concluding that the CUP method “might” be applied in one scenario and the second noting that a comparable resale price margin “might” be used in another.57

A more detailed discussion is needed, at a level of specificity similar to that provided in the 2002 Australian Taxation Office discussion paper on this issue.58 This would serve the dual purpose of providing much-needed guidance to taxpayers on this key issue and confirming an adequate level of agreement on it among tax authorities. The applicability of the basic principles set forth in the Transfer Pricing Guidelines regarding the choice of method also need to be confirmed. This is needed to address the current insistence by examiners in some countries, such as Canada,

55 Id. ¶ 262.
56 Id. ¶ 263.
57 Id. ¶¶ 182, 183.
India, and Korea, on the application of a profit split method to permanent establishments, despite the availability of other, more appropriate methods in many cases.

8. Dependent Agent Permanent Establishments

The 2004 Report adds a relatively detailed discussion of the treatment of permanent establishments that are deemed to arise because of the activities of a dependent agent. However, after acknowledging in the 2001 Draft that such “dependent agent permanent establishments” raise issues that need to be addressed, Working Party No. 6 has concluded that they should be subject to the same profit attribution rules as are actual branches.

Although it does not definitively rule out the possibility, the 2004 Report confirms that the activities of a “mere sales agent” are unlikely to result in the attribution of profits to a permanent establishment in respect of marketing or trade intangibles.\(^{59}\) It also confirms that the host country must allow an arm’s length reward for the services provided to the permanent establishment by the non-resident enterprise and suggests that there may be little or no net profits to attribute to the permanent establishment in some cases. In addition, although it may not reassure taxpayers that have already encountered such arguments on examination, the 2004 Report attempts to dispel concerns that a “force of attraction” rule may be applied by default in some countries to over-attribute profits to host countries.\(^{60}\) It also takes care to note that the application of the authorised OECD approach in the dependent agent context is not predicated on any lowering of the threshold of what constitutes a permanent establishment.\(^{61}\) These statements are positive but would be more helpful if the Report provided additional detail, for example, by defining what constitutes a “mere sales agent.”

On the other hand, the 2004 Report emphasizes that profits may be attributable to a dependent agent permanent establishment that arises, for example, in connection with the conversion of a full-fledged distributor into a “risk stripped” operation, if the same personnel continue to perform key entrepreneurial risk taking functions in the host country.\(^{62}\) The Report bases this conclusion on the position that “under the authorised OECD approach it is not possible within a single enterprise to strip risks from the key entrepreneurial risk-taking functions that give rise to those risks.”\(^{63}\) This discussion implicitly assumes the existence of a permanent establishment in such cases. It seems inappropriate to draw conclusions on this issue before Working Party No. 1, which has primary responsibility at the OECD for permanent establishment issues, has addressed the point and before the January 2005 roundtable discussion with business on this topic. Another

\(^{59}\) See 2004 Draft, ¶ 272.

\(^{60}\) Id. ¶ 267. A force of attraction approach would involve attributing to the permanent establishment profits beyond those generated by the activities of the permanent establishment.

\(^{61}\) Id. ¶ 266.

\(^{62}\) Id. ¶ 282.

\(^{63}\) Id. ¶ 285.
concern is that this discussion does not clearly state the implicit principle, namely, that the profits attributable to the permanent establishment, if any, will change if the functions, assets, and risks change. Recent examination experience in a number of countries, which have effectively sought to disregard valid restructurings, indicate that this point should be made more explicitly.

The 2004 Report dismisses the concern that dependent agent permanent establishments may give rise to documentation issues even more serious than those associated with other types of permanent establishments.\(^{64}\) Indeed, it confirms that the nonresident enterprise would, “just as for other types of PEs, be required to document how it has attributed profit to its dependent agent PE.”\(^{65}\) As acknowledged by the 2004 Report, however, this may present special challenges because the dependent agent permanent establishment may not have any separate accounting records and the nonresident enterprise may not have any physical presence in the host country. The 2004 Report gives no practical guidance on how taxpayers should anticipate the assertion by host countries of a deemed permanent establishment or should “document” dealings between such a permanent establishment and the rest of the enterprise. Nor does it indicate how taxpayers may rebut any challenge to their profit allocation based on whether the “conduct” of such a notional permanent establishment and its “economic reality” is consistent with that allocation.

The novel and practical difficulties of such an exercise, combined with the Report’s position that the taxpayer bears the evidentiary burden of justifying its profits allocation, raise serious concerns and difficulties for business. As suggested earlier, there is a belief among some in the business community that the compliance costs and uncertainties caused by the need to apply the Report’s very subjective standards may significantly outweigh the potential shift in tax revenues that could result from adoption of the OECD’s authorized approach. This is especially true in the case of dependent agent permanent establishments, where the likelihood of significant profits being found attributable to the permanent establishment is particularly low. It is perhaps ironic that one of the countries often thought of as among the most aggressive in its assertion of taxing jurisdiction against permanent establishments is India, and that the Indian tax authorities recently abandoned their proposal to demand greater tax revenue from foreign companies’ Indian dependent agent permanent establishments so long as the Indian entity receives an arm’s length fee for its efforts.

Similar issues may well arise for “fixed place of business” permanent establishments, where a non-resident entity is deemed to have a permanent establishment because another entity’s facilities in the host country are considered to be at its disposal. The 2004 Report does not provide any insight on these situations, although they presumably would present many of the same compliance difficulties as do dependent agent permanent establishments. Examiners in

\(^{64}\) Id. ¶ 287.

\(^{65}\) Id.
several countries have already begun to propose adjustments on this basis, so the Report should address these issues as well.

9. Legal Effect

The intended legal effect, if any, of the 2004 Report should be clarified in advance of its finalization and approval by the OECD. The 2004 Report suggests that, once finalized, its conclusions will be “implemented” through amendments to the Commentary on Article 7, and supplemented with “[f]urther practical guidance” in OECD background reports or in the OECD Transfer Pricing Guidelines. The 2004 Report also seems to reflect the view that any issues regarding authority can be addressed through “clarifying changes to the Commentary,” i.e., without changes to the OECD Model Convention or to existing or future bilateral treaties. This approach seems to be confirmed by the removal, in the 2004 Draft, of the reference in the 2001 Draft to the potential need for changes to the text of Article 7. This suggestion is surprising, given the admission by the 2004 Report that it is rejecting the prior OECD approach or interpretation of numerous points.

Tax authorities, including the U.S. Treasury Department and the Internal Revenue Service, should make known in advance their position on the legal effect of the Report and of any accompanying Commentary changes on their interpretation of existing or future bilateral treaties. As discussed below, it is appropriate that existing treaties, at least, be amended if tax authorities wish to apply the authorised OECD approach to the detriment of taxpayers. On the other hand, the adoption of implementing changes to the Commentary to reflect the final version of the 2004 Report may well give taxpayers a basis for demanding application of the authorized OECD approach where it is to their benefit.

As a general matter, it is appropriate to note that additional process steps are required before the 2004 Report can truly be viewed as having reached the stage of providing a legal and administrable framework for the attribution of profits to permanent establishments. Notwithstanding the official-sounding “authorised OECD approach” terminology used in the 2004 Report, the final version of the Report should caution both tax authorities and taxpayers that it cannot be viewed as having any legal effect. Moreover, there is a concern on the part of the business community that mere finalization of the 2004 Report will cause some countries to believe there are now well-developed rules for attributing profits to permanent establishments, which will likely lead to more ready assertions of permanent establishment status. In reality, however, the 2004 Report falls far short of providing the kind of clear and administrable guidance necessary to create a zone of certainty about the ultimate result. Several further steps will be required to approach that goal, including amendment of the Article 7 Commentary (and perhaps of the text of Article 7 itself) and refinement of the Transfer Pricing Guidelines to better

67 Id. ¶ 4.
illustrate how they should be applied “by analogy” to the permanent establishment situation. In addition, the renegotiation of bilateral treaties may be necessary in some countries to give legal effect to the proposed OECD approach, at least in the case of those predating these amendments.

D. Practical Implementation Issues

1. Issues for Governments

   a. Consistent and fair application

To ensure the consistent and fair application of the authorised OECD approach to taxpayers, adequate guidance must be provided in advance regarding the operation of that approach. As noted above, additional guidance providing a clearer and more detailed articulation of the applicable rules is needed on a number of issues.

   b. Access to information

The 2004 Report notes that the authorized OECD approach generally is preferable in terms of administrability to the “relevant business activity” approach; because the source jurisdiction is not required to determine the enterprise’s worldwide profits from the relevant business activity (unless a profit split method is used). It presumes that all necessary information regarding the attribution of profits will be readily available in both the residence and source jurisdictions, but does not indicate how this is to be accomplished. It would not seem feasible for the treaty exchange of information program to be used for this purpose, given the number of cases involved. On the other hand, the difficulties that would be raised by any requirement that taxpayers prepare and provide documentation are discussed below.

   c. Administrative resources

Tax administrations can expect to experience an increased demand for examination and other resources to administer the complexities of the authorised OECD approach. Similarly, they should expect an increased demand for competent authority resources to address the increased number of cross-border disputes that will arise upon implementation of that approach.

2. Issues for taxpayers

   a. Adequate guidance

Taxpayers need adequate guidance regarding the intended operation of the authorised OECD approach in order to apply it. As discussed above, although somewhat expanded relative to the

69 \textit{id.} ¶¶ 25, 26.

70 \textit{id.} ¶ 264.
2001 Draft, the guidance currently provided by the 2004 Report and, by analogy, the Transfer Pricing Guidelines, provides insufficient detail. Practical examples are also essential.

b. Documentation

The 2004 Report places increased emphasis on “documentation” and makes it clear that the onus will be on taxpayers to provide contemporaneous documentation of the manner in which they attribute profits to their permanent establishments.71 The 2004 Report recognizes that this will require the documentation in many cases of internal dealings for which no documentation is currently maintained or required, particularly where the taxpayer did not intend to create a permanent establishment. However, it characterizes this as an issue that can be addressed through taxpayer education.72 It also recognizes that there are transition issues for existing situations in which no documentation exists, but indicates that this issue will be considered after the Report is finalized and approved and solicits suggestions for how to address such issues.73

At the same time, the 2004 Report expresses great skepticism about the reliability of taxpayer documentation. It states repeatedly that, although contemporaneous taxpayer documentation is required and may provide a useful starting point, it will not be determinative where it departs from “the economic reality,” as determined under the factual and functional analysis performed by tax examiners.74 Internal documentation regarding attribution of risks is listed as the last of three factors that may aid in the “deduction” of how risks and responsibilities were divided within the enterprise, and is caveated by reference to a discussion of the limitations of taxpayer documentation.75 The 2004 Draft even suggests that “greater scrutiny” will be required in the case of dealings involving PEs than for transactions between separate legal entities.76 This apparent attitude of strong skepticism toward taxpayer documentation is unjustified and risks creating an atmosphere where disputes will be frequent and difficult to resolve. Given that taxpayers are to be subjected to significant new documentation burdens for profit attribution purposes alone, it would seem more appropriate to provide a presumption that their contemporaneous documentation will be respected unless shown to be inaccurate. The desirability of allowing taxpayers to create some certainty by responsibly documenting the nature of their permanent establishments’ activities is clear in the case of “fixed base” permanent establishments, but it is perhaps even more obvious in the case of dependent agent permanent establishments, where the “notional” aspect of the permanent establishment provides little alternative evidentiary proof of the nature of those activities.

71 Id.
72 Id. ¶ 265.
73 Id. Preface, ¶ 6.
74 See, e.g., 2004 Report, ¶¶ 67, 180, 264.
75 Id. ¶ 88.
76 Id. ¶¶ 174-176.
c. **Anti-abuse focus**

The 2004 Report contains numerous references to avoiding “less than single taxation,” which appear in tandem with references to double taxation concerns. Compared to the 2001 Draft, the 2004 Report also reflects an increased focus on perceived opportunities for tax avoidance thought to be available to taxpayers operating through permanent establishments rather than subsidiaries.\(^77\) It indicates that “greater scrutiny” will be required in the case of dealings with PEs than for transactions between separate legal entities.\(^78\) To the extent that such concerns have influenced the design of the authorised OECD approach, the balance needs to be restored to reflect the fact that the risks of double taxation outweigh the prospects of less than single taxation in the great majority of situations.

The 2004 Report also contains a new statement that appears to allow countries the discretion to apply “any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks.”\(^79\) This provision does not seem to distinguish legitimate shifting of risks out of the permanent establishment’s host jurisdiction from abusive transactions, and may, consequently, encourage some countries to attack even the former, where it results in reduced profit levels. This point should be clarified.

Finally, the tone of the 2004 Report seems to be largely negative vis-à-vis taxpayers. This approach seems inappropriate in circumstances in which taxpayers are being asked to assume significantly increased compliance burdens.

3. **Transition Issues**

The 2004 Report acknowledges that implementation of the authorised OECD approach will raise certain significant transition issues. However, it proposes to address such issues only after the Report is finalized.\(^80\) This piecemeal approach would create unnecessary uncertainty for taxpayers and should be abandoned in favor of addressing all identified issues at the time the Report is finalized.

4. **Other Administrative Burdens**

The 2004 Report notes that some countries require a dependent agent PE to file a tax return, while others find more administratively convenient ways to collect any tax due, including by collecting it from the dependent agent enterprise.\(^81\) It suggests that these issues should be left to

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\(^{77}\) See, e.g., 2004 Report, ¶¶ 66, 111, 147, 154, 155.

\(^{78}\) Id. ¶¶ 66, 175.

\(^{79}\) Id. ¶ 71.

\(^{80}\) Id., Preface, ¶6.

\(^{81}\) Id. ¶ 286.
the domestic rules of the host country. This discussion should be more prescriptive in urging countries to develop simplified administrative procedures for dependent agent PEs where possible. It should be clarified that it is not intended to give host countries carte blanche to tax the resident dependent agent enterprise on the profits otherwise allocable to the dependent agent permanent establishment, but rather to approve an administrative means of collecting the tax due from the permanent establishment.

Given the lack of clarity associated with these issues, it should also be confirmed that non-filing or late-filing penalties will not be assessed against dependent agent permanent establishments, unless the taxpayer is shown to have known, or to have had reason to know, that it had such a permanent establishment.


A. General Concerns

To date, the United States has agreed in only two recent treaty agreements—those with the U.K. and Japan—to the application by analogy of transfer pricing principles to attribute profits to a permanent establishment. Other recent treaty agreements have not included such a provision, and its absence has not been explained. This raises the question as to whether a negative inference regarding application of the new approach should be drawn from those other treaties.

Given the significance of the change and the need to ensure symmetrical approaches in the residence and source jurisdictions, we believe that it is appropriate to amend treaties where application of the authorised OECD approach is desired. Confirmation by the U.S. Treasury Department of its position in this regard would provide taxpayers with greater guidance and certainty.

The implications, if any, of applying the authorised OECD approach under some, but not all, U.S. bilateral treaties should be clarified. Will parallel application of the “old” and “new” profit attribution approaches create new risks of double taxation for global companies, in addition to increased administrative burdens for taxpayers that must apply parallel sets of rules? Is this merely a transition issue? If so, how urgent is its resolution? Should the United States consider the viability of single-issue protocols to address this issue more quickly?

Given the present insufficiency of guidance on the application of the authorised OECD approach, efforts to reach an international consensus through the OECD, in consultation with business, should be broadened and redoubled.

To minimize confusion during the transition period, adequate training should be provided to tax administrators and counsel.

B. Specific Drafting Issues

The recent U.S. treaties with the U.K. and Japan contain similar, but not identical, statements endorsing application by analogy of transfer pricing principles in the permanent establishment
context. The July 24, 2001 exchange of notes accompanying the treaty with the U.K. provides in
relevant part, in connection with Article 7, that—

[I]t is understood that the OECD Transfer Pricing Guidelines will apply, by
analogy, for the purposes of determining the profits attributable to a permanent
establishment. Accordingly, any of the methods described therein - including
profits methods - may be used to determine the income of a permanent
establishment so long as those methods are applied in accordance with the
Guidelines. In particular, in determining the amount of attributable profits, the
permanent establishment shall be treated as having the same amount of capital
that it would need to support its activities if it were a distinct and separate
enterprise engaged in the same or similar activities.

The notes subsequently exchanged on November 6, 2003 in connection with the signature of the
U.S.-Japan treaty state this point somewhat differently:

It is understood that the principle as set out in paragraph 1 of Article 9 of the
Convention may apply for the purposes of determining the profits to be attributed
to a permanent establishment. It is understood that the provisions of Article 7 of
the Convention shall not prevent the Contracting States from treating the
permanent establishment as having the same amount of capital that it would need
to support its activities if it were a distinct and separate enterprise engaged in the
same or similar activities.

There are two substantive differences in these formulations, which may or may not turn out to
have practical implications. The first is that the U.K. language is mandatory (“shall”), while the
Japanese language appears to be discretionary (“may,” “shall not prevent”). The Japanese
language seems puzzling, given that neither the 2004 Report nor the 2001 Draft characterizes
application of the authorised OECD approach in the treaty context as optional. While the
attribution of capital appears to be left to the discretion of the Contracting States, it is not clear
whether the application of Article 9 [transfer pricing] principles is meant to be at the discretion
of the Contracting States, of the taxpayer, or both. This creates a risk of disputes between the tax
authorities, and between the taxpayer and the tax authorities, regarding the approach to be
followed in a particular case. This uncertainty should be clarified and should be avoided in
future treaties.

The other substantive difference in the U.K. and Japanese treaty approaches is that the U.K.
agreement refers broadly, as does the 2004 Report, to the OECD Transfer Pricing Guidelines.
The Japanese language refers instead to Article 9(1) of the bilateral treaty. This may not make a
difference in practice, given other statements in the Notes regarding the OECD Guidelines.
However, the difference introduces potential confusion that also should be avoided in the future.
CHAPTER 2
PRACTICAL ISSUES REGARDING TREATY IMPLEMENTATION

I. Introduction

A. Importance of Proper Treaty Implementation

To fulfill their intended purposes, treaties must be properly implemented by both countries. This involves three essential aspects. First, treaties must be implemented in a manner that provides adequate guidance in advance regarding their interpretation, as a legal matter. Second, there also must be adequate certainty in advance regarding the manner in which the treaties will be applied in practice. Finally, mechanisms must be provided to ensure the effective and efficient application of the treaty and the resolution of any disputes that may arise regarding its interpretation or application.

Current experience indicates that treaties are properly implemented in most cases. However, where treaty provisions are not properly implemented, there are serious consequences. Both business and government incur increased administrative and compliance costs because of resulting disputes. Double taxation or inappropriate taxation may result, and may remain unrelieved. Finally, business confidence in treaties is undermined, which may cause distortions in cross-border trade and investment.

B. Summary of Key Issues Relating to Mutual Agreement Procedures

Failures to implement treaty provisions properly generally stem from a limited number of commonly recurring concerns, each of which is discussed in detail below. The first set of concerns involves situations where access to MAP consideration is either explicitly or effectively restricted, often because of inadequate transparency or through the unclear or unfair application of deadlines. Access problems can also arise from inflexibility regarding the parties to the MAP process, its unanticipated or undesirable interaction with domestic proceedings, failure to suspend the collection of asserted tax liabilities during MAP consideration, the improper assertion of anti-abuse exclusions, and the unwillingness or inability of some competent authorities to consider double taxation cases not explicitly provided for by the treaty.

The second set of general concerns involve structural issues relating to the MAP process. These include situations in which the competent authority has inadequate legal or organizational authority, lacks adequate independence, is not adequately coordinated with other governmental functions, is not adequately centralized, or lacks adequate resources.

Another type of concern relates to MAP operational issues, typically involving insufficient communication, inordinate case processing delays, or inappropriate case resolutions that are unprincipled, non-neutral, or inconsistent.
C. Summary of Conclusions and Recommendations on Mutual Agreement Procedures

A series of specific recommendations are outlined below to address concerns regarding restricted access to MAP consideration, its interaction with domestic proceedings, structural and operational issues regarding the MAP process, and other treaty implementation concerns. In addition to these specific recommendations, a number of general improvements are needed.

First, a much broader international consensus on key MAP process issues is needed to reduce compliance costs and eliminate procedural “traps for the unwary.” The Manual on Effective Mutual Agreement Procedures proposed by the OECD Dispute Resolution Report should help, but its non-binding nature will limit its utility. On key issues that can preclude MAP consideration, such as the definition of when “notification” of the taxpayer occurs for purposes of treaty MAP deadlines and the application of those deadlines in the withholding tax context, changes to the OECD Model Convention or Commentary, and to the U.S. Model Convention and Model Technical Explanation, are advisable. Certain issues, such as the applicability or non-applicability of domestic statutes of limitations, also should be addressed via bilateral treaty, to ensure binding and reciprocal effect. The conclusion of a bilateral agreement interpreting an existing bilateral treaty may be an alternative means of addressing other issues, such as the suspension of collection during MAP consideration. For example, the U.S. competent authority has usefully published agreements entered into with the U.K. and Netherlands competent authorities about agreed approaches to the competent authority process, and all such generic agreements between competent authorities should be made public as a matter of “best practice.”

