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The League of Nations' *Draft Convention for the Allocation of Business Income between States*—a new starting point for the attribution of profits to permanent establishments

The recent publication by the OECD of *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7*[1] has highlighted that it is time to go back to basics and reassess the attribution of profits to permanent establishments. The "Authorised OECD Approach" (the AOA)[2] to the attribution of profits to permanent establishments has not found many supporters, and has been rejected by a large group of countries.[3] It is time to rediscover the alternatives.

This is not the appropriate place to discuss why the AOA has not proved successful. Rather, the purpose of this short note is to point to alternative approaches to the attribution of profits to permanent establishments by going back to the historical origins of the work on attribution.

The League of Nations' *Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation* (the Draft Convention) has every reason to be given a high pedestal as the document that was the origin for the current approach *both* to transfer pricing between separate but associated companies *and* the attribution of profits to permanent establishments.[4] The publication of the Report of the Fiscal Committee (to which the Draft Convention was attached) followed a three year study of the issue of apportionment of profits of concerns operating in several countries by Mitchell B. Carroll.[5] The Draft Convention has every claim to be the founding source for the modern approach to transfer pricing and to the attribution of profits.

The main purpose of this note is to point to Article 3 of the Draft Convention as a new starting point for the discussion of the approach to the attribution of profits to permanent establishments

[1] OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7* (Paris: OECD, March 2018), available at: *http://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm* [Accessed 12 November 2018].

[2] See OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010), available at: *http://www.oecd.org/tax/transfer-pricing/45689524.pdf* [Accessed 12 November 2018].

[3] The United Nations Committee of Experts has rejected the AOA—see the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model) (New York: United Nations, 2017), Art.7, particularly the Commentary at para.1. In addition a growing number of OECD Member Countries have also entered reservations to the new (2010) version of the OECD Model Art.7 to the effect that they reserve the right to employ the older (pre-2010) version—see OECD, *Model Tax Convention on Income and on Capital: Condensed Version* (the 2017 OECD Model) (Paris: OECD, 2017), available at: *https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1* [Accessed 23 November 2018], Commentary on Article 7, paras 95–97, 99 and 100. The list of OECD countries now includes Australia, Austria, Chile, Greece, Latvia, Mexico, New Zealand, Portugal, Slovak Republic and Turkey.

[4] The Draft Convention is attached to the *Report of the Fiscal Committee of the League of Nations to the Council on the Fourth Session of the Committee* (published 26 June 1933). The reference is C.399.M.204. 1933.II.A.[F./Fiscal.76]. The text can also be found on the Tax Treaties History website, at: *http://www.taxtreatieshistory.org/* [Accessed 12 November 2018].

[5] The results of that research were published in five volumes. See M.B. Carroll and R.C. Jones, *Taxation of Foreign and National Enterprises: A Study of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country* (Geneva: League of Nations, 1932–33).

in place of the AOA. However, it is worth making a few general comments about the Draft Convention by way of background.

Though the Draft Convention never attained sufficient signatures to enter into force, this should not be taken in any way to undermine the importance or significance of this document. The mid- to late-1930s was hardly a propitious time for states to be entering into a multilateral convention, and already by the mid-1930s there was a distinct preference for bilateral double taxation agreements. It is immediately apparent, however, to anyone with a background in bilateral double taxation conventions how much the wording of the Draft Convention has influenced the wording of virtually all modern tax treaties.

If one compares Article 5 of the Draft Convention (quoted below) with Article 9 of the OECD Model[6] or the UN Model,[7] the parentage of the current provisions is immediately apparent. Even more significant for the subject matter of this note is the obvious link between the wording of the first paragraph of Article 3 of the Draft Convention and the general rule for attribution of profits to permanent establishments in Article 7(2) of the 2017 OECD Model and the UN Model. It is not necessary to resort to DNA testing to recognise that the parentage of the current provisions can be traced back to the 1933 Draft Convention.

The first general comment that might be made about the Draft Convention is that it clearly distinguishes between *transfer pricing* (between separate but associated companies) on the one hand, and the *attribution of profits to permanent establishments* on the other. What we would now call transfer pricing is covered by Article 5 of the Draft Convention; what we would now call the attribution of profits to permanent establishments is covered by Article 3. It can be inferred from this that the draftsmen of the 1933 Draft Convention (quite correctly) saw transfer pricing between separate but associated companies as a problem of a different nature from the attribution of profits to permanent establishments.[8]

Here it is appropriate to note one unfortunate legacy of the Draft Convention which has caused problems down to the present time, and that is the use of the term "enterprise".[9] Both Article 3 and Article 5 of the Draft Convention use this term. Of course, an *enterprise* may be a reference to the business activity or undertaking carried out by a person, or it may be a reference to the person that carries out the activity. Article 3 (quoted below) perhaps refers initially to the person ("an enterprise with its fiscal domicile in one contracting State"), but then to the undertaking ("the separate accounts pertaining to such establishment"). Article 5, would refer to the person.

[6] The 2017 OECD Model, above fn.3.

[7] The UN Model, above fn.3.