Second, the role of the competent authorities should be expanded to address additional issues where appropriate and feasible. For example, MAP agreements on particular cases should generally cover future years as well as past years, as is currently the case for transfer pricing issues addressed in APAs. The competent authorities should devote more attention to addressing general issues of process. They should also exercise more frequently their authority to resolve interpretive issues of general application, where appropriate.

Finally, as discussed in Chapter 3 of this study, recourse to mandatory, binding arbitration is urgently needed as an additional safeguard to ensure the appropriate functioning of the MAP process and the successful resolution of cases in instances where that process fails.

D. Key Issues and Recommendations on Other Treaty Implementation Issues

In the area of procedural requirements for claiming treaty benefits, problems can arise where countries are unwilling to grant treaty relief except through refund claims, or where the procedures for taxpayers to certify their entitlement to treaty benefits or to obtain certification of their residency status from their home country tax officials are unduly onerous, time-consuming, or expensive. This Report recommends significantly enhanced coordination between treaty
partners to simplify and streamline their procedures. It also recommends the institution of efforts by the United States and the OECD to establish, with input from the business community, an international consensus for more standardized and modernized procedures, as well as a “peer review” process to monitor treaty countries’ adherence to international standards.

Taxpayers should be able to obtain advance rulings on a timely basis on issues of treaty interpretation relevant to their situations. In the United States, this may require a more robust administration of the private letter ruling process, as well as an expansion of the Pre-Filing Agreement program. Greater use should also be made of the ability granted by treaties to competent authorities to enter into mutual agreements to resolve generic issues of interpretation and to improve the procedural mechanisms for claiming treaty benefits.

Finally, a note of caution is included about the increasingly prevalent and complicated anti-treaty shopping (“Limitation on Benefits”) provisions found in U.S. tax treaties, to ensure that appropriate attention is paid to their administrability, so that they do not become unduly restrictive in operation.

II. Implications for Business

A. Growing Concerns Regarding Treaty Implementation

The number and complexity of cross-border tax disputes is increasing.83 The geographic scope of such disputes is also expanding, with cases involving a total of 36 countries pending before the U.S. competent authority according to recent reports.84 Serious treaty implementation issues are arising in both OECD and non-OECD member countries. At the same time, it appears that instances where the competent authority process provides no relief, or only partial relief, may be increasing.

Several different types of concerns are arising. These concerns, which are discussed in turn below, include (1) treaty dispute resolution process issues, (2) other treaty implementation issues, and (3) substantive issues of treaty interpretation.

III. Implications for Governments

A. Resources

Most tax administrations already face existing and projected resource constraints. The growing number and complexity of treaty disputes can be expected to place additional strains on available


resources. Tax administrations should, consequently, have a strong incentive to find more
efficient and effective means of implementing treaties.

B. “Self-Help”

Real or perceived treaty implementation failures may encourage taxpayers to resort to “self-
help,” by settling foreign examinations without seeking MAP consideration and claiming
adjustments on their home country returns to relieve the resulting double taxation. The OECD
Dispute Resolution Report expresses concern that this “less than satisfactory unilateral solution”
may lead to taxation not in accordance with the treaty and increase compliance burdens. The inclination of taxpayers to seek “self-help” in some circumstances is understandable, but it
obviously can have negative revenue implications for the affected governments (although foreign
tax credit limitations may discourage this in some cases). A broader concern is that, if
widespread, such “self-help” behavior may have the perverse effect of perpetuating, and even
worsening, the inappropriate treaty implementation practices that prompted it.

C. Relationships

Persistent treaty implementation problems may have a broader detrimental effect on the general
relationship between the treaty partners. It may also negatively affect the relationships between
taxpayers and the governments concerned.

IV. Current Concerns Regarding Treaty Dispute Resolution Processes

A. Restricted Access to Mutual Agreement Process (MAP)

1. Lack of Transparency

In many countries, there is a general lack of transparency regarding MAP procedures. Often,
there is are no published procedures or other guidance regarding MAP, although the publication
of such guidance is recommended by the OECD Commentary on Article 25 (Mutual Agreement
Procedure) and by the OECD Transfer Pricing Guidelines. In such cases, taxpayers are not
notified of applicable MAP procedures, requirements, and expectations, and even the identity
and address of the competent authority may be unknown.

Even where the process is relatively transparent, the positions taken by the competent authority
on general issues of procedure or interpretation often are not published or widely known. Taxpayers may also lack information regarding interpretive issues, if any, that the competent
authority is unwilling to consider and may, therefore, be surprised by the unavailability of MAP
consideration in some cases.

85 OECD Dispute Resolution Report, ¶ 3.

86 See OECD Commentary on Article 25, ¶ 30; OECD Transfer Pricing Guidelines for Multinational Enterprises and
The transparency of the MAP process needs to be improved in many countries, including both OECD and non-OECD member countries. The OECD website posting of “Country Profiles” providing basic information is a positive development, but additional steps are needed. As the OECD Dispute Resolution Report confirms, countries need to publish more detailed guidance on their MAP processes and on positions taken by their competent authority regarding general issues of procedure and interpretation.87

2. MAP Application Deadlines

Access to the MAP procedures provided by treaty may be effectively denied if an application deadline is imposed in an unclear or unfair manner. This may result from the inappropriate interpretation or application of either a treaty provision or a domestic law provision.

a. Treaty Deadlines

Some treaties set a deadline by which the taxpayer must request MAP consideration, typically three years from the “first notification of the action resulting in taxation not in accordance with the provisions of the Convention.”88 In cases involving a treaty deadline, two types of issues tend to prevent access to MAP.

The first is an interpretive issue as to when the relevant “notification” of the taxpayer occurs. Disagreements arise in particular cases regarding what constitutes a “notification” or which “action” was the one “resulting” in the taxation at issue. The OECD Commentary suggests that such issues should be interpreted in the manner most favorable to the taxpayer,89 but this recommendation unfortunately is not universally followed in practice. It would be helpful to have a consensus on common interpretive issues developed and published, rather than leaving them to be resolved on an ad hoc basis.

The standard treaty MAP deadline provision creates special difficulties in cases relating to taxes withheld at source, because it is unclear when the relevant “action” and “notification” should be considered to occur. The OECD Commentary is less helpful on this issue, taking the position that “the time limit begins to run from the moment when the income is paid,” unless the taxpayer proves that it did not become aware of the withholding until a later date.90 Where this little-known interpretation is applied, the taxpayer may be denied MAP access even where the source country’s assertion of taxing jurisdiction is clearly contrary to the treaty. To its credit, the OECD Dispute Resolution Report acknowledges the difficulties that this presents in some cases and encourages “a common approach,” or at least the public indication by the competent authorities

87 OECD Dispute Resolution Report, ¶ 14.
88 See, e.g., OECD Model Convention, Article 25(1).
89 See OECD Commentary on Article 25, ¶ 18.
90 Id.
of their respective views on this issue. This could be helpful. However, the OECD Commentary also should be amended to address this issue affirmatively, ideally by indicating that the relevant “notification” occurs in such situations only if and when the residence country takes steps to deny relief from double taxation in respect of the taxation at source.

The second type of issue that arises in connection with treaty MAP application deadlines is that the deadline may expire while the taxpayer is still engaged in domestic proceedings that it is either required or well-advised to pursue in advance of MAP. The OECD Dispute Resolution Report notes that interpreting the treaty deadline to run during the conduct of domestic proceedings may not represent a good faith interpretation of the treaty, but it suggests only that any such interaction be clarified and that taxpayers be warned of any risk of losing MAP access. It is helpful to have this issue acknowledged, but an affirmative solution that clearly prevents such scenarios from arising (e.g., through clarification in the OECD Commentary of when the relevant “notification” or “action” occurs) would be more useful.

b. Domestic Law Deadlines

Problems can also arise when domestic law deadlines on adjustments or refunds are applied to limit MAP access, especially where this is done in an unclear or unfair manner. This can occur, for example, with the unexpected application of a domestic statute of limitations where the treaty does not provide a deadline for requesting MAP consideration. Applicable deadlines, if any, for invoking the MAP process should be clearly and publicly stated.

Some countries take a clear position on the application of their domestic law deadlines but do not permit taxpayers to extend the statute of limitations where it is necessary to allow MAP consideration. This can be a particular problem where the domestic statute period is very short and, thus, invariably expires before the examination is completed, but similar problems may arise in other cases. Taxpayers, therefore, should be permitted to extend a domestic statute of limitations that is applied for treaty purposes, to the extent necessary to allow subsequent MAP consideration.

3. Timing of Initiation

Often, it is also unclear at what point in the process the taxpayer may request MAP consideration. Article 25 clearly indicates that the taxpayer need not wait for double or inappropriate taxation to occur before initiating the MAP process. The OECD Commentary on Article 25 indicates that the taxpayer must demonstrate that “this taxation appears as a risk which is not merely possible but probable,” but does not indicate how this determination is to be made. This remains an issue on which countries differ, with some taking the position that

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91 OECD Dispute Resolution Report, ¶¶ 20-21.
92 Id. ¶ 22.
93 OECD Commentary on Article 25, ¶ 12.
MAP consideration may not be requested until a detailed proposed adjustment has been received. Unclear or conflicting positions on this issue may create not only confusion for taxpayers and for treaty partners, but also, in extreme cases, conflicts with MAP application deadlines, where applicable.

To avoid these difficulties, the point at which the taxpayer may apply for MAP consideration should be further clarified, preferably on an internationally consistent basis.

4. Inflexibility Regarding Parties

Access to MAP consideration is sometimes denied because of restrictions as to which competent authority a taxpayer may approach or which taxpayer is the recognized party at interest.

The first issue typically arises as a result of procedures specified by treaty. The U.S. Model allows the taxpayer to present its case to either competent authority, but the OECD Model and many bilateral treaties generally require that the taxpayer present its case to the competent authority in the taxpayer’s residence State. This restriction may have limited impact in the typical transfer pricing case involving related taxpayers, one of which is resident in each of the States. However, inflexible provisions of this sort can create problems, especially where the residence State has restrictive procedures or views about available solutions, or where the other State might be prepared to grant unilateral relief. To avoid such situations, treaties should be negotiated and interpreted to allow MAP requests to be initiated in either State.

Taxpayers that are withholding agents can also face obstacles. In some countries, such as Japan, MAP personnel take the view that only the income recipients themselves are eligible to access the MAP procedure. This can have the effect of denying MAP access in cases where the withholding agent, rather than the income recipient, has effective liability for the tax, or where the number of income recipients involved would make the MAP process unworkable as a practical matter. Treaties should be interpreted to eliminate such barriers to access by intended beneficiaries.

5. Interaction With Domestic Proceedings

a. Examination Adjustments

The efficacy and efficiency of MAP proceedings depend heavily, in the first instance, on the effectiveness of the tax examination process. If the adjustments proposed by examiners lack a sound basis in fact or are inconsistent with the provisions of applicable treaties, and MAP personnel are pressured or feel obliged to support those adjustments, the MAP consideration of those cases is unlikely to proceed smoothly or quickly. Inefficiencies may also be caused by insufficient explanation or documentation of the examiners’ analysis. Countries should take steps to address any such examination issues that may be interfering with the conduct of MAP proceedings.
b. Revenue Targets

These problems can be greatly exacerbated where examiners are given assessment quotas or revenue targets, or are otherwise evaluated or rewarded on the basis of the revenues involved in the cases for which they are responsible. The problem becomes particularly acute where examiners are measured solely on the basis of their initial proposed adjustments, without reference to subsequent reductions. Similar issues can arise where MAP personnel are evaluated or rewarded based on the adjustments they “sustain.” In such cases, at least one of the Contracting States is not applying the treaty in good faith. To prevent such interference, all revenue-based measures, implicit or explicit, should be eliminated throughout the tax administration.

c. Forced Settlements

In some countries, taxpayers are routinely pressured to settle cases at the examination level without MAP review. The taxpayer typically is presented with a questionable adjustment, together with the threat of a much larger adjustment (often four or five times greater) if it declines to waive MAP access. An alternative approach is to offer an amnesty program that purports to be voluntary but threatens the taxpayer with a much larger adjustment if it declines to participate. Taxpayers report that this examination practice is growing significantly, even in OECD member countries. It appears to be particularly common in Italy and Korea, but has also been experienced on occasion in other countries, such as Germany.

Such practices put the taxpayer in a difficult position, especially in countries with dysfunctional MAP processes, because its residence State will likely expect or require it to seek MAP review of such foreign adjustments. They clearly are inconsistent with the obligation of the parties to apply the treaty in good faith. The negotiation of examination settlements contingent on the taxpayer’s waiver of MAP access thus should be explicitly prohibited in published guidance to which the taxpayer can refer. In addition, the competent authority should publicly adopt a policy of disregarding any such restrictions negotiated by examiners.

d. Provisions of Domestic Law

Some countries take the position that domestic law provisions limit the flexibility of the competent authority in resolving disputes. Under this approach, the competent authority is not permitted to conclude MAP agreements that are inconsistent with the provisions of domestic law. This view seems flatly inconsistent with the country’s obligations under its tax treaties, which establish a common approach on agreed issues that often departs from the domestic laws of one or both of the Contracting States. While countries may differ in good faith regarding the interpretation of certain treaty provisions, there is no basis for the position that domestic law provisions govern the application of the treaty in particular cases.

Procedures should be established to ensure that the competent authority applies the provisions of the treaty in good faith, without reference to any conflicting domestic law provisions. At a minimum, circumstances in which the provisions of domestic law are considered to limit the ability of the competent authority to resolve cases should be publicly disclosed in advance.


e. Litigation

In many countries, including the United States and Canada, the competent authority regards itself as precluded from departing from any prior judicial decision in the case. While there may be a natural inclination for tax administrators to defer when the courts have spoken, such policies effectively require the taxpayer to forgo its access to domestic judicial review in order to ensure the availability of the MAP consideration contemplated by treaty.

In extreme cases, the competent authority may also take the position that MAP consideration terminates, and cannot later be reinstated, if the taxpayer concurrently seeks judicial review. This has occurred in China, for example, to the surprise of some taxpayers. Other countries, such as the United States and Canada, have taken the position that MAP consideration may not proceed while a case is pending before a court, although they generally do not preclude the subsequent consideration of the case by the competent authorities.

Interactions between the MAP and judicial processes that operate to deny access to either forum should be avoided, perhaps simply by providing procedures to suspend court proceedings during MAP consideration of a case, or vice versa. Ideally, this should be done on an internationally consistent basis to avoid conflicts in approach among countries. At a minimum, to avoid surprises, each country should issue clear guidance regarding the manner in which the MAP and judicial processes are considered to relate to each other.

f. Other Proceedings

Other domestic proceedings can affect the scope or availability of MAP consideration in many countries. For example, some countries take the position that the taxpayer must choose between domestic appeals review and MAP consideration. Thus, the taxpayer may effectively be required to forgo certain domestic procedures, to which it would otherwise have recourse as a matter of right, in order to preserve its access to MAP consideration, which treaties generally also provide as a matter of right. Not all countries put taxpayers on notice regarding these issues or provide adequate information so they may be identified and evaluated in advance.

Countries should take steps to address issues created by the interaction of domestic administrative processes and MAP, with a view to ensuring that taxpayers maintain access to the MAP consideration provided by treaty without having to forfeit their rights under domestic administrative review procedures. Situations in which MAP and domestic processes are considered mutually exclusive should be kept to a minimum and should be clearly identified in advance.

6. Suspension of Collection

Many countries, including the United States, India, and Korea, have adopted either a formal policy or an administrative practice of suspending the collection of taxes in dispute under the
MAP process until that process is concluded. However, there are notable exceptions to this rule, such as Canada.94

The suspension of collection during MAP consideration is important for several reasons. First, as the amounts at issue in MAP often are substantial and typically represent double (or unanticipated) taxation, advance collection of the asserted tax liability can create cash flow problems that effectively deny MAP access to some taxpayers. Second, the collection of tax prior to completion of MAP may exacerbate the problematic situation that exists under some treaties, where the taxpayer is charged interest on an underpayment in one country but is not paid interest on an overpayment in the other. Finally, although it represents a failure to apply the treaty in good faith, some countries clearly are less willing in practice to reach a MAP agreement that would require the refund of taxes already collected.

For these reasons, it is essential to the proper functioning of the MAP process that collection be suspended until that process is complete. The universal adoption of this practice should be strongly encouraged by the OECD, and should be confirmed, if necessary, by bilateral treaty or competent authority agreements.

7. Anti-Abuse Exclusions

Some countries attempt to exclude cases from competent authority consideration if they regard the taxpayer as having engaged in abusive behavior. This practice seems to be increasing, with such concerns even being raised for the first time at the competent authority level in some cases. This concern has arisen, for example, in cases with Australia, Canada, and Switzerland.

This practice is particularly surprising and troubling where such allegations relate to a transaction or structure that has already passed muster on examination, or where the legal standards for an abuse determination are unclear. Very few countries have published policies regarding the circumstances in which competent authority consideration will be denied, and those that do often do not provide sufficient guidance on this issue.

The OECD Dispute Resolution Report expresses concern regarding the exclusion of cases from MAP based on perceived abuse, noting that countries take different views on what constitutes fraud or tax avoidance. This is reflected, for example, in the differences between the current policies of the United States and Canada, two of the few countries with published positions on this issue. The U.S. procedures do not apply anti-abuse notions to exclude cases from competent authority consideration, but they do exclude cases relating to transactions involving “fraudulent activity” by the taxpayer.95 The Canadian policy, as reflected in the pending CRA competent authority draft circular, would be to deny Canadian relief under MAP in cases involving tax avoidance “where the primary position of a Canadian-initiated reassessment was made under

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94 Canada requires payment of 50 percent of the asserted liability as a prerequisite for competent authority consideration.

anti-avoidance sections of the *Income Tax Act* including the Income Tax Regulations. While clearly more circumscribed than a purely subjective determination of abuse, the Canadian approach references broad domestic law anti-avoidance principles and would, therefore, clearly set a much lower threshold for exclusion than would the U.S. fraud standard.

The European experience under the EU Multilateral Convention on Arbitration is instructive in this regard. Access to the arbitration proceedings established by the Convention is denied for cases involving “serious penalties.” The rationale for a penalty-based exclusion is not clear. However, it is clear that it has a disparate impact on taxpayers resident in different EU Member States, due to differences in laws among the Member States. Each Member State has, therefore, had to provide a unilateral statement of its interpretation of this provision, as an annex to the Convention. The business members of the EU Joint Transfer Pricing Forum have also expressed fairness concerns regarding the application of this factor, as it is largely within the control of a single would-be party to the arbitration proceeding.

Similar concerns seem likely to arise in connection with any standard for excluding cases from MAP consideration that is subject to unilateral interpretation. The OECD Dispute Resolution Report notes this concern and suggests that it be avoided by prohibiting the exclusion of cases from MAP consideration except on agreed grounds specified in the treaty itself. This recommendation is an excellent one that should be adopted by the United States and other countries.

8. Double Taxation Cases

Proper treaty implementation also may be impeded by issues regarding the operation of the MAP process under Article 25(3) in cases of double taxation “not provided for in the Convention.” Article 25(3) provides that the competent authorities “may … consult together for the elimination of double taxation” in such cases. The OECD Commentary notes that this provision is of particular relevance in cases where a third-country resident has a permanent establishment in each Contracting State. The OECD Dispute Resolution Report adds that Article 25(3) is of growing importance as the sole source of MAP access for cases involving allocations between permanent establishments.

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96 Draft IC 71-17R5, section 38.

97 See EU Multilateral Convention on Arbitration, Article 8.


99 OECD Commentary on Article 25, ¶ 37.

100 OECD Dispute Resolution Report, ¶ 120.
Not all countries include an Article 25(3) provision in their treaties, however. Even where it is included, some countries take the view that taxpayers do not have access to MAP consideration under Article 25(3) as a matter of right and limit such access in practice. Other countries take the position that the competent authority lacks the authority to relieve double taxation in such cases, as they are not addressed by the treaty. The OECD Commentary acknowledges and appears to support the latter position.101

It is imperative that MAP consideration be made universally available in cases of double taxation not otherwise addressed by treaty. As noted by the OECD Dispute Resolution Draft, this is especially critical for purposes of addressing issues regarding the attribution of profits to permanent establishments where the enterprise is resident elsewhere. Universal access to MAP consideration under Article 25(3), and the right of taxpayers to invoke and receive such consideration, should be provided contemporaneously with the implementation of the new OECD approach on profit attribution.

B. MAP Structural Issues

1. Inadequate Authority

Treaty implementation issues may arise not only from restrictions on MAP access but also from critical shortcomings in the structure or operation of a country’s MAP program. One set of common problems arises from the failure to provide the competent authority with adequate authority to conclude MAP agreements and ensure their implementation. To ensure the good faith implementation of treaties, it is critical that the competent authority be provided with adequate authority of both a legal and an organizational nature.

The competent authority must have the legal authority to depart from domestic law where necessary and appropriate to implement treaty provisions, to provide unilateral relief where appropriate, to direct the implementation of MAP agreements, and to protect taxpayer confidentiality in accordance with the requirements of the treaty. Otherwise, the competent authority cannot properly fulfill its role in ensuring that the treaty is implemented as intended.

In addition to legal authority, however, the competent authority function must have adequate authority in fact. If it lacks authority as a matter of organizational politics, the competent authority will be unable or unwilling to perform its responsibilities under the treaty. Effective authority within the organization is required, for example, to compromise adjustments proposed by the examination function where warranted and to ensure good faith implementation of MAP agreements by other administrative functions, including the prompt issuance of agreed refunds.

2. Inadequate Independence

Another common structural shortcoming is failure to provide the competent authority with adequate independence. To fulfill its role in ensuring the proper implementation of treaties, the

101 OECD Commentary on Article 25, ¶ 37.
competent authority must operate independently from the examination function. Otherwise, competent authority personnel will lack the ability or the inclination to review proposed adjustments critically and to compromise them where appropriate under the treaty.

For similar reasons, competent authority personnel must be free of any revenue targets or revenue-driven performance measures, implicit or explicit, that could impair their judgment or impartiality.

Finally, care must be taken to insulate competent authority personnel from any other inappropriate influences that may impede the proper performance of its function, such as external pressures to provide inappropriate treatment in a particular case.

3. **Inadequate Coordination**

Although the independence of the competent authority must be safeguarded, it must coordinate with other governmental functions on general issues to the extent necessary to ensure the appropriate application of the treaty. For example, there must be a process to ensure that the competent authorities interpret the treaty in accordance with the clear intention of the negotiators. In addition, where the policymakers of both countries have agreed to a common interpretation of the treaty as reflected in the OECD Commentaries or in bilateral materials, there should be adequate coordination to ensure that both competent authorities apply that interpretation correctly. This can be a problem in some countries where there is not adequate coordination between the policy and administrative functions.

4. **Inadequate Centralization**

Problems may also arise from the inadequate centralization of MAP authority. If it is unclear who has the ultimate authority to make decisions, or if this information is not public, the competent authority function will operate less efficiently. In some cases, this lack of clarity and transparency can result in the effective denial of MAP access.

5. **Inadequate Resources**

The MAP process can be seriously undermined by a failure to dedicate adequate resources to it. Appropriate resources are needed in several arenas. First, the competent authority function must be staffed with adequate personnel to analyze and discuss cases thoroughly and promptly. Second, those personnel must receive sufficient training to perform their designated duties. Third, adequate travel funds are needed to enable competent authority personnel to meet face-to-face where necessary to resolve cases. Other needed resources, such as access to economists and other experts, also must be provided to ensure the proper functioning of MAP.

C. **MAP Operational Issues**

Additional problems may arise from the inefficient or improper operation of the MAP process. Several types of difficulties are commonly encountered in practice.

1. **Insufficient Communication**
The first issue is simply insufficient communication regarding pending cases. There is a surprising lack of communication in some countries between competent authority personnel and taxpayers and their representatives regarding unresolved factual or interpretive issues, or even the status of the case. There can be a similar lack of communication between the competent authorities themselves. The competent authorities should adopt procedures to ensure regular and adequate communication so that consideration of cases progresses smoothly and efficiently. For example, joint presentations by the taxpayer to the competent authorities should be encouraged to minimize confusion, where they would expedite fact-finding.

2. Processing Delays

The second set of operational problems relates to excessive delays in case processing. Treaty MAP provisions require that the competent authorities endeavor to reach agreement but do not set timeframes for the conduct or conclusion of their discussions. The lack of deadlines leaves room for unresponsiveness, intentional “stone-walling,” and other inappropriate negotiating behaviors that impede the efficient and effective operation of the MAP process.

Competent authorities should implement procedures, both unilaterally and bilaterally, to prevent unnecessary delays in the MAP process. They should streamline their internal case-handling procedures, including appropriate monitoring processes, where necessary. They also should publish annual data on the effectiveness of their MAP procedures (e.g., statistics on average case cycle times and percentage of double tax relief achieved). This would promote increased accountability, and would help to address the general perception of MAP as a “black box” process. In the interest of greater transparency and accountability, these statistics should be analyzed and published on a country-by-country basis.

Bilaterally, the competent authorities should schedule meetings, telephone calls, and other opportunities to discuss cases as frequently as resources permit, and, where appropriate, set target timeframes on a bilateral basis for the resolution of cases. Appropriate elevation procedures should be considered for cases that the competent authority personnel have been unable to resolve on a timely basis. This should be done only where it appears that elevating the case to more senior competent authority officials would improve case processing. Care must be taken to avoid creating procedures that could have a negative effect on the handling of cases, for example, by effectively discouraging the resolution of cases at lower levels.

3. Inappropriate Resolutions

The MAP process also fails to operate properly, even where cases are resolved, if the resolutions lack a principled basis or are not concluded in a neutral or consistent manner. Such practices create an unfair and unacceptable level of uncertainty regarding the tax treatment of global companies in affected jurisdictions. They also cause taxpayers to lose faith in the MAP process generally.

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102 See, e.g., OECD Dispute Resolution Report, ¶ 9.
A general failure to resolve cases on a principled basis can easily undermine the operation of the MAP process. This typically happens where competent authority personnel are focused more on maximizing national revenues in each case than on resolving the issues presented in good faith, on the basis of general principles.

Similar issues are raised when there is a failure to resolve cases on neutral basis. This occurs whenever competent authority personnel promote or permit inconsistent treatment as between resident and non-resident taxpayers, or as between foreign- and locally-initiated adjustments, whether for revenue-driven reasons or otherwise.

Finally, if the competent authorities do not take care to ensure adequate consistency in the treatment of similarly situated taxpayers, the MAP process can have the collateral effect of creating undesirable competitive imbalances.

The competent authorities must be alert to the concerns caused by inappropriate resolutions and take affirmative steps to ensure the resolution of each case on a principled, neutral, and consistent basis, without regard to revenue implications.

V. Other Treaty Implementation Concerns

A. Procedural Requirements for Claiming Treaty Benefits

A critical factor in the effectiveness of tax treaties in reducing barriers to international trade and investment is the manner of their implementation by the United States and its treaty partners. Procedural mechanisms for claiming treaty benefits that are unduly burdensome, costly, or time-consuming can threaten to undermine the basic goals treaties are designed to achieve.

There are a number of aspects to the procedural implementation of treaty benefits, beyond specific-case mutual agreement proceedings, that are important.

One significant issue relates to whether treaty relief is available at the time of the initial receipt of income, or only through refund procedures. Many countries, including the United States, follow the general policy of allowing withholding tax relief on payments from sources within those countries at the payment stage, subject to appropriate certification by the income recipient of its entitlement to treaty relief. Other countries, however, require their tax to be collected up front, with treaty relief available only through applications for refund. Treaties themselves do not restrict a country’s choice of mechanism for granting relief. That being said, it is the experience of the business community that the practice of granting relief only through refunds tends to impair significantly the value of the treaty benefit, both from a time value of money perspective (i.e., because such countries do not typically compensate income recipients for the over-withholding of tax) and because such countries’ refund procedures are often onerous and lengthy. The practical difficulties of obtaining refunds from some countries after the fact may cause U.S. taxpayers to claim higher foreign tax credits than was contemplated by the treaty bargain, adversely affecting the U.S. fisc. An even worse problem may arise with respect to countries that offer relief only through compliance with specified procedures at the withholding stage, but where the complexities of those procedures make them difficult to complete before withholding must occur.
Accordingly, it would be useful for the United States to ensure, to the greatest extent possible, that its treaty partners grant treaty relief through reasonable procedures available at the withholding stage. This should be an issue that is discussed as part of treaty negotiations, and it should also be an issue that is dealt with through appropriate discussions between competent authorities. In addition, the OECD should be urged to take steps to encourage both its member countries and other countries to offer treaty relief at the withholding stage.

Another issue relates to the reasonableness of the procedures implemented by various countries for claiming treaty benefits, and to the coordination between treaty partners to ensure that taxpayers are able to comply reasonably with those procedures. Even for those countries that do offer relief at the withholding stage, the availability of that relief may be problematical due to the complexity of the procedures themselves.

A major overhaul of the U.S. cross-border withholding tax procedures (i.e., the section 1441 withholding regulations) in recent years has both clarified and significantly tightened the rules for claiming treaty relief. The U.S. approach has generally been to expand its demands for self-certification by foreign taxpayers that they are entitled to treaty benefits (but not to require the foreign taxpayers to produce residency certifications from their home country tax authorities). While the policy considerations underlying those reforms are reasonable, careful monitoring of their practical implications is warranted to ensure that the United States has struck the appropriate balance between enforcement and administrability.

Many if not most countries require certifications that may involve a combination of a self-certification from the taxpayer and a residency certification from the taxpayer’s home country tax authority. Thus, compliance with those procedures requires the taxpayer not only to produce timely paperwork on its own (e.g., by completing foreign government forms), but also to obtain timely residency certifications from its home government. The difficulties of meeting these goals can be exacerbated by problems with either country’s procedures. The United States during 2004 revised its procedures for granting residency certifications to U.S. taxpayers, in a generally laudable effort to rationalize and streamline that process (e.g., through the introduction of a standard request form). Notwithstanding these efforts, the process remains challenging and very paper-intensive for taxpayers facing withholding deadlines. The business community would welcome further IRS efforts to streamline that process (e.g., by minimizing the need for repetitive paperwork, improving communications channels between taxpayers and IRS processors, and improving the training of IRS processors).

The difficulty of complying with a foreign country’s procedures for claiming treaty relief at the withholding stage can be exacerbated by a number of circumstances. One problem arises where the foreign country requires repeated certification of the same status for recurring claims (e.g., requiring a U.S. company to produce certification of its status as such every year, or even with respect to every separate contract under which it receives payments or every separate payment). Poorly designed or confusing forms can also be a problem, as can unreasonable time delays in processing forms by either the source or residency country tax authorities. Inadequate legal protection for withholding agents who attempt to comply reasonably with prescribed procedures can also lead to over-withholding. The difficulties of complying with procedures have also been exacerbated by the complexity of the procedures relating to partnerships and other non-corporate
entities (the use of which has been increasing by business taxpayers) and by U.S. treaty partners’ efforts to enforce U.S. treaty “limitation on benefits” provisions against U.S. taxpayers at the withholding stage.

Other problems that arise in this area include the significant variations among the procedures of different countries, which increase the compliance burden and cost to the taxpayer that receives income from multiple countries, as well as the lack of coordination between residence and source countries to streamline procedures wherever possible.

A number of steps could be taken to improve the procedures for establishing entitlement to treaty benefits, thereby reducing costs and increasing certainty for taxpayers. For example, the procedures for obtaining residency certifications and completing other documentation requirements for obtaining treaty benefits in the United States and its treaty partners should be published, and should be simplified and expedited to the extent possible. The United States should be at the forefront of efforts to establish international consensus for more standardized and streamlined procedures on a broader basis. Innovative approaches should be actively explored, including, for example, the potential use of secure on-line databases of residency status of taxpayers to allow for rapid confirmation of treaty entitlement, without the need for costly and repetitive paperwork. OECD Working Party No. 8 should be encouraged to make such a project one of its priorities. It should work closely with business representatives to evaluate issues and alternatives. It should also be encouraged to establish a “peer review” process to monitor member States’ (and perhaps non-member States’) adherence to international standards and to press for improvements.

B. Mechanisms for Confirming Availability of Treaty Benefits

Taxpayers should be able to obtain advance rulings on a timely basis on issues of treaty interpretation relevant to their situation. The scope for obtaining determinations on such issues should be fairly broad and should include not only legal issues of interpretation but also factual issues (e.g., permanent establishment determinations, qualification for coverage under special provisions for particular forms of treaty relief, etc.) In the United States, this may require a more robust administration of the private letter ruling process, as well as an expansion of the Pre-Filing Agreement program. In connection with U.S. private letter ruling requests, the IRS policy of not issuing “comfort” rulings or “factual” rulings should be interpreted narrowly, and ruling requests should be processed as quickly as possible, given the importance of treaty benefits.

Issuance of broadly applicable guidance should be considered as an alternative to taxpayer-specific determinations to address issues more efficiently. One potentially significant but infrequently used procedure for addressing issues of treaty application and implementation is the mutual agreement procedure. Treaties routinely grant to competent authorities the authority “to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application” of the treaty. This authority can usefully be invoked to address particular substantive or procedural issues that arise under treaties, with a view towards the publication of
generic guidance reflecting the mutual agreement on the issue. The U.S. competent authority should vigorously exercise its ability under these provisions to reach agreements with foreign governments on more streamlined procedures for claiming treaty benefits. Competent authorities should communicate and coordinate on a regular basis to identify and resolve implementation problems.

C. Limitations on Benefits Issues

A final implementation issue to which the United States needs to be sensitive is the now almost universal presence of “limitation on benefits” provisions in U.S. treaties. Such provisions set conditions for qualification for treaty benefits which are often quite complicated and which extend far beyond mere residence. As more and more treaty partners join the United States in implementing procedures for enforcing these provisions, there is likely to be increasing pressure on the need for effective treaty implementation and for avoidance of an overly restrictive qualification process. The United States should carefully consider the administrability of such provisions, both at the negotiation stage and in discussions with treaty partners about procedural processes for enforcing them.

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103 See, e.g., Announcement 2004-60 (guidance on effective date of U.S.-Japan Treaty); Announcement 2001-119 (guidance on transition rules under U.S.-Luxembourg Treaty); Mexico’s 2003 miscellaneous regulation on the procedures for U.S. limited liability companies’ claims to Mexican treaty benefits.
CHAPTER 3

ARBITRATION

I. Introduction

A. Overview of Historical U.S. Treaty Policy

Compared to their counterparts in many other countries, U.S. tax policymakers have been slow to embrace arbitration in the tax treaty context. Until several years ago, the office of the U.S. competent authority was opposed to the provision of arbitration in U.S. tax treaties, on the assumption that it was not generally needed and could even interfere with the successful resolution of MAP cases. Following this cue, U.S. Treasury Department negotiators agreed reluctantly to demands in the late 1980s and early 1990s from some treaty partners for arbitration provisions, but only on a voluntary basis that allowed either treaty partner to opt out of arbitration in a particular case. In considering the first U.S. tax treaty arbitration provision, in the 1989 treaty with Germany, the Senate, while acknowledging that the tax system potentially had much to gain from the use of arbitration, suggested to the Treasury Department that it would nevertheless be appropriate to gain experience with that provision before putting additional arbitration provisions into effect. The U.S.-Germany provision was put into effect, but similar provisions in U.S. treaties with other countries (including Canada, France, Ireland, Italy, Kazakhstan, Ireland, Italy, Mexico, and the Netherlands) have not yet been put into effect. In the fifteen years since then, no cases have gone to arbitration under the U.S.-Germany Treaty, and anecdotal evidence suggests that the working relationship between the competent authorities of those two countries is very good.

B. Other Tax Arbitration Provisions

1. Other Bilateral Treaties

In recent years, many other countries have moved forward to include arbitration provisions in their tax treaties. The OECD Dispute Resolution Report indicates, for example, that over 60 bilateral treaties now contain arbitration provisions. The new treaty between Germany and Austria contains one of the most far-reaching arbitration clauses, providing for mandatory, binding arbitration on a broad range of treaty issues.

104 See Report of the Senate Foreign Relations Committee to the 1989 treaty with Germany (“The Committee believes that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws … However, the Committee also believes that the appropriateness of such a clause in a future treaty will depend strongly on the other party to the treaty, and the experience that the competent authorities have under the provision in the German treaty”).

105 OECD Dispute Resolution Report, ¶127.
2. EU Multilateral Convention

In 1995, European Union Member States put into effect a multilateral convention providing for mandatory arbitration of tax treaty disputes on transfer pricing and permanent establishment issues. During the initial five-year term of the EU Multilateral Convention, arbitration proceedings occurred in only one case, involving only two affiliates of a single taxpayer and two of the fifteen Member States. Anecdotal evidence suggests that the competent authorities resolved many cases, often immediately before the date on which arbitration would have become available under the Convention, in order to avoid arbitration. This experience demonstrates the positive effects that a mandatory arbitration provision can have for the MAP process generally.

3. OECD Dispute Resolution Project

Beginning in 2003, OECD Working Parties No. 1 and 6 formed a Joint Working Group to evaluate treaty dispute resolution issues and make recommendations for improvements. Among other issues, the Joint Working Group is studying arbitration and other “supplementary dispute resolution” mechanisms. Its initial report in July 2004, the OECD Dispute Resolution Report, contains a discussion of arbitration, including selected issues and alternatives.

The OECD dialogue regarding arbitration may have a number of benefits, including an increased understanding of arbitration processes and an appreciation of the role that arbitration can play in resolving treaty disputes. However, the potential benefits of the OECD project are limited by its terms, because the Joint Working Group’s consideration of arbitration is explicitly limited to study and discussion of issues. Even if the project resulted in a broad consensus supporting arbitration, an actual agreement or series of bilateral agreements would be required to implement arbitration processes.

C. Summary of Current Concerns

As acknowledged by the OECD Dispute Resolution Report, tax treaty disputes are growing in number and difficulty. Many taxpayers and tax administrations have growing concerns regarding the current and future ability of existing competent authority processes to address disputes in an effective and timely manner.

D. Summary of Conclusions and Recommendations

Although they generally work well, the voluntary dispute resolution processes currently provided by U.S. treaties are not adequate to address the most problematic cases and relationships. Relevant experience suggests that the operation and effectiveness of the competent authority process and the implementation of treaties generally, could be improved with the addition of arbitration as a mechanism to “back-stop” the competent authority process. The U.S. competent authority office has acknowledged this by reversing its prior opposition to arbitration. Mandatory, binding arbitration provisions should be added without delay to U.S. treaties.

106 OECD Dispute Resolution Report, ¶ 1.
II. Implications for Business

Business strongly supports the universal inclusion of mandatory, binding arbitration provisions in treaties to supplement the competent authority procedures. From the taxpayer’s perspective, such provisions would offer four key benefits. First, they would set an effective deadline for the conclusion of the competent authority process, thus improving its efficiency. Second, they would encourage competent authorities, and presumably examiners as well, to moderate any extreme positions they might otherwise be inclined to adopt. Third, arbitration provisions would provide assurance that treaty disputes ultimately will be resolved. Finally, they could have the additional benefit of providing book and accounting benefits by reducing contingent reserve requirements, as taxpayers could be assured of ultimate relief from double taxation even where the relationship between the competent authorities is not functioning smoothly.

III. Implications for Governments

Governments also stand to derive a number of benefits from the addition of arbitration provisions. First, such provisions would provide all treaty partners with a strong incentive to deal in good faith in the MAP process, and could have similar effects on the examination process. Second, arbitration would operate to ensure a resolution even where the treaty partner fails to participate in good faith in MAP cases. Third, arbitration would conserve government resources by setting an effective deadline for the resolution of MAP cases, thus eliminating lingering disputes.

From the government’s perspective, it presumably will be important to ensure that any mandatory, binding arbitration provisions included in treaties are properly designed, to avoid raising broader policy concerns regarding a loss, or perceived loss, of sovereignty. It should be possible to address any sovereignty concerns that may arise by structuring the arbitration process as an adjunct to the competent authority process rather than as a quasi-judicial proceeding, by making arbitration available by treaty only for issues already within the purview of the competent authorities, and by providing that arbitration decisions have no precedential legal effect for other cases.

IV. Arbitration Process Design Issues

The design of an arbitration procedure raises a series of design issues on which a number of alternatives could be adopted. The discussion below briefly summarizes the preferred approach of NFTC member companies on key issues.