[8] The point is obvious to make: that transfer pricing involves separate legal entities, each capable of owning its own assets and of entering into binding contracts with one another, while the attribution of profits involves two parts of the same legal entity, without separate legal ownership of assets and without the capability of the two parts to enter into binding legal agreements (but only to have arrangements or dealings between the parts). In the case of transfer pricing, each company is likely to have its own financial statements disclosing its profits, and legal intervention is only needed to make adjustment when the conditions between these two companies do not reflect the arm's length principle. In the case of attribution of profits, however, there may or may not be separate accounts, and in most cases it is necessary to apportion the global profit between the two parts of the same entity.

[9] On this see G. Maisto (ed.), *The Meaning of "Enterprise", "Business" and "Business Profits" under Tax Treaties and EU Tax Law* (Amsterdam: IBFD, 2011), especially Ch.5, 61–83, by K. van Raad, "'Enterprise' and 'Enterprise of a Contracting State': Towards a Century of Confusion Regarding the Term 'Enterprise' in the Model Double Taxation Conventions".

In defence of the Draft Convention, the Protocol contains a definition of "enterprise" which implies that it may have been intended to be used more in the sense of an undertaking:

> "2.(a) As used in this Convention, the term 'enterprise' includes every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity."[10]

It is clear from the wording of Article 5 of the Draft Convention and from its Commentary that it was concerned with the relationship between separate but associated companies. Article 5 provides as follows:

> "When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise."[11]

References to "participation in the management or capital…" by one enterprise in the other enterprise gives a clear indication that this Article was intended to apply to separate but associated companies. The Commentary makes this even clearer:

> "Ad *Article 5*. — Article 5 deals with *subsidiaries* which will be taxed as independent enterprises provided no profits or losses are transferred as a result of the relations between the *affiliated companies*. If such transfers are effected, the administration will make the necessary adjustments in the balance-sheets." (Emphasis added.)[12]

The wording of Article 5 of the Draft Convention is also something of a clue to the slightly unusual wording of Article 9 of the 2017 OECD Model and the UN Model and its reference to "conditions are made or imposed…".[13]

[10] Draft Convention, above fn.4, Protocol Art.2(a).
[11] Draft Convention, above fn.4, Art.5.
[12] Draft Convention, above fn.4, Commentary on Article 5.
[13] The UN Model, above fn.3, Art.9 and the 2017 OECD Model, above fn.3, Art.9 both provide:

> "1. Where
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,
> or
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Turning to the main topic of this note, which is the call for a new start (but based on historical origins) to the attribution of profits to permanent establishments, Article 3 of the Draft Convention merits quotation in full:

> "If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated.
>
> The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.
>
> If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.
>
> If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting."[14]

The first paragraph of Article 3 of the Draft Convention contains phraseology in its first sentence which will, of course, be immediately familiar to anyone with any knowledge of Article 7(2) of the 2017 OECD Model and the UN Model. The phrase "there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions" will immediately engender a warm feeling of familiarity.[15] In many senses, this was

[14] Draft Convention, above fn.4, Art.3.

[15] For those less familiar, compare the wording of the (old, pre-2010) OECD Model Art.7(2) (OECD, *Articles of the Model Convention with Respect to Taxes on Income and on Capital* (as they read on 15 July 2005), available at: *http://www.oecd.org/tax/treaties/35363840.pdf* [Accessed 12 November 2018]):

> "Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State

the innovation introduced by the League of Nations Report and the Draft Convention: to treat each permanent establishment as if it were an independent enterprise (bringing with it all the confusion from the fact that an "enterprise" may refer to the business activity or the entity that carries it out).

What, however, is likely to be quite unfamiliar to those with a background in current tax treaty practice is the remaining three paragraphs of Article 3. Sadly, this is the "lost" material in the Draft Convention, which has lain buried in the sand for so long. In the wake of the failure of the AOA, this material deserves to be rediscovered and re-examined. It was, after all, the result of several years of study by Mitchell B. Carroll, and was endorsed by the experts at the League of Nations in the 1930s.

The purpose of this note is absolutely clear: to recommend that the OECD, UN and other bodies should go back and re-examine the approach to the attribution of profits to permanent establishments, taking as a starting point the methodologies discussed in this Article 3 of the Draft Convention.

The starting point should be the separate accounts maintained for the permanent establishment (as is clear from the first paragraph of Article 3 of the Draft Convention). This is absolutely logical (and totally ignored under the AOA): if there are accurate branch accounts, then that should be the starting point (and the end point in most cases) for the attribution of profits.