A. Mandatory vs. Voluntary

It is essential to provide agreed arbitration procedures that are mandatory, with a commitment to submit cases to arbitration in specified circumstances (e.g., if competent authority process does not produce agreement within two years). This is needed to prevent Contracting States from agreeing to arbitration in principle but opting out of the process on a case-by-case basis. Taxpayers should be allowed, however, to opt out of arbitration before it commences, if they prefer to pursue litigation or other available remedies.
B. Binding vs. Non-Binding

Contacting States should agree by treaty to be bound by, and to promptly implement, the arbitration decision. To address government concerns regarding resources, it seems fair to expect taxpayers also to agree in advance to be bound by the arbitration decision. For similar reasons, taxpayers should be prepared to agree not to withdraw from the arbitration process once it has commenced. To avoid unnecessary added delay and expense, the approach of the EU Multilateral Convention allowing the competent authorities to modify the arbitration decision by subsequent agreement should not be adopted.

C. Eligible Disputes

Arbitration should not be limited to transfer pricing and permanent establishment disputes, as is the case under the EU Multilateral Convention. This would fail to provide recourse with respect to some of the most contentious issues of interpretation currently arising under tax treaties, such as characterization issues relating to withholding taxes and permanent establishment definition issues. Rather, arbitration should be available for any issue that the competent authorities may resolve by mutual agreement under the treaty, including issues of treaty interpretation and cases of double taxation not addressed by the treaty.

D. Coordination with MAP Process

To avoid potential interference with the MAP process, arbitration should become available only after MAP consideration has failed to produce an agreement within a specified time period. To address government concerns regarding resources and forum-shopping, arbitration should not be allowed to address dissatisfaction with the outcome of the MAP process, where the governments have reached agreement. However, situations in which only partial relief is provided by the competent authorities should be eligible for arbitration with respect to unresolved issues or amounts. Similarly, to address government concerns regarding interference with the MAP process, arbitration procedures should be designed carefully to avoid creating an unintended incentive for taxpayers to withhold cooperation during competent authority process.

E. Coordination with APA Process

Arbitration should be made available in the APA context as well, both in the general interest of dispute resolution and to avoid creating a disincentive for taxpayers to use that process. Special coordination procedures may be required, however, because APAs involve both domestic contractual agreements and, in the case of bilateral and multilateral agreements, competent authority negotiations.

F. Coordination with Domestic Processes

Taxpayers should have the right to pursue otherwise available domestic processes if they prefer, up to the time that arbitration commences. They should be alerted to the fact that some domestic processes, such as litigation resulting in a final determination or settlement, may limit the availability of MAP consideration under applicable procedures in some jurisdictions. If this occurs, the availability of arbitration under the treaty may also be adversely affected. Taxpayers,
therefore, should give careful consideration to the sequence in which they pursue remedies that may be mutually exclusive.

In addition, under U.S. law, taxpayers are required to exhaust all “effective and practical remedies,” including the competent authority process, to protect their rights to claim foreign tax credits.\footnote{See Treas. Reg. § 1.901-2(e)(5).} It should be clarified in advance whether arbitration, where available, will be considered one of the “effective and practical remedies” that taxpayers must exhaust for this purpose.

**G. Constitution of Arbitration Panel**

Procedures should be established for the selection of a panel that will be regarded by the Contracting States and the taxpayers as unbiased, have a specified odd number of members (for tie-breaking purposes), and be no larger than necessary. Although a variety of processes could work, these criteria would seem most efficiently satisfied by forming a panel of three arbitrators, with one selected by each Contracting State and the third selected by agreement of the first two. (An alternative selection mechanism will, of course, need to be provided in case the first two arbitrators cannot reach agreement on the third.) The EU Multilateral Convention provides for a larger panel, but it is not clear what benefit this provides, and a large panel would seem likely to result in unnecessary additional costs and delay.

The desired qualifications of the arbitrators could be considered by the Contracting States on a bilateral basis if desired. To avoid the delays experienced in the selection of arbitrators under the EU Multilateral Convention, however, it would seem easiest to allow each Contracting State to exercise its discretion in selecting the arbitrator that it appoints to the board, and to allow the arbitrators thus selected to exercise their discretion in selecting the third.

The compensation of the arbitrators should be agreed in advance by the Contracting States on a bilateral basis.

**H. Operating Procedures**

Procedures need to be specified in advance, by treaty or accompanying agreements, in sufficient detail so that they can be applied without creating a basis for further controversy and delay during the arbitration proceeding. The procedures should be akin to administrative rather than judicial proceedings. This will expedite the process, reduce costs, and minimize potential sovereignty concerns.

Both taxpayers and the Contracting States should have right to make their views known to the arbitration panel and to rebut arguments presented by each other. To expedite and simplify the arbitration process, serious consideration should be given to a process in which all contact with arbitration panel occurs in writing.
The treaty should establish a clear deadline for arbitration proceedings, for example, two months to appoint the panel and six months thereafter for the panel to make its determination.

I. Bases for Decision

A last-best-offer (“baseball”) arbitration mechanism, in which the arbitration panel would be required to base its decision on the position of one party or the other, would have several advantages. First, it would deter the adoption of unfounded or extreme positions, which could also have a positive effect on the competent authority process and the bilateral treaty relationship generally. Second, it would simplify and expedite the arbitration process itself. Finally, it would enable each of the Contracting States and the taxpayer to propose and advocate its desired outcome. The possibility of a tie could be addressed by giving the third arbitrator a tie-breaking vote.

If desired, the treaty or accompanying materials could specify acceptable or preferred bases for the arbitration decision. These could include, for example, applicable treaty provisions, accompanying materials evidencing the intention of the treaty negotiators, relevant judicial decisions, relevant OECD materials agreed to by the Contracting States, and relevant domestic law provisions (where not in conflict with the treaty).

J. Decision of Arbitrators

A brief written statement summarizing the decision should be provided to the taxpayers and the Contracting States. An explanatory opinion should not be prepared, because it could be misinterpreted as having an unintended and unwarranted precedential effect, could be subject to public release in some jurisdictions, putting taxpayer confidentiality at risk, and could create a potential disincentive for some governments to embrace arbitration. A written opinion is not necessary if it is agreed that arbitration proceedings will have no precedential effect.

K. Implementation of Arbitration Decision

The competent authorities should be given responsibility for implementing the arbitration decision, with a specified deadline if desired. This is appropriate because the arbitration process will operate as an adjunct to the MAP process. The competent authorities also have the greatest experience in implementing cross-border agreements under tax treaties.

L. Availability of Judicial Review

The decision of the arbitration panel should not be subject to judicial review. This would undermine the goal of expediting the dispute resolution process at a reasonable cost.

There should be a right of judicial action solely for purposes of enforcing an arbitration decision, should it become necessary. However, competent authority experience suggests that this is highly unlikely, given the usual context of an ongoing tax treaty relationship. Unlike in commercial arbitration cases, implementation of MAP agreements, once concluded, has not proven problematic even in contentious cases.
M. Costs

Although arbitration provisions can be expected to conserve resources for governments on an overall basis, certain out-of-pocket expenses will be incurred in connection with any cases that go to arbitration. It should be agreed in advance as a general matter, on a bilateral basis, how such costs will be paid. The most appropriate approach would appear to be for taxpayers and Contracting States to cover their own expenses and for Contracting States to split the out-of-pocket costs associated with the arbitration panel’s expenses.

A mechanism would need to be provided to ensure that each Contracting State meets its cost obligations. Procedural appropriations issues also would need to be addressed in advance, at least in the United States.

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CHAPTER 4
PERMANENT ESTABLISHMENT ISSUES

I. Introduction

A. Overview of Historical U.S. Treaty Policy

The United States historically has sought to include in its treaties a permanent establishment threshold that maintains an appropriate balance between the revenue claims of source and residence countries. For this purpose, U.S. treaties have included in Article 5 (Permanent Establishment) provisions precluding source country taxation of the business profits of a non-resident enterprise unless the enterprise’s participation in the source country’s economy exceeds a specified level. Most U.S. treaties have followed closely the language of Article 5 of the OECD Model Convention, which historically has been interpreted as setting a permanent establishment threshold that generally favors residence-based taxation of business profits.

B. Summary of Current Concerns

Global businesses are experiencing a significant increase in examination activity around the world relating to permanent establishment issues. These cases are being referred to the competent authorities in greater numbers, and they already are encountering difficulty in resolving many of them. Recent efforts within the OECD to clarify the parameters of the permanent establishment concept arguably have led to its expansion in some respects and have introduced certain potential ambiguities that may exacerbate current trends. Business is concerned about the increased risk of multiple or unanticipated taxation, the exposures associated with unexpected permanent establishment challenges, the difficulty of resolving cross-border controversies on these issues, and the associated compliance burdens.

C. Summary of Conclusions and Recommendations

The recent efforts at the OECD to achieve a broad international consensus on certain permanent establishment issues represent a potentially positive step, although they have raised some new concerns and ambiguities. Many of the remaining concerns likely could be alleviated by clarifying the intended interpretation of the OECD Commentary on several important issues. These include issues relating to dependent agent permanent establishments and to the “fixed place of business” requirement, as well as issues relating the meaning of the terms “at its disposal,” “place of management,” “authority to conclude contracts,” and “independent agent” acting “in the ordinary course of business.” Additional guidance on these issues would assist both taxpayers and tax authorities attempting to apply treaty permanent establishment provisions and to minimize the risks of multiple or unanticipated taxation that the competent authorities may be unable to resolve. Serious consideration also should be given to the adoption of clear, internationally agreed time “floors”, which could further these goals if properly designed and applied.
II. Purpose of Permanent Establishment Threshold

The purpose of the permanent establishment threshold is to strike an appropriate balance between source- and residence-based taxation by preventing taxation of a non-resident enterprise unless its contact with the source country exceeds a specified threshold. This approach reflects both policy and practical considerations.

A. Policy Considerations

As a policy matter, the setting of a permanent establishment threshold reflects a view that the source-based taxation of business profits is appropriate only where the enterprise has a sufficient level of penetration in the local economy. It properly balances revenue with administrative concerns, in the interest of facilitating cross-border trade and investment, where there is relatively little at stake for either the company or the government.

B. Practical Considerations

There are also practical reasons for avoiding the source-based taxation of business profits where the enterprise’s contact with the source country is limited. The permanent establishment threshold plays an important role in preventing the imposition of a cumulative tax compliance burden and aggregate level of uncertainty that could impede the global conduct of business. Properly applied, the permanent establishment threshold eliminates the requirement to file tax returns and manage the tax compliance process in every jurisdiction with which the business has any contact whatsoever, which would quickly become cost-prohibitive for global businesses. The permanent establishment threshold also eliminates the need to perform complex tax computations, such as the sourcing of income and the attribution or allocation of expenses, for jurisdictions in which the enterprise has a limited presence.

Another practical consideration is that the source jurisdiction is unlikely to have access to the information it would need to properly determine the net-basis tax liability of the permanent establishment. It is not feasible or appropriate to require the enterprise to provide information on its worldwide operations to every jurisdiction with which it has any contact. Nor can the exchange of information provided for by treaty efficiently remedy this shortcoming, given the large volume and broad geographical scope of information needed.

In addition, the residence country typically is in a better position to collect a net-basis tax liability. The enterprise may have no representatives situated in the source country if it is deemed to have a permanent establishment in the absence of a branch office, and it often will have no or very limited assets there. Some treaties do provide for assistance in the collection of taxes owed to the other contracting state, but such provisions are rare and do not normally provide for a state to collect tax from its own residents.

III. Implications for Business

A. Increased Risk of Multiple or Unanticipated Taxation
The number of permanent establishment challenges raised on examination is increasing. Permanent establishment issues were identified as a leading concern in the National Foreign Trade Council’s 2004 Tax Treaty Survey of its member companies, with more than 80 percent of respondents naming permanent establishment issues as one of their top two treaty concerns in at least one jurisdiction. At last count, the U.S. competent authority reported an increasing number of cases, with 29 pending and 7 closed cases involving permanent establishment issues.108 The French competent authority recently reported a similar increase in permanent establishment cases, with some 15 cases pending as of July 2004 and 5 closed in 2004.109

This increased focus on permanent establishment issues is widespread among both OECD and non-OECD member countries. Of the 29 pending cases recently reported by the U.S. competent authority, 18 were initiated by Asian countries, 3 by European countries, 1 by the United States, and 7 by other Western Hemisphere countries.110 In the 2004 Tax Treaty Survey, NFTC member companies expressed concern about PE issues in 28 of the 37 countries included. Australia, Brazil, Canada, China, Denmark, France, Germany, India, Italy, Japan, Korea, Mexico, the Netherlands, and Singapore are particularly active on permanent establishment issues in the experience of member companies, but concerns have also been expressed, in the Survey or subsequently, by one or more NFTC member companies regarding permanent establishment positions taken by Angola, Argentina, Azerbaijan, Belgium, Chile, Colombia, Indonesia, Ireland, Israel, Kazakhstan, Malaysia, New Zealand, Pakistan, Russia, Saudi Arabia, South Africa, Spain, Switzerland, Taiwan, Thailand, Turkey, and Venezuela.

This growth in the competent authority inventory reflects the fact that countries are not only increasing examination activity on permanent establishment issues but also adopting inconsistent positions on those issues. New disagreements are surfacing where none were apparent based on published guidance or past administrative practices. Taxpayers are being surprised by proposed adjustments often lacking a clear legal or factual basis. A prime example is the recent Italian court decision in the Philip Morris case, holding that an Italian company created permanent establishments for multiple Philip Morris affiliates on grounds widely regarded as inconsistent with prevailing permanent establishment interpretations.111


111 Ministry of Finance (Tax Office) v. Philip Morris (GmbH), Corte Supreme di Cassazione, No. 7682/02 (May 25, 2002).
The current lack of clear, internationally agreed rules regarding the amount of profit attributable to various types of permanent establishments, addressed in Chapter 1 of this Study, contributes greatly to the risk of multiple or unanticipated taxation. Moreover, to the extent the evolving guidelines for the attribution of profits to permanent establishments increase the likelihood for such attribution to occur, they also inevitably lead to a greater chance that the existence of a permanent establishment will asserted. Thus, the business community is concerned about the difficulty of separating the two issues in practice. The pressures placed on the Article 5 definition of permanent establishment (as well as on the Article 23 double taxation relief article) by the work being on the attribution of profits to a permanent establishment should not be underestimated.

B. Unmanageable Exposure Level

The exposure to multiple or unanticipated taxation is reaching levels that are unmanageable from a business perspective. Several factors contribute to this exposure.

First, companies challenged after the fact on the basis of an asserted permanent establishment, where they did not believe a permanent establishment existed, and face indefinite exposure in many countries. Generally, non-resident companies have no income tax return filing obligation in the absence of permanent establishment, although a transaction tax return may be required. The statute of limitations on assessment and collection often does not run if no return is filed. Therefore, companies may be surprised by the asserted existence of a permanent establishment many years after the fact, after substantial interest and penalty charges have accrued. While some countries, such as the United States, permit taxpayers to partially mitigate such exposure by providing for the filing of a protective (“nil”) return in respect of a potential permanent establishment, most countries do not offer taxpayers this option.

Value Added Tax (VAT) or Goods and Services Tax (GST) exposure also is routinely asserted in many countries if a permanent establishment is found to exist for income tax purposes, and vice versa. This widespread practice improperly ignores important legal differences between the permanent establishment thresholds applicable for income tax and consumption tax purposes. The situation is further exacerbated by the fact that taxpayers typically are not permitted to claim input credit for prior periods for which they did not file VAT or GST returns and, thus, face a greatly inflated potential exposure.

Exposure to other local laws (e.g., data protection requirements) also may be asserted if a permanent establishment is found to exist. The taxpayer may face additional monetary or other penalties for past non-compliance with such laws as a result of a permanent establishment assertion arising after the fact.

C. Unmanageable Administrative Burden

The aggregate administrative burden associated with permanent establishment issues is reaching an unmanageable level for businesses operating globally. With the apparent lowering of the permanent establishment threshold, companies face the prospect of multiple additional tax return filing obligations throughout the world, often in countries where no filings are presently
required. They already are experiencing increased numbers of permanent establishment examinations, which can be expected to grow exponentially if the dependent agent and fixed place of business permanent establishment concepts are expanded, as discussed below. Based on recent experience, the current increase in cross-border permanent establishment disputes seems likely to continue, despite recent OECD efforts to clarify the application of the permanent establishment threshold.

D. Dispute Resolution Issues

Existing treaty dispute resolution processes are not working well for permanent establishment cases. Competent authorities have indicated that they are finding such cases particularly difficult to resolve.\(^{112}\) This presumably is attributable not only to the relative novelty of the issues and the current lack of clear and agreed rules, but also to the all-or-nothing consequences of the permanent establishment determination for jurisdiction to tax.

IV. Implications for Governments

A. Potential Shifting of Revenues

The current expansion of the permanent establishment concept and the growing examination focus on permanent establishment issues already is prompting increased claims of taxing jurisdiction by source countries around the world. This seems likely to result in a shift of tax revenues from the residence to the source country in particular cases and to an overall shift where a disproportionate percentage of enterprises are resident in one of the countries.

B. Increased Burden on Tax Administrations

Permanent establishment issues are difficult for tax administrations to address, in part because of their relative novelty but also because of their highly factual nature, the hypothetical analysis required in the deemed permanent establishment context, and the limited interpretive guidance currently available. An increased focus on permanent establishment, therefore, can be expected to create new burdens for tax administrations.

C. Increased Pressure on Competent Authority Process

As noted above, competent authorities already are encountering a growth in cases involving permanent establishment issues and are finding such cases relatively more difficult to resolve. The implementation of more expansive permanent establishment notions will create demand for increased competent authority resources and place greater pressure on bilateral relationships in which the views of the competent authorities diverge.

V. OECD Commentary Issues

As in the case of the profit attribution issues discussed in Chapter 1, many of the current developments on permanent establishment issues are occurring on a multilateral basis, under the auspices of the OECD. A number of amendments were made in 2003 to the OECD Commentary on Article 5, and additional changes are currently under consideration. These steps generally represent a positive effort to confirm and describe a broad international consensus on certain permanent establishment issues. However, as discussed below, a number of issues remain in need of further clarification and should be addressed through additional amendments to the Commentary as soon as possible.

A. Proposed Article 5 Commentary Clarifications

A number of “proposed clarifications” to the OECD Commentary on Article 5 were released for public comment on April 12, 2004. They reflect a potentially positive attempt to clarify the confusion on several points resulting from the Italian court decision in the Philip Morris case. The draft changes to the Commentary on Article 5 usefully confirm that the determination as to whether an enterprise has a permanent establishment must be made on a separate company basis and has no implications for other members of a corporate group. They are also helpful in confirming that attendance at or participation in the negotiation of a contract does not necessarily create a dependent agency permanent establishment. However, as discussed below, several points relating to the provision of services and the use of premises, under proposed new paragraphs 41 and 42, could benefit from further clarification.

B. Issues in Particular Need of Clarification

1. Dependent Agent Permanent Establishment Issues

It is not presently clear when the conduct of activities (other than the conclusion of contracts) by one company for another company will create a permanent establishment, on a dependent agent theory, for that other company in the jurisdiction(s) where the activities are carried out. Such dependent agent permanent establishment issues are increasingly being raised on examination in a number of countries, especially in related person contexts. The new paragraph 42 text proposed for inclusion in the Article 5 Commentary attempts to address the dependent agent issues highlighted by the overbroad Philip Morris decision, but may not provide sufficient clarification to preclude future controversy regarding its interpretation. The proposed text would be more useful if it addressed five issues more explicitly.

First, the language of proposed new paragraph 42 appears to be aimed at drawing a distinction between cases where one company has at its disposal the premises of an affiliate in order to allow the first company to carry on its business there through its own employees, and cases where the affiliate, acting through its own personnel at its own premises, is providing services to the first company as part of the affiliate’s own business. This language seems to focus on whether or not the first company is able to carry out activities at the affiliate’s premises through its own employees. If, as appears to be the intent, this means that a company cannot be deemed to have a permanent establishment at an affiliate’s place of business unless the company’s own employees are carrying out activities there, the language could usefully be clarified to confirm that point. Moreover, to avoid ambiguity, it should also be clarified that existing paragraph 10 of
the Article 5 Commentary, which says that the business of an enterprise is carried on by employees “and other persons receiving instructions from the enterprise (e.g. dependent agents),” does not cause a company to have a permanent establishment at the fixed location where an affiliate (acting through the affiliate’s employees, perhaps including employees seconded from the company) carries on activities on behalf of, at the request of, and in response to instructions provided by, the company. For example, if a company contracts with its affiliate to have the affiliate perform certain services on behalf of the company, with the affiliate acting through its own employees at its own premises, the Commentary should explicitly confirm that those circumstances do not create a permanent establishment for the company at the affiliate’s location.

Second, the scope of proposed paragraph 42 could be further clarified. The discussion is captioned “[m]anagement services provided to another company of the group.” Management services are the only example given of services that one member of the group may provide to another without creating a permanent establishment for the latter. To eliminate any doubt, the Commentary should explicitly confirm that the same interpretation applies with respect to other types of intercompany services performed within the multinational group. Moreover, the Commentary should confirm and explain that these circumstances do not create a “place of management” permanent establishment for the recipient company within the meaning of Article 5(2)(a), because the activities in question are not conducted by employees of the principal.

Third, it would be useful for the discussion to confirm explicitly that a company conducting activities for another member of the group will not be considered to give rise to a permanent establishment merely because it conducts those activities exclusively or principally for the other member, even if those activities relate to a core function of that other member. The proposed paragraph 42 language is potentially ambiguous as to whether the determination that the provision of services to a company by an affiliate, acting through the affiliate’s employees at the affiliate’s fixed place of business, creates a permanent establishment for the company depends on whether the activities are “part of the business of the company” or part of the business proper of the affiliate. For example, does it matter whether the services are in the nature of services on a subcontract to fulfill part or all of the company’s obligations to a third party as primary contractor? Does it matter whether the services relate to a core function normally carried out by an enterprise in the company’s business? If it is important to draw this distinction, much more guidance is needed on the proper standards for doing so. If this distinction is not important, the Commentary should clearly state that.

Fourth, instances in which premises are considered to be “at the disposal” of another group company should be further clarified, both in connection with this point and, as discussed below, more generally. The language of new paragraphs 41 and 42 does not clearly describe the circumstances in which the premises of one company will be considered to be “at the disposal” of an affiliated company such that the affiliated company will be deemed to have a permanent establishment at the first company’s premises. New paragraph 41 explicitly states that any space or premises belonging to a subsidiary that is “at the disposal” of the parent company and that constitutes a fixed place of business through which the parent company “carries on its own business” will constitute a fixed place of business permanent establishment of the parent
company under Article 5(1) (i.e., without regard to whether the subsidiary has any authority to enter into contracts in the name of the parent company). Existing paragraph 10 states that the business of an enterprise is carried on by the enterprise’s “personnel,” including its “employees and other persons receiving instructions from the enterprise (e.g. dependent agents).” The Commentary should explicitly confirm that, if a company hires its affiliate as a dependent agent to perform certain services on behalf of the company, and those services are physically performed at the affiliate’s premises by employees of the affiliate (who thus become sub-agents of the first company), the affiliate’s premises are not thereby deemed to be “at the disposal” of the company.

Finally, it would be useful to clarify the relationship between this portion of the Commentary and the more general references in the Model Convention and Commentary to a “place of management.” This point is also discussed in greater detail below.

In addition to these issues relating to proposed paragraphs 41 and 42, it would be useful for the Commentary to address common situations where an enterprise’s own employees may be conducting activities at another person’s place of business. For example, can an enterprise’s loan-out of an employee to another enterprise, either at cost or on a cost-plus basis, give rise to a permanent establishment at the first enterprise at the second enterprise’s location? Does it matter whether the employee is fully seconded to (transferred to the payroll of) the second enterprise? What about individuals who wear two hats (e.g., are employees or officers of two corporations, subject to a dual contract arrangement, or an employee of one and an officer of the other)? Such business arrangements are increasingly common in some sectors, and taxpayers and tax authorities need more guidance to ensure their proper treatment for tax purposes.

It is also important to provide specific guidance on the circumstances, if any, in which a dependent agent permanent establishment arises in connection with a commissionaire structure or other types of what the OECD has termed “risk-stripped” operations. The discussion regarding such operations in the recent revision of Part I of the OECD Report on the Attribution of Profits to a Permanent Establishment has created significant confusion that should be clarified as soon as possible.

### 2. Meaning of “At Its Disposal”

The Article 5 Commentary uses the phrases “at its disposal” and “at its constant disposal” in a number of paragraphs, to refer to circumstances in which an enterprise may be deemed to have a “place of business” based on premises other than its own. The intent appears to be for the enterprise to be considered to have premises “at its disposal” only if it, in fact, has unrestricted access to and uses those premises (through activities of its own employees) to carry on business.

However, some of the examples added to the Article 5 Commentary in 2003, particularly the parent company employee example and the painter example, leave room for confusion on this point. It would be helpful to have a clearer enunciation of the underlying principle and of the factors to be taken into account in determining whether premises are at the disposal of an
enterprise in a particular case, along with examples illustrating the manner in which such factors should be applied in practice. Those factors should, at a minimum, include the following:

a) Whether the visitor is allowed to carry on unrelated activities on the host enterprise’s premises, or is only permitted to use the premises for purposes of carrying on specified activities on behalf of the host enterprise;

b) Whether the presence of the visitor at the host enterprise is publicly acknowledged, for example, by posting the person’s name, or the enterprise’s name, on the door, by providing a dedicated telephone or fax line, business cards, etc.;

c) Whether the visitor is present continuously, or comes and goes;

d) Whether other persons are allowed to use the space used by the visitor; and

e) Whether the visitor is permitted to access the host enterprise’s premises at will at any time.

It also would be useful to clarify the interaction between (1) the concept in paragraph 4.1 of the Commentary that a place can be at an enterprise’s disposal even where the enterprise occupies it illegally and conducts business there, and (2) the concept in paragraph 4.2 that the mere presence of an enterprise at a particular location does not necessarily mean that the location is at the disposal of the enterprise.

In addition, the services discussion in proposed new paragraph 42 should confirm explicitly that the premises of a company will not be considered to be at the disposal of, or made available to, another company of the group merely because one holds a controlling ownership interest in the other.

It is also essential to clarify certain aspects of paragraph 10. As currently drafted, paragraph 10 might be misread to suggest that an agent is automatically deemed to be carrying on the business of its principal, and, therefore, that the place at which the agent carries on its business is deemed to be a place at which the principal is carrying on its business. In a related party context, such an interpretation would seem inconsistent with the intent of the provisions of Article 5(7) of the Model Convention, which state that the existence of a control relationship between two companies “shall not of itself constitute either company a permanent establishment of the other.”

Clarification of paragraph 19 of the Article 5 Commentary also would be useful. Paragraph 19 indicates that time spent by a subcontractor working on a building site will “be considered as being time spent by the general contractor on the building project.” The discussion does not make clear what the basis for this conclusion is. It could, therefore, be read to suggest that the general contractor may have a right of access to the site by operation of contract or local law.
Alternatively, it could be read to mean that the general contractor automatically is deemed to have the site at its constant disposal merely by reason of the subcontracting relationship, which would be of significant concern to business. To avoid unintended inferences regarding the application of Article 5 in cases other than building site cases, the rationale for the conclusions suggested in paragraph 19 should be clearly stated and distinguished from the application of the general “at its disposal” requirement.

3. Issues Regarding the “Fixed Place of Business” Requirement

a. “Time Test” for Services

Except in certain dependent agent contexts, a permanent establishment normally exists under OECD-style treaties only if there is a “fixed place of business” through which the business of the enterprise is wholly or partly carried on. However, a proposal currently is under discussion at the OECD to add a physical presence “time test” to the fixed place of business threshold for cases involving the performance of services. The United Nations has long provided such a time test for services in its model income tax treaty.113 Under this approach, the furnishing of services by personnel of an enterprise in the source country on the same or a “connected” project for periods aggregating more than six months during a twelve-month period is considered to create a permanent establishment for that enterprise under Article 5, regardless of whether it had a fixed place of business in that country.114 The fixed place of business test continues to apply as an additional basis for finding a permanent establishment, even where the time test is not met. A proposal to add a U.N.-style time test to the OECD Model was briefly outlined and discussed by the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits in its Public Discussion Draft of November 26, 2003.115

As a matter of policy, U.S. treaty negotiators historically have opposed requests to agree to U.N.-style time tests for services and have made exceptions reluctantly, such as in the case of the nine-month threshold provided in the 1993 treaty with the Czech Republic. While such provisions typically have set a threshold higher than that advocated by the U.N. Model Treaty, they have been viewed by many as a dangerous lowering of the permanent establishment threshold that is apt to create onerous administrative burdens. Moreover, these types of tests tend to raise difficult interpretive issues (e.g., relating to the question of how to measure days of service, when to aggregate services provided by different individuals or by the same individuals on different projects, etc.).

113 See United Nations Model Double Taxation Convention Between Developed and Developing Countries (the “U.N. Model Treaty”), Articles 5(3)(b) and 14(1)(b).

114 The U.N. Model Treaty provides a similar but not identical rule, setting a physical presence threshold of 183 days, for the performance of independent personal services covered by Article 14.

Some have suggested that, given the current uncertainties regarding the parameters of the “fixed place of business” permanent establishment threshold, a bright-line test could provide certain practical advantages in the services context. As acknowledged by the Business Profits TAG Discussion Draft, a time test could provide more certainty with respect to services than do the existing rules.\textsuperscript{116} While it is true that a time test for services might provide greater certainty, this would be true only if it operated as a safe harbor or “floor” against the finding of a “fixed place of business” permanent establishment in the case of services provided through a fixed place of business for less than a specified time period. A test that did not include this safe harbor feature would not provide any greater certainty that a taxpayer had not crossed the permanent establishment threshold. Moreover, such a test would also have the highly undesirable effect of creating a permanent establishment in many cases where none currently exists. On balance, the NFTC members advise strongly against including a time test for services in the permanent establishment definition.

If, however, a time test for services is to be introduced into the permanent establishment definition, it should be noted that international consensus would need to be reached on four key points for taxpayers and tax administrations to realize the potential benefits of any time test for services. First, to provide the benefits of simplification, the time test would have to operate as a safe harbor that will prevent the finding of a permanent establishment where the time threshold is not met, as well as a deeming rule that may create a permanent establishment. This means that other potential bases for finding a permanent establishment, such as the fixed place of business test, would not apply in addition to the time test, in cases where the taxpayer’s activities at the fixed place of business consist of the performance of services.

Second, an adequate length of time would need to be set as the threshold for the time test. For this purpose, the twelve-month threshold set by Article 5(3) of the OECD Model for construction and installation projects would appear to be the most appropriate analogy. There is no apparent rationale for setting a lower threshold for the performance of personal services than for construction and installation projects. The agreed time threshold should not be applied with retrospective effect to the detriment of taxpayers.

Third, the manner of measuring the periods of time to be taken into account under the time test would have to be specified in adequate detail. Clear rules would need to be provided for determining when a project commences and ends how interruptions are to be treated, when separate projects may be aggregated, and so forth. If a time test is to be relied upon to set the permanent establishment threshold for services, these issues will need to be addressed with greater specificity than under the current OECD Commentary.

Finally, an administrable method of attributing profits to the resulting permanent establishment would need to be specified in adequate detail to avoid double taxation. The administrative

\textsuperscript{116} See Business Profits TAG Discussion Draft of Nov. 26, 2003, \textit{Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?}, at ¶ 244.
challenges associated with the attribution of profits to a permanent establishment are discussed in Chapter 1 of this Study.

b. Six-Month Reference in 2003 Article 5 Commentary

The Article 5 Commentary was amended in 2003 to include the following provision, which has been interpreted by some as providing that a permanent establishment may be considered to exist whenever business is carried on through a place of business for a period of six months or more:

Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months).117

While this statement, on its face, is merely descriptive of the practices of OECD member countries, absent other specific guidance in the Commentary, it has been interpreted by many as likely to have a prescriptive effect leading to the general application of a six-month permanent establishment threshold by OECD members. On the other hand, the Commentary makes clear that it does not intend to set a bright-line test, under which a permanent establishment could be considered to exist only after six months. Rather, it notes that a six-month threshold is not applied in all cases and provides examples of cases in which a permanent establishment may be considered to arise in less than six months (i.e., where the place of business is used recurrently for short periods or where the business has a short duration because of its “nature” but is carried on entirely within the source country).118 It is, therefore, clear that six months is not intended to operate as a “floor” below which no permanent establishment can be found.

Additional guidance on this point is essential from a business perspective. The Commentary should be clarified to indicate clearly whether the new six-month reference was, in fact, intended to provide a normative guideline to member countries. If there was no intention to prescribe six months as the general threshold for finding a permanent establishment, the Commentary should so state.

Apart from the interpretation of the current Commentary language, it might prove useful to consider the potential benefits of prescribing a clear time threshold for the finding of a “fixed place of business” permanent establishment. If clearly stated, such a threshold could eliminate much of the current uncertainty and disagreement regarding this aspect of the permanent

117 See OECD Commentary on Article 5, ¶ 6.

118 Id.
establishment concept, and would make that concept easier for both taxpayers and tax administrators to apply. To provide these benefits, however, any “bright-line” threshold would need to be structured to operate as a floor; the NFTC opposes using specified time thresholds to trigger permanent establishment status. If exceptions permitting the finding of a permanent establishment within a shorter period were regarded as necessary, they would need to be specified in greater detail than under the current Commentary. More specific guidance also would need to be provided regarding the manner in which time would be accounted for under such a test, and the circumstances in which projects would be aggregated. If this were done, and if the threshold were set at an appropriate level (i.e., at a minimum of twelve months), such a clarification might facilitate international tax administration and compliance. It would be important, of course, to ensure that the agreed threshold is very carefully drafted and is not applied retrospectively to the disadvantage of taxpayers. Further consultation with the international business community on the advisability of such a change would also be essential.

4. Meaning of “Place of Management”

A “place of management” is specified in Article 5(2)(a) as a type of presence that, prima facie, may be regarded as constituting a permanent establishment. The great majority of U.S. treaties include this provision, as does the U.S. Model. Nevertheless, the exact meaning of the term remains elusive, creating concerns about the types of activities or presences that may give rise to a permanent establishment under this rubric.

The Article 5 Commentary confirms that a “place of management” may constitute a permanent establishment only if it satisfies the requirements of paragraph 1 of Article 5 (i.e., is a fixed place of business through which the business of the enterprise is wholly or partly carried on). However, the only explanation of the term “place of management” that it provides is the following:

The term “place of management” has been mentioned separately because it is not necessarily an “office”. However, where the laws of the two Contracting States do not contain the concept of “a place of management” as distinct from an “office”, there will be no need to refer to the former term in their bilateral convention.

This discussion indicates that the reference to “place of management” was intended to track domestic law provisions distinguishing such a presence from that of an “office.” However, it casts no additional light on what was intended by the term. In addition, it provides no guidance on how that term is to be interpreted where it is included in the treaties of countries, such as the United States, without a domestic law concept of “place of management.” The inherent

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119 Id. ¶ 12.

120 Id. ¶ 13.
uncertainty regarding the “place of management” provision has been heightened by the overbroad analysis adopted in the recent Philip Morris case.

It would be useful for the Commentary to further elaborate on the meaning of “place of management,” to ensure that it is not interpreted to defeat the OECD’s current attempt to clarify that the performance of activities (such as management services) by one company for another company in its group does not automatically create a permanent establishment for that other company. It would also be useful to clarify that stewardship activities conducted by one company with respect to another company do not give rise to a permanent establishment for the second company at the location of those activities.

5. Meaning of “Authority to Conclude Contracts”

Paragraph 5 of Article 5 provides that an enterprise may be deemed to have a permanent establishment by virtue of the activities of a person other than an independent agent acting on its behalf, only if that person “has, and habitually exercises, in [that] Contracting State an authority to conclude contracts in the name of the enterprise.” The exercise of contracting authority has, therefore, long been viewed as a definitive prerequisite for the finding of a dependent agent permanent establishment.

New paragraph 32.1, added to the Article 5 Commentary in 2003, creates a potential ambiguity in this connection. It states that an agent may be deemed to possess the actual authority to conclude contracts if he solicits, receives, and transmits order which are “routinely” approved and fulfilled by his principal. This language introduces the potential for greater subjectivity of judgment on an issue that had been subject to a relatively clear, objective standard. It is not clear, for example, what implications, if any, the new language would have in cases where enterprises offer standard terms of contract to their customers. What about situations where local personnel are involved in certain aspects of “just-in-time” wholesale inventory management, but do not have the authority to conclude contracts? Does it matter if the order states that there is no binding contract until it is approved by the principal? Do local law standards of when a binding contract exists control, or does the Commentary reflect an attempt to create some independent tax or treaty law standard? Given the importance of contracting authority in the dependent agent determination, it is important that the intent of new paragraph 32.1 be clarified to eliminate any doubt on this point for taxpayers and tax authorities.
6. Meaning of “Independent Agent” Acting “In the Ordinary Course of Business”

Paragraph 6 of Article 5 provides an exception to the dependent agent provisions of paragraph 5, stating that an enterprise will not be deemed to have a permanent establishment in a contracting state merely because it carries on business there through an “agent of independent status” that is acting in the ordinary course of its business. The Article 5 Commentary indicates that an agent will be considered independent only if it is “independent of the enterprise both legally and economically,” and that economic independence turns on whether the agent or the enterprise bears “the entrepreneurial risk.” The Commentary adds that an agent will not be considered as acting in the ordinary course of its business if it performs “activities which, economically, belong to the sphere of the enterprise rather than to that of [its] own business operations.”

If an agent must bear “entrepreneurial risk” to be independent, it should be clarified that cost-plus arrangements do not cause agents to be considered dependent rather than independent. Many third-party business contracts are based on cost-plus arrangements.

The Commentary should also clarify what standards apply in determining whether agents are performing activities “which, economically, belong to the sphere of the enterprise rather than to that of their own business operations” and hence are not acting in the ordinary course of their business. How does this concept interact with the concept in proposed new paragraph 42 that services performed by a company that are “part of its own business” and “not the business of [the company for which the services are performed]” do not create a deemed permanent establishment? The language in proposed paragraph 42 presumably was intended as a clarification of the economic sphere concept referred to in existing paragraph 38.7, but it would be useful for the Commentary to confirm this explicitly.

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121 Id. ¶ 37.
122 Id. ¶ 38.
123 Id. ¶ 38.7.
CHAPTER 5

WITHHOLDING RATE PROVISIONS

I. Introduction

A. Overview of Historical U.S. Treaty Policy

The clear preference of U.S. tax policymakers, reflected in the U.S. Model Treaty and in most bilateral U.S. treaties, has long been to eliminate withholding taxes on cross-border payments of interest, royalties, or service fees by treaty on a reciprocal basis. The United States historically has maintained positive rates of withholding tax on direct and indirect dividends, generally at 5 and 15 percent, respectively. In several recent treaty agreements, the United States has departed from this practice and decided to eliminate withholding on direct dividends. This is consistent with the elimination of such withholding under dozens of bilateral treaties concluded by other countries and under the EU Parent-Subsidiary Directive. United States Treasury officials have stated that this is an appropriate development in light of the United States’ overall treaty policy of reducing tax barriers to cross-border investment. Thus far, however, they have indicated that these zero-rate agreements are not necessarily appropriate for all treaties and must instead be evaluated on a case-by-case basis.

B. Summary of Current Concerns

The NFTC strongly supports the reciprocal elimination by treaty of withholding taxes on cross-border payments of dividends, interest, royalties, and service fees. Situations in which this goal has not yet been accomplished in its entirety, despite the best efforts of U.S. treaty negotiators, leave U.S. resident companies with an excessive tax burden that hampers international trade and investment and put them at a competitive disadvantage relative to companies resident in EU Member States or other jurisdictions that have achieved this on a broader scale.

Businesses and withholding agents also encounter interpretive difficulties in situations where the intended scope of a withholding tax exemption is not entirely clear from the treaty text.

C. Summary of Conclusions and Recommendations

The NFTC applauds the recent efforts and successes of the U.S. Treasury Department in eliminating withholding taxes by treaty on significant cross-border flows of direct dividends, interest, and royalties. It encourages U.S. treaty negotiators to continue to press for the broadest possible elimination or exemptions from withholding taxes on such amounts, as well as on service fees. Treasury should also confirm that it supports the reciprocal elimination of withholding on direct dividends as a matter of general policy, within the context of otherwise acceptable treaty agreements. It also should take the opportunity now to reevaluate the need for some of the limitations on the zero dividend rate that have been provided by treaties thus far.
Where it is not possible to eliminate withholding taxes in their entirety, U.S. treaty negotiators should seek partial exemptions that are as broad as possible. It is important that the scope of these and other withholding tax exemptions be defined as precisely as possible, to ensure that they operate as intended. A number of the interpretive difficulties that have arisen over the years regarding the application of treaty withholding tax exemptions might have been avoided, for example, through the inclusion of additional definitions or details in the treaty or in accompanying bilateral documents.

II. Benefits of Eliminating Cross-Border Withholding Taxes

A. Facilitation of International Trade and Investment

The elimination of withholding taxes on cross-border payments of dividends, interest, royalties, and service fees removes potential double taxation and, thus, a potential barrier to international trade and investment. This recognition has long motivated the United States and most of its major trading partners to conclude treaties that eliminate withholding taxes on cross-border flows of interest, royalties, and service fees and, increasingly, on direct dividends as well. The OECD has also acknowledged, in its Commentary on the OECD Model Convention, that withholding taxes create “a very important obstacle” to international investment. This consideration was recognized by the Joint Committee on Taxation of the U.S. Congress, in its Explanation of the then-proposed U.S.-U.K. Income Tax Treaty, as “the principal argument in favor of eliminating withholding taxes on certain direct dividends.”

B. Tax Policy Considerations

The elimination of cross-border withholding taxes promotes both of the guiding international tax policy principles—capital export neutrality and capital import neutrality—historically embraced by the United States and other countries. This conclusion was reached in an important 1992 OECD study, Taxing Profits in a Global Economy: Domestic and International Issues, and has been supported by other commentators.

The principle of capital export neutrality, or efficiency, requires that the effective tax rate on domestic and overseas investment be equal. This principle is furthered by the removal of withholding taxes, because they are imposed only on cross-border flows and, therefore, create a tax disincentive for foreign investment relative to domestic investment.

124 See OECD Commentary on Articles 23A and 23B (Methods for Elimination of Double Taxation), paragraph 50. See also, e.g., OECD Commentary on Article 11 (Interest), ¶ 2.

125 See JCS-4-03 (March 5, 2003).

126 See, e.g., Zero Withholding on Direct Dividends: Policy Arguments for a New U.S. Treaty Model, Prepared for the Zero Dividend Withholding Coalition by PricewaterhouseCoopers LLP, 20 Tax Notes Int’l 1113 (March 6, 2000), for a more detailed discussion of these points.
The principle of capital import neutrality, or competitiveness, requires that foreign and domestic investors in a particular market be subject to the same tax burden. The elimination of withholding taxes also promotes this principle because such taxes apply only to, and thus discriminate against, foreign investors relative to domestic investors.

C. Economic and Trade Policy Considerations

Withholding taxes on cross-border dividends, interest, and other payments for the use of capital can operate effectively as tariffs on the importation of capital. Where this occurs, it creates an obstacle that distorts the international flow of capital. The elimination of withholding taxes is, therefore, particularly important for the United States and other leading exporters of capital.

III. Implications of Withholding Taxes for Business

A. Competitiveness

The imposition of withholding taxes may affect a company’s competitiveness by increasing its cost of doing business relative to its competitors, if they are not also subject to such taxes. This is a potential concern for U.S. businesses whenever treaty negotiators are unable to eliminate withholding taxes on cross-border payments, as a growing number of other countries have eliminated such taxes either by treaty or by statute. Although withholding taxes have been eliminated with respect to interest, royalties, and service fees in most U.S. treaties, they can significantly hamper the competitiveness of U.S. business where this has not yet been achieved.

The imposition of withholding taxes on direct dividends raises similar concerns on a broader scale, as they continue to apply under most U.S. treaties at present. This creates particularly significant competitive distortions for U.S. resident companies relative to those residents within the European Union, where the Parent-Subsidiary Directive generally eliminated withholding on cross-border direct dividends within the EU more than a decade ago. It should be noted that one of the key rationales cited for the adoption of the Parent-Subsidiary Directive was the provision of tax rules to foster the “competitive strength at the international level” of companies resident in EU Member States.

B. Excessive Tax Burden

Although withholding taxes impose a significant burden in any case, the fact that they are applied on a gross rather than a net basis makes them particularly onerous for businesses with a relatively low profit margin. This fact is often cited as a particular concern for withholding taxes

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127 Id.


129 Id. at Preamble.
on interest received by taxpayers, such as financial institutions, that borrow in turn to finance their lending. However, it is also a significant concern for any business that incurs significant expenses in connection with payments subject to withholding taxes, such as research and development expenses incurred to develop a royalty-producing intangible asset.

C. Interpretive Issues

Interpretive issues relating to treaty withholding tax provisions may create competitive pressures or unexpected tax exposures that cause obvious difficulties for both businesses and withholding agents. They often also give rise to disputes between treaty partners regarding the proper characterization of a transaction or an amount.

From a business perspective, of course, the ideal solution to such issues is to eliminate all withholding on cross-border payments of interest, royalties, dividends, and service fees. Where it is simply not possible to do this, it is important that withholding tax provisions be drafted with as much precision as possible to avoid such ambiguities. Otherwise, withholding agents may withhold taxes as a precautionary matter, even where the treaty was intended to reduce or eliminate them.

IV. Implications for Governments

A. Macro-Economic Effects

It is generally believed that the elimination of cross-border withholding taxes provides substantial benefits to the national economy as a whole, by removing barriers to cross-border trade and investment. The elimination of withholding on cross-border interest, for example, is seen as reducing the costs of borrowing for residents generally. In addition to providing a level playing field for businesses operating internationally and reducing foreign tax credits claimed, the general removal of barriers to cross-border capital flows is thought to increase inbound investment and, thus, the national tax base.

B. Revenue Implications

It is often assumed that the elimination of withholding taxes will entail a revenue loss to the fisc of the countries involved. A recent study by PricewaterhouseCoopers LLP reached the opposite conclusion, however, with respect to the United States, based on the anticipated offsetting reduction in foreign tax credits claimed with respect to withholding taxes as a result of the reciprocal nature of the exemption. Even if a short-term revenue loss were believed likely, the

130 See, e.g., OECD Commentary on Article 11 (Interest), ¶ 13.
131 See, e.g., JCS-4-03, supra, n. 19; Report on Behalf of the Zero Dividend Withholding Coalition, supra, n. 20.
132 Id.
133 See Report on Behalf of the Zero Dividend Withholding Coalition, supra, n. 20.
significant macro-economic benefits of eliminating withholding taxes should outweigh any concerns. The JCT Explanation of the recent U.S.-U.K. Treaty, for example, acknowledged that this likely would prove to be the case even though the U.K. had already eliminated its withholding tax on dividends through domestic legislation.\textsuperscript{134}

V. Current Withholding Tax Issues

A. Zero-Rate Provisions for Direct Dividends

1. Adoption of General Policy

Business strongly supports the reciprocal elimination of withholding on direct dividends and applauds the U.S. Treasury Department for entering into recent treaty agreements with Australia, Japan, Mexico, the Netherlands, and the U.K. to eliminate such withholding. The United States unfortunately has lagged behind EU Member States and most other major countries in concluding such agreements, but is now moving in a positive direction.

These recent advances should be expanded to other U.S. treaties. The U.S. Model Treaty should be amended to indicate that the general U.S. policy is to seek a reciprocal zero percent rate of withholding on direct dividends. Existing treaties that permit a positive rate of withholding on such dividends should be evaluated and prioritized for renegotiation, if appropriate.

If exceptions to this policy are considered necessary, the U.S. Treasury Department should, following Congressional consultations as appropriate, articulate the circumstances in which it generally will not be prepared to agree to a zero rate. This will provide both taxpayers and prospective treaty partners with an understanding of situations in which a zero rate is unlikely to be provided. This approach could also promote the resolution of areas of concern, thus eliminating obstacles to a zero-rate agreement. Given the strong policy justifications for a zero rate, however, such exceptions should be limited to circumstances in which the treaty partner is unwilling to agree to a reciprocal zero rate provision or to include adequate limitation on benefits and exchange of information provisions in the treaty.

Although the general elimination of withholding on direct dividends is preferable as a policy matter, it should continue to be accomplished by treaty, rather than by legislation as some countries have done, to ensure the provision of reciprocal benefits. However, a zero-rate agreement should not be precluded, in the context of an otherwise desirable treaty agreement, where the treaty partner provides a legislative exemption from withholding on direct dividends to U.S. residents. The negotiation of a treaty provision in such cases would protect U.S.-based companies from subsequent legislative amendments permitting withholding, as occurred in Mexico during the 1990s. It would be consistent with the approach taken in the recent treaty with the U.K. A contrary policy could have the perverse effect of encouraging other countries to

\textsuperscript{134} See JCS-4-03, supra, n. 19.
raise or maintain higher statutory withholding rates in anticipation of the negotiation or renegotiation of their treaties with the United States.

2. Design Issues

In view of the increased inclusion of zero-rate dividend provisions in U.S. treaties, several aspects of their design should be reviewed at this time.

a. Ownership Threshold

The ownership threshold required for the zero rate should be reevaluated. The general approach to date has been to require the ownership of shares representing at least 80 percent of the voting power of the payor, as provided in the recent agreements with the U.K., Australia, and Mexico and the pending protocol with the Netherlands. The new treaty with Japan sets the threshold at more than 50 percent of the voting stock of the payor.

While the treaty with Japan is a positive step in this regard, a 50-percent threshold remains too high in many cases. Commercial or regulatory restrictions may make it impossible to achieve an 80-percent ownership level. In addition, local law may limit foreign investors to a minority interest. Finally, there are many situations in which business considerations call for a still lower level of investment. To address such situations, future U.S. treaties should provide an ownership threshold of 10 percent for the zero rate on direct dividends.

There is no clear policy rationale for preserving a 5-percent withholding rate with respect to ownership of between 10 percent and 50 (or 80) percent, and much precedent for a 10-percent threshold. For decades, 10 percent has been set by U.S. treaties as the ownership threshold for a direct investment entitled to the minimum dividend withholding rate, as distinguished from an indirect investment subject to a higher withholding rate. A 10-percent threshold also is consistent with the 2003 amendments to the EU Parent-Subsidiary Directive and is, therefore, the relevant benchmark to ensure that U.S. businesses are not put at a competitive disadvantage. Section 902 of the Internal Revenue Code provides additional precedent for treating 10 percent as the appropriate threshold for direct investments in the cross-border context.

b. Other Ownership Requirements

Future U.S. treaties also should clarify that the ownership threshold may be satisfied through either direct or indirect ownership, as specified in the treaty with Japan, rather than requiring direct ownership, as in the pending protocol with the Netherlands, or failing to provide an explicit rule, as in the treaty with the U.K.

The requirement that the requisite ownership interest be held for a period of at least 12 months prior to declaration of the dividend, which appears in all U.S. zero-rate dividend provisions thus far, should be eliminated. The U.S. Treasury Technical Explanations of these provisions do not explain why such a holding period is considered necessary. No holding period has been imposed as a precondition for claiming the historical 5-percent rate on direct dividends. The imposition of any holding period for entitlement to treaty withholding rates is a highly unusual, if not
unprecedented, provision in modern U.S. treaty practice. The concerns regarding restructurings that have been cited as the reason for the special limitations on benefits provisions in these agreements would not appear to require, or to be addressed by, this holding period provision. Rather, the imposition of a 12-month rule simply denies the benefit of the zero rate for a substantial period to taxpayers that restructure, even if they do so in a manner that is acceptable under applicable limitation on benefits provisions. It is not clear, in any event, why a holding period that far exceeds those prescribed for limited circumstances under Code sections 246(c) and 901(k) would be necessary.

**B. Royalty and Service Fee Withholding Tax Issues**

1. **Royalties**

The United States should vigorously pursue the U.S. Model Treaty policy of achieving a zero rate of withholding on royalties across the board, which is consistent with the internationally accepted policy long reflected in the Royalties Article of the OECD Model Convention. The general policy considerations cited above support the elimination of any gross basis withholding tax on royalties. Elimination of the gross basis withholding tax on royalties has the additional benefit of eliminating disputes with tax authorities about the characterization of transactions (e.g., as licenses rather than as sales or services). Across-the-board exemptions for royalties also avoid the troublesome allocation questions that otherwise arise in the context of bundled payments (e.g., involving trademarks and copyrights, patents and know-how, intangibles and services, etc.). Finally, the elimination of the withholding tax avoids problems that can arise in determining the proper source of royalty payments, as well as the risk of cascading royalty taxes.

Where the full elimination of withholding on royalties simply cannot be achieved in the context of an otherwise desirable treaty, the royalty withholding rate should be kept to an absolute minimum. In such cases, the treaty should also clarify the definition of the term “royalties” to promote greater consistency in practice with the provisions of the OECD Commentary relating to software transactions. Although much progress has been made in achieving a broad international consensus on these issues, taxpayers continue to encounter difficulties in certain countries, such as Korea, Japan, and India, regarding the treatment of site and enterprise licenses, and sometimes even the sale of “shrink-wrap” software. In addition, issues have arisen, for example with India, regarding the treatment of industrial equipment that includes embedded software. Sales of such equipment should not be subject to royalty withholding tax under treaties.

2. **Service Fees**

Policy considerations support the elimination of withholding taxes on services as well as those on royalties. In addition to raising policy concerns, treaty provisions permitting the withholding of tax on services subject to withholding taxes can be difficult to define with adequate precision.

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135 It is hoped that the provision of a zero rate of withholding for royalties under the new U.S.-Japan Treaty will eliminate such disputes with respect to Japan.
It often is not entirely clear which services are covered. For example, although carefully drafted, the definition of “fees for included services” under the U.S. treaty with India has led to controversies in a number of cases. This creates a risk that withholding tax provisions for services will be applied in practice even more broadly than intended. U.S. treaty negotiators, therefore, should continue to strongly oppose the imposition of any withholding taxes on fees for technical or other services.

C. Interest Withholding Tax Issues

Withholding taxes on cross-border interest payments also should be eliminated by treaty whenever possible. If the complete elimination of withholding on interest simply cannot be achieved in an otherwise desirable treaty, exceptions from withholding should be negotiated for as many types of payments as possible.

The scope of these exceptions should be drawn as broadly and as clearly as possible. To provide adequate guidance to taxpayers and withholding agents and avoid unnecessary controversy, the treaty should take care to define key terms used in connection with such exceptions. Issues have arisen under recent U.S. treaties, for example, regarding the meaning of the following terms, which have not been defined clearly enough for this purpose:

1. Bank

Many U.S. treaties provide an exemption from withholding tax for interest derived by a bank, but do not define the term “bank.” Nor do the U.S. Treasury Technical Explanations of these provisions typically provide a definition. As a general matter of treaty interpretation under Article 3, the definition of this key term is, therefore, left to the domestic law of the contracting state concerned, unless the competent authorities agree to a common interpretation. This approach is not ideal, in that it does not provide adequate guidance to taxpayers and tax administrators. Nor does it ensure the reciprocal application of the exemption by the two contracting states. Where the scope of the withholding tax exemption must be limited to interest derived by a bank, the treaty should avoid interpretive doubts and ensure reciprocal operation of the exemption by providing an explicit definition of the term “bank.”

On the other hand, any exemption which is limited to entities engaged in a financial services business should be available to a broader category of entities than those that meet traditional “bank” definitions, given the variety of forms such businesses take and the competitive distortions that would be caused by too narrowly defining the exempt category. Accordingly, serious consideration should be given to ensuring that the exemption extends to banks, investment banks, insurance companies, finance companies, and other similar financial institutions.

2. Investment Bank

Similar issues are raised where the treaty specifically exempts interest derived by an “investment bank” but does not define the term. The new U.S.-Japan Treaty, for example, suggests that the term “bank” includes “an investment bank,” but fails to define either term. The U.S. Treasury
Technical Explanation of the recent U.S. Protocol with Australia also refers to “investment banks,” as a type of financial institution potentially eligible for exemption, again without defining the term. While it is helpful and desirable for treaties to confirm that the interest withholding exemption extends to investment banks, it would be more helpful if the exact scope of this exemption were clearly defined.

3. Financial Institution

The recent U.S.-Australia Protocol includes “financial institutions” as one of the types of entities entitled to the withholding tax exemption for interest. This agreement departs from the usual U.S. practice and provides a definition of the term “financial institution” for this purpose:

For the purposes of this Article, the term “financial institution” means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

While the inclusion of a definition is helpful, its utility is limited by the fact that the Protocol does not define the term “bank” or any of the other operative terms used in this definition, including “substantially,” “profits,” “raising debt finance,” “financial markets,” “taking deposits at interest,” and “business of providing finance.” Nor are most of these terms clearly defined for domestic tax law purposes in either Australia or the United States. Perhaps in recognition of this fact, the U.S. Treasury sought to provide clarification with the following statement in its Technical Explanation of the Protocol:

For this purpose, a financial institution is a bank or other entity that issues debt or takes deposits and uses those funds to carry on a business of providing finance. Thus, a financial institution regulated as a bank under the Federal Depository Institutions Act would be a financial institution, as would an entity that issues debt in financial markets and uses that debt, directly or indirectly, to lend money or purchase debt obligations. Investment banks, brokers and commercial finance companies (but not captive financing companies) are covered by this exemption provided that they obtain their funds by borrowing from the public.

While the intent of this statement presumably is to clarify the intended scope of the exemption, when read together with the Australian Taxation Office’s Draft Taxation Ruling interpreting the same provision, it becomes apparent that there is a divergence of views on certain key issues. For example, it is not entirely clear whether investment banks would automatically as financial institutions under the proposed Australian interpretation, or whether Australia would extend the

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136 See TR 2004/D17, Draft Taxation Ruling, Income Tax: ascertaining the right to tax US and UK resident financial institutions under the United States and the United Kingdom Double Taxation Conventions in respect of interest income arising in Australia.
exemption to cases in which debt is used “indirectly” by an entity other than the one that raised it.\footnote{For additional examples, see, e.g., International Banks and Securities Association of Australia, \textit{Comments on Draft Taxation Ruling 2004/D16} (Oct. 15, 2004).}

4. “Captive Financing Companies,” “Commercial Finance Companies,” and “Consumer Credit Companies”

As noted above, the U.S. Treasury Technical Explanation of the recent Protocol with Australia states that “commercial finance companies,” but not “captive financing companies,” constitute “financial institutions” potentially eligible for the exemption from withholding on interest. The intended meaning of the terms “commercial finance companies” and “captive financing companies” is not explained. These are not defined terms, either under the Protocol or for U.S. domestic tax law purposes. It is, therefore, unclear how this exclusion would operate in certain common situations. For example, companies used to provide financing in the commercial context (e.g., for large consumer purchases) often are wholly-owned by a related company that manufactures or distributes the purchased product. This financing is provided to unrelated persons at arm’s length, so it would seem inappropriate to apply a “captive financing company” exclusion to deny the interest exemption in such cases. However, the intended result is not entirely clear from the language of the Technical Explanation. In addition, neither the text of the Protocol, nor those of prior U.S. treaty agreements or technical explanations, specify or explain the technical basis for such a limitation. The legal authority for this interpretation is, therefore, unclear. It also is not clear whether Australia concurs with the position taken by the U.S. Treasury Technical Explanation, as Australia’s Draft Taxation Ruling on the interest exemption is silent on this issue.

This issue is further complicated by a statement in the U.S. Treasury Technical Explanation of the new Treaty with Japan, which takes the position that “commercial finance companies” and “consumer credit companies” qualify for that Treaty’s interest exemption for financial institutions “provided that they obtain more than half of their borrowed funds by borrowing from the public.” Although it is helpful to confirm the availability of the exemption, again, this language does not appear in the Treaty or accompanying agreements, and the terms used are not defined. It is, therefore, not entirely clear what the intended scope of the exemption is or whether Japan agrees with this interpretation, as it appears only in a unilateral U.S. explanation. It also is not clear to what extent this interpretation is intended to be consistent with that offered in the Australian Protocol.

To avoid confusion and controversy, this point should be clarified in the context of the U.S.-Australia Protocol and the U.S.-Japan Treaty. U.S. treaty negotiators should also strive, in future treaty agreements, to include a clearer indication in the text of those agreements or accompanying bilateral documents of the shared intention of the parties on the scope of the withholding exemption for interest.
5. “Wholly Independently”

Similar interpretive issues are presented by the use of the term “wholly independently,” for example as a prerequisite for a financial institution’s entitlement to the interest exemption under the recent U.S.-Australia Protocol. The Australian Taxation Office’s Draft Taxation Ruling suggests that this term was intended to require dealings at arm’s length with the payor, in an Article 9 transfer pricing sense. However, the text of the treaty also specifies that the interest in question must be derived from unrelated parties, who are not subject to the provisions of Article 9 in any event. It is possible that the “wholly independently” requirement was intended to preclude the withholding exemption from applying with respect to interest on receivables purchased from an affiliate, but such an interpretation would seem both overbroad and inconsistent with the positive reference in the U.S. Treasury Technical Explanation to debt that is “used directly or indirectly.” This point should be clarified as well.

6. Interest Paid “In Connection With” Sales on Credit

Certain treaties also provide for an exemption for interest on debt arising in connection with sales on credit. These provisions, too, can involve ambiguities about their scope. For example, does it matter whether the holder of the debt and recipient of the interest is the same person as the one who sold the goods on credit, or can a receivable acquired by an affiliate of the seller also qualify? How about a receivable purchased by a party unrelated to the seller of the goods? If the exemption applies to interest on debt held by a person other than the seller of the goods, does the residence of the seller of the goods matter, or only the residence of the interest recipient? These sorts of questions should be addressed if such a formulation is used.

7. Treatment of Multiple-Entity Groups

Treaties should also provide appropriate guidance, where needed, regarding the treatment of multiple entity groups. For example, the 2003 U.S.-Japan Treaty provided an exemption for interest derived by certain “enterprises” that satisfied certain requirements concerning the nature of their liabilities and assets. This language raised a question as to whether the requirements were intended to be applied on a separate company or some form of group-wide basis. A subsequently published “Record of Discussions” between the U.S. and Japanese Governments provided some guidance on this point, including a reference to consolidated financial statements prepared for the enterprise and its consolidated subsidiaries. In many cases, financial services functions carried on by members of a corporate group are divided among group members, so the application to such groups of any definitional standard for what constitutes a financial enterprise eligible for a treaty exemption can be very important.

D. Issues Regarding Bifurcated Rate Provisions

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138 See May 19, 2004 Record of Discussions.
As indicated above, business strongly favors the general elimination of withholding taxes on cross-border payments. However, if agreement to eliminate such withholding taxes entirely cannot be achieved and the overall balance of benefits nonetheless warrants conclusion of a treaty agreement, exceptions should be negotiated to eliminate or reduce withholding for as many types of payments as possible. In these situations, however, the scope of the exceptions must be crafted with great care, for several reasons. First, clarity is important to avoid interpretive issues that may prevent the intended beneficiaries from enjoying the benefit of those exceptions, either as an initial matter or permanently. Second, it is important to avoid drawing unintended distinctions among categories of payments or taxpayers. Finally, careful crafting of exceptions is required to provide guidance that minimizes administrative burdens on taxpayers, withholding agents, and governments.

Provisions that apply more than one rate of withholding tax to a type of payment, or to a single, “bundled” payment based on the characterization of its component parts, should be avoided wherever possible. Such provisions create undesirable technical and administrative complexity and increased controversy risk. For example, a number of companies have encountered issues in Canadian examinations regarding the interpretation of the bifurcated royalty rate provisions of the U.S.-Canada treaty, such as the proper scope of the “franchise” exception providing for a 10-percent (rather than a zero-percent) rate of withholding.

E. Amounts Derived by Pension Plans

U.S. treaties should routinely provide for a zero rate of withholding on interest and dividends received by a qualified pension plan or arrangement. Such treatment has been provided by a number of U.S. treaties, including those with Canada, Japan, the Netherlands, and the U.K. However, it is still absent from some U.S. treaties with major trading partners, such as Germany.

U.S. treaty negotiators should seek the inclusion of such provisions in future U.S. treaties as a matter of general policy. This position should also be reflected in the U.S. Model Treaty. To simplify treaty interpretation and avoid any unintended negative inferences among treaties, it would be helpful to develop a text for this purpose that is somewhat more standardized than are the various permutations used in treaties thus far.

F. Amounts Derived Through Flow-Through Entities

The United States should continue to include language in its treaties that specifically confirms the availability of treaty rates of withholding for amounts derived by U.S. residents through flow-through entities. Denial of the treaty rates with respect to such amounts is both inappropriate from a policy perspective, as acknowledged by the 1999 OECD Report on The Application of the OECD Model Tax Convention to Partnerships, and inconsistent with U.S. domestic tax policy, as reflected in section 894(c) of the Code and the Treasury Regulations thereunder.

Although the availability of treaty withholding rates for payments derived by U.S. residents through flow-through entities generally has not been an issue under current treaties, there have been a number of exceptions. Both Germany and the Netherlands, for example, have taken the
view that it was necessary to issue a notice confirming the availability of reduced treaty rates for amounts derived through U.S. limited liability companies. The same issue was addressed in Mexico through the issuance of a miscellaneous regulation in 2003, pursuant to an agreement reached by the competent authorities. Unfortunately, it remains unresolved with Canada to date.

To avoid the risk that treaty benefits will be inappropriately denied in such cases, it is advisable for U.S. treaties to explicitly confirm their availability, as has been done in several recent treaties. The new U.S. treaty with Japan contains the most detailed and clearest language provided thus far for this purpose, which could serve as a useful model for future treaties. Similar language should also be added to the U.S. Model Treaty.

G. Anti-Conduit Provisions

The anti-conduit provisions included in the withholding tax articles of recent U.S. treaties should be clarified as to scope and manner of application and meaning of key undefined terms. Such provisions have appeared in a number of recent U.S. treaties, but their intended scope and operation, and the manner in which they will be applied in practice, is not yet entirely clear. Where confusion has arisen, it may arise in part due to the significant differences from treaty to treaty in the manner in which these anti-conduit provisions have been drafted. These differences presumably are attributable to the fact that these provisions apparently were requested by the U.K. and Japan, respectively, but they make it more difficult to understand the policy intent of the provisions and the manner in which they are likely to be interpreted. In any event, it continues to be the view of the business community that these types of provisions should be avoided in U.S. treaties if at all possible, because they can give rise to undesirable uncertainty about the availability of treaty benefits in certain ordinary business transactions and create needless confusion about their interaction with U.S. domestic law anti-conduit rules.

H. Sourcing Provisions

The sourcing provisions of U.S. treaties should also be clarified. It is the business community’s view that every U.S. treaty should include a sourcing rule which recognizes the foreign source character of income items the treaty authorizes the treaty partner to tax, since that is an indispensable element of avoiding double taxation.

Many U.S. treaties contain language providing that domestic sourcing rules apply in some circumstances in lieu of the general treaty sourcing rules provided for certain cross-border payments. The typical formulation defers to “such source rules in the domestic laws of the Contracting States as apply for purposes of limiting the foreign tax credit” (emphasis added). As a general matter, it should be clarified that this formulation defers to only that subset of U.S. domestic law sourcing rules which apply exclusively for purposes of the foreign tax credit limitation, not to general sourcing rules such as those in sections 861-865 of the Code.

Moreover, even as to that subset of source rules, interpretive issues have arisen in the past as to whether this limiting language renders the election otherwise available under Code section 904(g)(10) unavailable in some circumstances, particularly with respect to dividends that qualify for the new zero rate of withholding. To eliminate any doubt, it should be confirmed, as a
general proposition, that this formulation does not prevent a U.S. taxpayer from invoking the section 904(g)(10) election in order to preserve foreign source treatment under a treaty sourcing rule. It should also be confirmed as a general proposition that dividends from a subsidiary in a country with which the treaty provides for a zero rate of withholding are eligible for the election under Code section 904(g) (10). This is consistent with the explicit confirmation provided in connection with the new U.K. treaty.

I. Anti-“Cherry-Picking” Interpretation

The U.S. Treasury’s Technical Explanations of certain treaties have included references to a so-called “anti-cherry-picking” principle of treaty interpretation. In its most basic sense, this “principle” appears to be aimed at prohibiting taxpayers from selectively invoking favorable provisions of both a treaty and domestic law in order to achieve a tax result for a particular type of income that is better than could be achieved by applying all provisions of either the treaty or domestic law exclusively.

Notwithstanding the Technical Explanations’ description of anti-cherry-picking as a “basic principle of treaty interpretation” recognized by the United States and its treaty partners, there is no U.S. jurisprudence which establishes or delineates such a principle. Moreover, the illustration of the principle in the Technical Explanation is highly questionable as a legal matter. For example, the illustration says that if a treaty provides a lower withholding rate for royalties (i.e., 10 percent rather than 30 percent), but a potentially more expansive U.S. source rule than U.S. domestic law (i.e., all royalties paid by U.S. residents, rather than only those royalties paid for the use of an intangible within the United States), a treaty country resident must choose to apply either the reduced treaty rate to the expanded category of U.S. source royalties or the higher domestic law rate to the smaller category of U.S. source royalties. This conclusion conflicts with the explicit principle found in U.S. treaties which states that treaty provisions do not restrict in any manner any exclusion, deduction, credit, or other allowance accorded by domestic law. Thoughtful commentators have raised serious questions about the appropriateness and scope of any anti-cherry-picking principle that might apply to the interpretation of treaties. Unless and until further analysis is conducted that establishes appropriate legal grounds for, and parameters of, an anti-cherry-picking principle, Treasury should refrain from including references to such a principle in its Technical Explanations of treaties.


140 One revenue ruling is cited as support for the principle, but that ruling cites no legal basis for its denial of treaty benefits to the taxpayer in question. Rev. Rul. 84-17, 1984-1 C.B. 308.

J. Refund and Certification Issues

The successful operation of treaty withholding tax provisions turns in very large part on the application of appropriate procedures for claiming the benefits of those provisions. The practice of granting relief only through refunds tends to diminish the value of those benefits. Similar problems can arise in connection with advance certification requirements, if designed or applied in a manner that effectively precludes enjoyment of the relief provided by treaty. These concerns are discussed in greater detail in Chapter 2 of Part One of this Study.

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CHAPTER 6
ISSUES REGARDING PENSIONS AND EQUITY-BASED COMPENSATION

I. Introduction


Most U.S. bilateral treaties contain either limited provisions relating to pensions or no specific provisions at all. The U.S. Model Treaty contains general provisions designed to address the taxation of distributions, contributions, earnings, benefit accruals, and rollovers, and similar provisions appear in a handful of U.S. bilateral treaties, including those with Canada and France. On a positive note, the new U.S. treaty with the U.K. contains relatively more detailed provisions addressing a greater variety of pension issues. However, most other U.S. treaties contain only very limited provisions relating only to the taxation of pension distributions.

B. U.S. Treaty Provisions Regarding Equity-Based Compensation

U.S. treaty negotiators are to be commended for including provisions addressing certain cross-border stock options issues in the recent treaty agreements with the U.K. and Japan. However, these are the only treaties that specifically address cross-border tax issues relating to stock options, and none contain specific provisions regarding other forms of equity-based compensation, such as restricted stock, phantom stock, and stock appreciation rights. The U.S. Model Treaty contains no specific provisions relating to equity-based compensation. Such provisions are similarly rare in bilateral treaties concluded by other countries.

C. OECD Report on Employee Stock Option Plans

Certain international tax issues relating to stock options have been considered recently on a multilateral basis under the aegis of the OECD. The OECD work has been reflected in a useful report, Cross-border Income Tax Issues Arising from Employee Stock Option Plans, approved by the OECD Committee on Fiscal Affairs on August 23, 2004.\(^\text{142}\) The OECD Report makes a number of specific recommendations, which are discussed in greater detail below.

\(^{142}\) In September 2004, the Secretary-General also released an analytical study prepared by the OECD Secretariat on Employee Stock Option Plans: Impact on Transfer Pricing, which does not reach conclusions or make recommendations. Its subject matter is beyond the scope of this Study.
D. Summary of Current Concerns

Business is concerned about the relative lack of international coordination on the taxation of pensions, stock options, and other forms of equity-based compensation. The lack of coordination results in unrelieved double or multiple taxation in the increasingly numerous instances of cross-border employment. This hampers employee mobility and impedes the efficient conduct of global operations.

E. Summary of Conclusions and Recommendations

U.S. treaty negotiators have made important advances in a couple of recent treaties towards providing broader cross-border coordination on certain pensions and stock options issues. They are to be applauded for these efforts and should be encouraged to expand such coordination to cover additional issues, particularly issues relating to equity-based compensation other than stock options and the other issues discussed below. Wherever possible, this treaty coordination should occur on a multilateral basis. The recent OECD report on Cross-border Income Tax Issues Arising from Employee Stock Option Plans represents a positive step in this direction. Bilateral treaty efforts should be pursued, however, as an interim measure where no multilateral consensus appears likely. Finally, attempts to develop consistent approaches to the taxation of pensions and equity-based compensation in the cross-border context should be kept as simple as possible, to facilitate administration and compliance.

II. Implications for Business

A. Employee Mobility

National tax systems vary significantly in their treatment of pensions and equity-based compensation, as does the form taken by those arrangements from country to country. Tax treaties generally have not addressed most of these differences. Where an employee is sent abroad on temporary assignments, as is increasingly common in global companies, such differences often result in double or multiple taxation. The company may also lose deductions that would otherwise have been available for contributions made to the employee’s pension arrangements. Whether the resulting burden falls primarily on the employee or is assumed by the company, the current lack of coordination imposes additional costs that hamper the cross-border mobility of personnel.

B. Operational Efficiency

The current multiplicity of taxing regimes and relative lack of cross-border coordination increase both the risk of double or multiple taxation and the costs of global tax compliance. This is a significant concern for businesses because it hinders their ability to operate globally in an efficient manner.
III. Implications for Governments

A. Avoidance of Double Non-Taxation

Governments recently have shown increased interest in tailoring treaties to avoid instances of double non-taxation. In the pension context, this is evidenced by the provision in the new treaty with the U.K., unique among U.S. treaties, which grants the country of source the sole taxing jurisdiction over pension distributions paid in a “lump sum.” This unusual rule operates to prevent lump sum distributions from U.S. pension arrangements to U.K. residents from escaping taxation in both the U.K. and the United States, as was possible in some circumstances under the prior treaty. Where such double non-taxation is not a potential problem, however, the United States should avoid including this kind of provision in its treaties.

B. Protection of Tax Base

Some countries are also focused increasingly on the protection of their tax bases in connection with pensions, seeking to retain taxing jurisdiction over distributions to persons who exercised their employment there, and who presumably were allowed to claim deductions for contributions to their pension arrangements. These concerns may have been prompted by the increased willingness of employees to retire abroad, especially within Europe. In these cases, it seems likely that the countries in which such workers tend to exercise their employment will seek to retain taxing jurisdiction at source, while those countries to which such workers tend to retire will seek jurisdiction to tax based on residence. This situation is, unfortunately, likely to make the development of a broad international treaty policy consensus on pensions more difficult.

IV. Current Concerns Regarding Pensions

Most treaties do not adequately address cross-border tax issues relating to pensions. Many specify that pension distributions are subject to tax only at residence or, in a few cases, at source, but most do not adequately address either the tax issues relating to such distributions or other issues. The period between the making of contributions and accrual of earnings and benefits to the pension arrangement and the distribution of amounts from the arrangement typically spans a number of years or decades. The double or multiple taxation resulting from the variations among national tax regimes is, therefore, often not relieved.

Some U.S. treaties have attempted to address certain issues relating to pensions, which represents a positive step. However, they have tended to provide specific rules that cover particular bilateral cases, rather than general principles. This has resulted in a patchwork of tailored provisions that vary, sometimes significantly, from treaty to treaty. The resulting multiplicity of approaches increases the interpretive difficulties and administrative costs for taxpayers and tax administrations of applying treaty pension provisions. They also often fall short in addressing issues that arise in the increasingly common case of peripatetic employees, who move from one

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143 See Article 17(2).
international assignment to another and may even retire abroad, rather than doing a short overseas assignment and returning to their home country. A certain degree of tailoring in treaty pension provisions probably is inevitable, given the need to mesh differing national tax systems. However, U.S. treaty negotiators and their foreign counterparts should continue to seek broader international consensus on cross-border pension issues wherever possible. Given the highly specialized nature of the subject matter, input should be obtained throughout this process from benefits experts to ensure that these issues are addressed appropriately.

Where differences among domestic taxation regimes, or imbalances in cross-border employee assignment or retirement flows, currently preclude broad consensus, treaty negotiators should continue to seek broader international consensus on cross-border pension issues wherever possible.

Whether agreement is reached multilaterally or bilaterally, it should address as many cross-border pensions issues as possible as broadly as possible, to minimize the risk of double or multiple taxation. Issues should also be addressed in as simple a manner as possible, to facilitate compliance and administration. Although perhaps not always avoidable due to technical and policy considerations, it should be remembered that taxpayers and tax administrators face very significant challenges, and greatly increased administrative and compliance costs, when required to apply the provisions of another country’s laws.

The mutual agreement process ideally should be used not as a surrogate for treaty agreements but rather to relieve double or multiple taxation where necessary, pending the negotiation of specific treaty provisions. U.S. treaties that have attempted to address pension provisions have tended to condition the availability of relief on an advance determination by the competent authority concerned that the foreign pension arrangement “generally corresponds” to one of its country’s own arrangements. Such determinations often have been made in the past only after the treaty has been in effect for some time, or not at all, and have resulted in the coverage of only limited categories of pension arrangements. The diplomatic notes that accompanied the new U.K. Treaty represent a helpful effort to resolve this issue in advance with respect to that Treaty, but they did not resolve all questions.

Cross-border pension issues have arisen in practice on seven points in particular, each of which should be addressed in future treaties wherever possible. These points are discussed in turn below.
A. Definition of “Pension”

Treaties that address issues relating to “pensions” often do not specify what that term includes. Its definition has, therefore, been left largely to unilateral interpretation, which has varied from country to country and even from treaty to treaty. For example, the U.S. Treasury Department and Internal Revenue Service have taken the position, in interpreting similar treaty provisions over the years that the term “pension” both includes and excludes Individual Retirement Accounts and similar arrangements. The U.S. Model Technical Explanation of Article 18 sets forth the U.S. Treasury’s current position regarding the definition of the term “pension,” but that definition is not consistent with Treasury’s interpretation of more recent treaties. Further, the specific criteria set forth in the Model Technical Explanation, namely, that the plan be written, that it be “nondiscriminatory” in the case of an employer-maintained plan, that it contain restrictions on the non-retirement use of assets by participants, and that it require minimum distributions so that death benefits to survivors are merely incidental, are not descriptive of many pension arrangements commonly provided by companies. For example, a typical, supplemental pension arrangement for key employees of a company would not be a pension plan under these criteria. The fact that such a plan may be regarded as “discriminatory” for certain purposes under U.S. domestic law should not be a basis for denying treaty coverage in the cross-border context. Similarly, it would be helpful for treaties to clarify that a plan need not be “funded” in the technical U.S. domestic law sense in order to qualify as a pension plan for treaty purposes.

To ensure reciprocal application, promote consistent interpretation of similar provisions, and avoid unintended inferences, covered pension arrangements should be specified by treaty or contemporaneous bilateral agreement. The defined scope should be as broad as possible, to maximize relief from double or multiple taxation.

B. Covered Forms of Distributions

The U.S. Treasury and IRS have also taken differing positions over the years as to whether treaty pension provisions apply to distributions paid in a lump sum, rather than as periodic payments. It should be clarified that all otherwise qualifying pension distributions are covered by treaty, regardless of the form in which the distribution is made.

C. Timing of Distributions

The pension provisions of some U.S. treaties have been interpreted as applying to non-U.S. pension arrangements only if they are subject, among other requirements, to the same limitations on the timing and frequency of distributions as apply for purposes of U.S. domestic tax law. The U.S. Model Technical Explanation of Article 18 specifically refers to these requirements as prerequisites for a finding by the competent authorities that a non-U.S. pension plan “generally corresponds to” a U.S. plan. Such U.S.-specific interpretations should be avoided, as they significantly limit the utility of treaty pension provisions and increase the likelihood of double or multiple taxation.

D. Characterization of Distributions
National tax systems vary in their characterization of pension distributions, particularly on the issue of what portion, if any, of the distribution should be treated as the recovery of basis. It would be very helpful for treaties to address this issue to ensure consistent characterization. The new U.S. Treaty with the U.K., for example, attempts to address the basis recovery issue by providing that the residence country generally may not tax a distribution to the extent that the distribution would be exempt from taxation in the source country if the beneficial owner were a resident of that country. However, such provisions unfortunately are rare.

E. Employer Deduction for Contributions

Issues also arise regarding the deductibility of contributions made by an employer on behalf of an employee working in one country (the “work country”) to a pension arrangement established under the laws of another country (the “home country”). Despite their significance, these issues have been addressed by only a few treaties to date, and generally only with respect to coverage predating the transfer assignment.

F. Timing of Taxation of Benefits

A variety of timing issues arise in the cross-border context with respect to pension arrangements, reflecting significant differences of approach among national tax systems. International coordination on these timing issues is particularly important because of the obstacles they can present for double taxation relief, especially in credit countries that provide a limited carryback or carryover period.

1. Contributions

The key issue with respect to contributions is whether an employee is subject to tax currently in the work country on contributions made to a home-country pension arrangement, or whether the taxation of such amounts is deferred until they are distributed. This issue arises with respect to contributions made by the employee, as well as with respect to those made on his or her behalf by the employer. Again, only a few treaties address this issue. It can be difficult to resolve because of the significant differences among national tax systems, with some taxing upon contribution and others deferring taxation until distribution.

2. Earnings and Benefit Accruals

Similar differences arise in the cross-border context with respect to the time at which earnings and benefits that accrue within a pension plan are taxed. Again, these are issues that can easily result in double taxation but have rarely been addressed by treaty.

G. Taxation of “Rollovers”

\[144 \text{ See Article 17(1)(b).}\]
Cross-border issues are arising with increasing frequency regarding the treatment of amounts “rolled over” from one pension arrangement to another. The issue here is whether tax will be imposed when an amount is rolled over from a qualifying pension arrangement in one country to a qualifying pension arrangement in another country, or whether it will be deferred until distribution from the second arrangement. Several U.S. treaties permit tax-free rollovers to arrangements that satisfy certain requirements, but this issue is not addressed in other treaties.

V. Current Concerns Regarding Stock Options and Other Equity-Based Compensation

While they represent important progress on the issue, only two very recent U.S. treaties, those with the U.K. and Japan, currently contain specific provisions relating to stock options. No U.S. treaties specifically address the cross-border tax issues relating to other forms of equity-based compensation, such as restricted stock, stock appreciation rights, and phantom stock. As a result, double or multiple taxation of such compensation remains a significant risk.

As noted above, some progress has been made recently at the OECD in developing a multilateral consensus on certain issues relating to stock options. The OECD Committee on Fiscal Affairs recently approved a report advocating changes to the OECD Model Commentary that recommend consistent international approaches on the following key points:

- Relief from double taxation should be granted by the residence country, even if it taxes the employment benefit derived from stock options in a different year than does the source country;

- Income accrued on a stock option prior to exercise generally should be characterized as employment income, while amounts that accrue thereafter generally should be treated as capital gains;

- The employment services to which a stock option relates should be determined on the basis of the facts and circumstances of each case, in accordance with specified guidelines;

- When employment services are provided in more than one jurisdiction, the percentage of income attributable to the performance of services in a specific country, and thus potentially subject to tax in that country, should be determined on the basis of the number of days during which employment was exercised in that country, relative to the total number of days on which services were performed during the relevant period; and

- The same rules generally also should apply to stock options granted to members of a board of directors.

U.S. treaty negotiators should continue to seek a broad international consensus on cross-border stock option issues wherever possible. They should also seek to expand that effort to provide analogous treatment for other forms of equity-based compensation, such as restricted stock, stock appreciation rights, and phantom stock, which were specifically excluded from the scope of the recent OECD report. As in the case of pensions, such efforts should be as broad in scope as possible and should provide approaches that minimize administrative and compliance burdens to the extent feasible. Where a broad international consensus cannot be reached, U.S. treaty negotiators should continue to negotiate bilateral treaty provisions to address as many of these issues as possible.

Cross-border coordination is particularly needed to avoid double taxation with respect to the following issues relating to equity-based compensation, some but not all of which would be addressed by the recent OECD recommendations:

A. Measurement of Taxable Income

A greater international consensus appears to be emerging, but there are still significant differences at present among some countries regarding the measurement of taxable income recognized by employees in connection with equity-based compensation. These differences are particularly marked in the stock option area. Countries may take very different approaches to when income in respect of stock options should be measured, whether when the option is granted, when it vests, when it is exercised, when the shares obtained upon exercise are sold, or at some other time. Taxable income may vary substantially from country to country if the measurement of income occurs at different times. In addition, countries may regard themselves as taxing different events. As acknowledged by the recent OECD report, both of these factors may make it difficult or impossible for companies to obtain effective relief from double taxation in all cases.

B. Timing of Taxation of Benefits

Taxation of equity-based compensation may occur at the time the income is measured or at a different time or times. Where there is a timing mismatch between countries, double taxation relief often will be hindered, as in the case of pension benefits, unless there is a cross-border agreement to address the issue. Any such limitation should, wherever possible, take into account the practical systems limitations that companies face in tracking relevant employment information, to avoid the creation of new compliance burdens.

C. Sourcing Issues

While sourcing issues also arise for other forms of compensation in the cross-border context, they are particularly common with respect to stock options and equity-based compensation. These sourcing issues tend to arise as a result of two major factors. First, the sourcing provisions of national tax systems may diverge. Second, countries may apply different methods for determining the services to which the equity-based compensation relates, with some tending to view such compensation as paid for past services and others as paid for future services. Where
the employment services considered relevant are rendered in more than one country, or where the employee’s residence changes during the relevant measurement period or periods, these differences may result in double or multiple taxation on the basis of residence, as well as the more common double taxation as between residence and source countries. The imposition by some countries of “departure taxes” on individuals at the time of any cross-border change in residence raises similar issues. It is unlikely that double or multiple taxation will be avoided in such cases in the absence of international coordination on sourcing issues.

D. Characterization Issues

In some instances, countries take differing positions regarding the characterization of amounts realized in respect of equity-based compensation. Some treat the entire amount as ordinary or employment income and, therefore, as “remuneration” for treaty purposes under Article 15 (Income From Employment). Others may take the position that a portion of the amount realized represents capital gain, for example, the difference between the value of a stock option at exercise and its value upon grant or vesting. Such amounts would fall instead under Article 13 (Capital Gains) for treaty purposes. Such differences of approach on characterization issues create potential double or multiple taxation that may not be relieved under standard treaty provisions.

E. Employer Deduction

Another set of differences among countries relates to the deductibility by the employer of the costs of the equity-based compensation. These differences may relate to both amount and timing, or even to the very availability of a deduction, and they may lead to unrelieved double or multiple taxation. The appropriate resolution of these issues, where they arise in the cross-border context, is critical from a business perspective.

F. Issues Arising as a Result of a Corporate Reorganization

Where, as a result of a corporate reorganization, options to acquire shares in one company are replaced with options to acquire shares in another company, some countries may consider the options to have been alienated as a result, or may impose technical notification or ruling requirements for tax-free treatment. Where countries take different positions on this issue, or where they assert overlapping claims of jurisdiction upon such an event, double or multiple taxation may arise. To help resolve these issues, U.S. treaty negotiators should seek to provide clarification that an exchange of options or shares in this context should be tax-free to the optionholder or shareholder, as the case may be, and that holding periods will be tacked for this purpose.

G. Additional Issues for Equity-Based Compensation Other Than Stock Options

Additional issues may arise with respect to restricted stock, stock appreciation rights, phantom stock, or other forms of equity-based compensation. For example, in the case of restricted stock, countries may take differing positions regarding the types of restrictions that may have an effect on its taxation and on what that effect should be. To provide adequate cross-border coordination,
it may be necessary to identify and address such points in addition to the generally applicable issues identified above.

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CHAPTER 7

ISSUES REGARDING THE U.S. MODEL TREATY

I. Introduction

A. Background

The United States has long been active in the multilateral drafting and interpretation processes relating to the OECD Model Convention and Commentary, which are widely used in the negotiation and interpretation of bilateral treaties. The United States is virtually unique among major countries in also maintaining a published model income tax treaty of its own, which differs in some respects from the OECD Model.\(^{146}\) The U.S. Model Treaty was first published in 1977 and soon followed by a new version, released in draft form, in 1981. It was last updated in 1996, at which point a Model Technical Explanation was added. The current U.S. Model Treaty and Technical Explanation do not reflect significant developments since 1996, but the U.S. Treasury Department announced in early 2004 that it is in the process of preparing a partial revision of those documents.

B. Role of U.S. Model Treaty

The U.S. Model Treaty and Technical Explanation play an important role in notifying treaty partners, taxpayers, and others of general U.S. Treasury Department negotiating positions and changes in those positions. The U.S. Model Treaty is not intended to represent an ideal U.S. treaty, as each treaty must be tailored to reflect unique bilateral considerations and negotiations. However, the U.S. Model Treaty and Technical Explanation facilitate the negotiation of bilateral treaties by enabling the efficient identification of points for discussion. They also promote consistency of language across treaties, reducing interpretive ambiguities and facilitating the development of broadly applicable interpretive guidance. This is particularly important for issues or interpretations on which the preferred U.S. position differs from that reflected in the OECD Model Convention and Commentary.

C. Summary of Key Issues

The U.S. Model Treaty and Technical Explanation play an important part in making U.S. treaty policy more transparent, facilitating more efficient bilateral U.S. treaty negotiations, and promoting greater consistency in bilateral U.S. treaty texts. However, issues have arisen regarding their proper role and interpretation in the treaty negotiation and ratification processes, the frequency of revisions and the process by which such revisions are made, the scope of the U.S. Model Treaty and Technical Explanation, and their use as vehicles for providing interpretive guidance.

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\(^{146}\) Other countries with published model treaties include Croatia, Malaysia, Mexico, Peru, and Sweden.
D. Summary of Conclusions and Recommendations

Business supports the continued development and publication of a U.S. Model Treaty and Technical Explanation, because they serve certain useful purposes that cannot be served by the multilateral OECD Model Convention and Commentary. The process of developing and interpreting the U.S. Model Treaty and Technical Explanation, however, could be improved in some respects.

The role of the U.S. Model Treaty and Technical Explanation must be clearly understood if they are to serve their intended purposes. The U.S. Model and Technical Explanation should be regarded as a means of identifying and providing standard texts for points on which it is believed necessary and appropriate for the preferred U.S. negotiating position to depart from the OECD Model Convention and Commentary. It should be recognized that the U.S. Model Treaty does not represent an ideal treaty that can be used as a definitive standard to evaluate the acceptability of a proposed bilateral U.S. treaty, or a series of positions subject to “cherry-picking” by prospective treaty partners regardless of overall balance.

The U.S. Model Treaty and Technical Explanation should be updated with much greater frequency. The U.S. Treasury Department should be encouraged to undertake partial revisions if resource constraints require, as it is now in the process of doing for the first time. Changes should be issued in draft form with an opportunity for public comment before finalization. New U.S. negotiating positions should be proposed first as revisions to the U.S. Model Treaty rather than in bilateral treaties, wherever possible.

The scope of the U.S. Model Treaty should be expanded to include texts for provisions that U.S. negotiators may not be willing to include in all bilateral treaties, as well as new provisions not yet included in any bilateral U.S. treaty. Changes to the U.S. Model Treaty and Technical Explanation should be proposed for comment before they are made. Taxpayers and practitioners need additional guidance on issues of treaty interpretation, but caution should be taken in using the U.S. Model Treaty or Technical Explanation for this purpose. In most circumstances, the issuance of general published guidance is preferable on issues subject to unilateral U.S. interpretation, while issues on which reciprocal treatment is sought should be addressed in bilateral documents with binding effect under international law. The U.S. Treasury Department and Internal Revenue Service should clarify their position regarding the effect of changes in U.S. or OECD Model documents on their interpretation of bilateral U.S. treaties and regarding the interaction, if any, between the U.S. and OECD Model documents. They also should confirm that they will not seek to apply changes in treaty interpretation to the retrospective disadvantage of taxpayers.
II. Implications for Business

The development and publication of a U.S. Model Treaty and Technical Explanation benefits business and other constituencies by providing notice of the treaty negotiating positions generally preferred by U.S. negotiators. It also provides an opportunity, at least in theory, for general comment on those positions outside of the context of the ratification process relative to specific bilateral treaties.

III. Implications for Governments

The development and publication of a U.S. Model Treaty and Technical Explanation provides similar benefits for governments. It is an efficient means of notifying treaty partners, taxpayers, and others of general U.S. negotiating positions and of changes in those positions. It also may be used as a vehicle for obtaining public comment on preferred positions in advance of the negotiation of bilateral treaties.

IV. Current Concerns Regarding U.S. Model Treaty

A. Role

Issues regarding the role of the U.S. Model Treaty have arisen from time to time. To avoid confusion and unintended results, it is important that the U.S. Model be interpreted and applied as intended.

The first issue regarding the role of the U.S. Model Treaty is that it may be viewed by the Senate Committee on Foreign Relations and other Congressional tax policymakers as a checklist for evaluating proposed bilateral treaties. This is suggested by the fact that the explanations prepared by the Staff of the Joint Committee on Taxation and the reports issued by the Committee on Foreign Relations typically include a detailed catalogue of the points on which a proposed bilateral treaty differs from the text of the current U.S. Model Treaty. This approach raises unnecessary issues in many cases. The U.S. Model Treaty is not intended to represent an ideal U.S. bilateral treaty, but rather is designed to be tailored to address issues specific to each bilateral relationship and treaty negotiation. A bilateral treaty represents an agreement between two sovereign nations that cannot reasonably be expected to conform to the initial U.S. negotiating position on each and every issue. In addition, unless the U.S. Model Treaty is revised frequently, it obviously will not necessarily reflect the current preferred U.S. negotiating position on all issues. Conversely, in some circumstances, a bilateral treaty will adopt a previous U.S. Model position that has changed after the negotiators reached agreement on the point, which the U.S. negotiators have little leverage to revisit. While the U.S. Model Treaty plays an important role in promoting transparency and consistency, it should not be viewed, in itself, as a definitive standard for assessing the desirability of proposed bilateral treaties.

Another issue regarding the role of the U.S. Model Treaty is that potential treaty partners may view it as a minimum offer on each issue, rather than as an overall package subject to bilateral negotiation. They may attempt in treaty negotiations to insist that the United States agree to the Model position on selected issues and depart from the Model on other issues. The risk that potential treaty partners will attempt to interpret the U.S. Model in this fashion is heightened by the fact that other countries do not generally publish a model treaty of their own. This interpretation of the U.S. Model is inappropriate. A bilateral treaty must represent a balanced agreement that each of the Contracting States views as consistent with its overall interests. In addition, the position generally preferred by the United States on one issue may turn directly on how another, related issue is addressed.

Finally, in developing the U.S. Model Treaty and Technical Explanation and determining when it is appropriate to depart from their provisions in bilateral negotiations, it is necessary to strike a proper balance between the need for adequate recognition of particular U.S. policy or interpretive concerns on the one hand, and the desirability of maximizing consistency with the OECD Model Convention and Commentary on the other. While it is sometimes preferable to depart from the general international consensus in order to address particular U.S. concerns, such departures must be carefully weighed, as they increase the risk of international disputes that can result in unrelieved double taxation and additional administrative costs for both taxpayers and governments.

Despite these potential issues, business strongly supports the continued development and publication of a U.S. Model Treaty and Technical Explanation. These documents promote consistency among U.S. treaties where appropriate, and their publication is preferable to the use by negotiators of non-published model texts.

B. Revision Process

The U.S. Model Treaty has had limited utility thus far as a vehicle for announcing changes in U.S. negotiating positions, due to the infrequency with which it has been updated. More frequent updating of the Model Treaty and Technical Explanation is essential if they are to serve their intended purposes. The infrequency with which they have been revised in the past presumably is attributable to the substantial time and resources required for a complete revision. To avoid this difficulty, the U.S. Treasury Department should be encouraged to undertake more frequent partial revisions, as it is now in the process of doing for the first time. This is consistent with the approach taken since 1992 by the United States and other OECD member countries in revising the OECD Model Convention and Commentary, portions of which are now being updated every year or two.

Changes to the U.S. Model Treaty and Technical Explanation should be issued in draft form with an opportunity for public comment before finalization. This approach was taken in 1981 with the issuance of a revised model in draft form. The publication of proposed changes in draft form would benefit both business, by providing a formal mechanism for comment, and government, by providing a mechanism for input on policy and technical concerns before new positions are included in proposed bilateral treaties.
Similarly, new U.S. negotiating positions should ideally be reflected first as revisions to the U.S. Model Treaty, rather than in bilateral treaties. This would provide an opportunity for public comment on policy and technical issues before new positions are adopted in signed bilateral treaties, and would help avoid ratification issues and subsequent interpretive controversies. Where treaty negotiating dynamics preclude this approach, the nature of any changes agreed to in bilateral treaty negotiations should be clarified. If the agreed provision does not reflect a change in the general U.S. negotiating position, this should be indicated in the U.S. Treasury Technical Explanation of the treaty. If the new provision does represent a change in the preferred U.S. position, it should be proposed for comment before inclusion in the U.S. Model Treaty or in subsequent bilateral treaties.

C. Scope

The U.S. Model Treaty historically has contained only provisions that U.S. negotiators are willing to include in any otherwise acceptable bilateral treaty. Consequently, there is no Model Treaty or Technical Explanation language for many provisions frequently included in bilateral treaties, such as the “derivative benefits” safe harbor in Limitation on Benefits Articles. The texts of such provisions have tended to vary, sometimes substantially, from treaty to treaty, as have the accompanying U.S. Treasury Technical Explanations. As an interpretive matter, it has sometimes been difficult to discern whether these variations were intended as substantive differences or mere drafting clarifications.

The scope of the U.S. Model Treaty and Technical Explanation should be expanded to address this situation. Model texts should be included for provisions that the United States may be willing to include in some but not all treaties. They should also be provided for new provisions that U.S. negotiators may be willing to consider in appropriate circumstances, such as the mandatory arbitration provisions sought by business. Alternative texts should be published for provisions on which differing approaches may be used from treaty to treaty. This approach, which has been used successfully in the OECD Model Convention and Commentary, would promote transparency in the treaty process as well as greater drafting consistency where appropriate. To avoid confusion, the fact that such texts are appropriate only to certain circumstances or are alternatives appropriate to different situations could be explained in footnotes to the U.S. Model Treaty or in the Model Technical Explanation.

D. Interpretive Guidance

Taxpayers and practitioners need additional guidance on issues of treaty interpretation. Treaty texts tend to be brief and general in nature and are not always accompanied by a sufficiently detailed memorandum of understanding or other bilateral agreement. Additional interpretive guidance is often needed, sometimes after the treaty has been signed or even after it has entered into force.

148 See Chapter 3, Arbitration, supra.
Interpretive issues have sometimes been addressed in the U.S. Treasury Technical Explanation of a bilateral treaty. This approach may suffice as a practical matter, assuming that the issue is one that is properly subject under the treaty to unilateral U.S. interpretation and that the Technical Explanation is not inconsistent with the plain text of the treaty. Where an issue is addressed in one Technical Explanation but not in others relating to the same treaty text, however, an interpretive issue may arise as to whether any inference is created with respect to those other treaties. Such language arguably should create a positive inference regarding the U.S. Government’s interpretation of the text, at least with respect to existing treaties containing the same text, although it is not clear that such interpretations should be considered binding on taxpayers. Where subsequent treaties contain the same text but omit the Technical Explanation discussion, however, it is not clear whether a negative inference should be drawn.

Such interpretive issues should be avoided where possible through the publication of general guidance regarding common issues. The publication of more general guidance also would help to facilitate interpretation of treaty provisions and avoid “traps for the unwary,” which can easily result from the publication of interpretations in isolated Technical Explanations of which practitioners who are not treaty specialists may be unaware.

Interpretive issues on which reciprocal treatment by the treaty partner is needed or desired, such as definitions of key terms, should be addressed in the text of the bilateral treaty or in other bilateral documents with binding effect under international law. While such issues should be addressed prior to entry into force of the treaty where possible, the competent authorities should be encouraged to reach agreements to resolve other issues efficiently, where appropriate.

While they may provide information regarding general U.S. treaty policy and guidance to Internal Revenue Service personnel, the U.S. Model Treaty and Technical Explanation normally are not ideal vehicles for the provision of legal guidance regarding the interpretation of a bilateral treaty. They are unilateral in nature and, thus, have no binding effect on the treaty partner. They may be considered as persuasive evidence of the U.S. negotiators’ intent with respect to identical bilateral treaty texts and, therefore, as determinative of the Internal Revenue Service’s interpretation of such texts, but their legal effect is unclear even for U.S. purposes. There are similar issues regarding the legal effect, if any, of the OECD Commentary on the interpretation of existing or future bilateral treaties. In addition, it is not clear what inference, if any, should be drawn where the provisions of the OECD Commentary differ from or, as is commonly the case, provide more detail than those of the U.S. Model Technical Explanation.

Both the Preamble of the U.S. Model Technical Explanation and the Introduction of the OECD Commentary indicate a general intention to interpret previously negotiated bilateral treaties in an ambulatory manner, consistent with subsequent changes, if any, to the Explanation or Commentary. The U.S. Treasury Department and Internal Revenue Service should clarify their position regarding the effect of changes to the U.S. Model Treaty or Technical Explanation or to the OECD Model Convention or Commentary on their interpretation of the same language in bilateral U.S. treaties. They should also clarify the intended interaction, if any, between the U.S. and OECD materials. In addition, they should confirm that they will not seek to apply subsequent changes in treaty interpretation to existing U.S. treaties in a manner that
retrospectively disadvantages taxpayers. If a modification is viewed as a clarification rather than a change, or as not disadvantageous to taxpayers, this position should be publicly stated to put taxpayers on notice of the intended interpretation. Clarification of these points would provide valuable assistance to taxpayers and practitioners seeking to interpret bilateral treaties in the context of limited interpretive materials.

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