The primacy of the branch accounts is also emphasised in the Commentary on Article 3 of the Draft Convention:

> "Ad *Article 3*. — Under Article 3, the fiscal authorities must, in principle, treat a permanent establishment situated in their territory as an independent enterprise.
>
> If the taxpayer produces, in respect of that establishment, separate accounts in proper form which show its relations with the international enterprise to be normal and adequately reflect them, the fiscal authorities will take those accounts as a basis for the assessment.
>
> If, on the other hand, the relationship between the establishments has led to the granting of specially favourable terms to one or other of them, or has caused the accounts to give an inaccurate idea of the situation, the administration will make the necessary corrections.
>
> If the nature or importance of those corrections render such adjustment impossible in practice, the fiscal authorities will resort to another method of assessment and will tax the profits either on the basis of the turnover or by some other appropriate method.
>
> These methods will also be applied when the taxpayer does not furnish appropriate accounts or when he agrees to the use of one of these methods.…"[16]

The difficulty, of course, is that there are no generally agreed accounting principles for separate accounts of a permanent establishment. However, there is a great deal of learning on the production of accurate *management accounts*, without which businesses would have extreme difficulty in knowing whether local branches, for example, were profitable or not.[17] It might be

> be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

[16] Draft Convention, above fn.4, Commentary on Article 3.

[17] The author recalls with mixed pleasure the course he took in Management Accounting during his MBA, and refers to the large number of textbooks on Management Accounting which can be consulted for this purpose.

wondered whether the OECD would have been better employed in the years between 1998 and 2010 in developing principles of *management accounting of permanent establishments for tax purposes*, rather than the publication of the various Discussion Drafts which ultimately produced the AOA.

The authors of Article 3 of the Draft Convention recognised, however, that the separate accounts prepared for a permanent establishment might not accurately reflect the profits attributable, or the value that would prevail between independent persons dealing at arm's length. The Article suggests that suitable adjustments might be made where necessary. Again, it might be wondered whether the OECD would have been better employed in the years between 1998 and 2010 in developing principles for identifying the situations where separate accounts might not reflect values which would prevail between independent persons dealing at arm's length, and then recommending how to make appropriate adjustments.

Looking further at Article 3 of the Draft Convention, it offers in fact three approaches to the attribution of profits to permanent establishment in the following order:

1. attribution based upon the separate accounts of the permanent establishment (adjusted if necessary);
2. empirical determination by applying a comparable percentage to the turnover of the permanent establishment;
3. formulary apportionment of the total income derived by the enterprise.

The draftsmen of Article 3 of the Draft Convention understood that there might be circumstances where separate accounts would not be prepared for the permanent establishments or where accounts did not accurately reflect the profits attributable (and rectification could not resolve that problem), or where the taxpayer might agree to an alternative approach. In those circumstances, the third paragraph of Article 3 suggests that the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.

The third paragraph of Article 3 of the Draft Convention refers explicitly to turnover, but there seems no reason in principle why this second approach could not be developed based upon any reliable profit level indicator (PLI). Thus, for example, it might be more appropriate to base the attribution on the costs incurred by the permanent establishment, or the capital employed in the permanent establishment, or sales as a PLI.

Interestingly, the last sentence of the paragraph introduces comparability analysis: the appropriate percentage to be applied to the PLI should be fixed in comparison with the results obtained by similar enterprises operating in the country. There is room, therefore, for experts to identify the appropriate PLI, and to carry out comparability analysis and apply appropriate databases.

Once again, it might be wondered whether the OECD may have been better employed in the years between 1998 and 2010 in developing further guidance on the application of appropriate PLIs and the comparability analysis needed to apply this approach.

In many respects, it is the final paragraph of Article 3 of the Draft Convention which offers real hope for the much-needed movement away from the arm's length principle. It may come as a shock to many of those involved in transfer pricing, but the very people who in Article 5 of the Draft Convention laid the groundwork for transfer pricing, also contemplated formulary apportionment in exactly the same document. The final paragraph of Article 3 effectively describes formulary apportionment of the total income of the enterprise by applying coefficients based on "a comparison of gross receipts, assets, number of hours worked or other appropriate factors…".[18]

This is effectively a recognition that it may be appropriate in some circumstances to take the total profits of an enterprise (or a company, or a group of companies) and apportion those profits to different countries on the basis of various factors. Once again, it might have been more valuable for the OECD between 1998 and 2010 to have developed principles identifying: 1. when it would be appropriate to apply formulary apportionment to the attribution of profits to permanent establishments; 2. what might be the appropriate factors to take into account; and 3. what might be the appropriate weighting to give to the different factors.

It goes without saying that Article 3 of the Draft Convention provides no support whatsoever for the AOA. Nowhere is there a suggestion that it is an appropriate approach to *hypothesise* the permanent establishment as if it were a *functionally separate enterprise*, or to identify the *dealings* between that functionally separate enterprise and the other parts of the company of which it is part. Of course, there is no suggestion of the application of the *Transfer Pricing Guidelines*[19] (or, for that matter, any approach adopted in connection with Article 5 of the Draft Convention) by analogy.

It is not too late to go back and reassess the attribution of profits to permanent establishments based upon the approaches outlined in Article 3 of the Draft Convention. Quite the contrary, the widespread rejection of the AOA makes this not only appropriate but essential. If the OECD has difficulty in travelling down this line because it remains wedded to the AOA, then this is a perfectly appropriate project to be taken up by the UN Committee of Experts. After all, that Committee has rejected the AOA.

The purpose of this short note is to show that those who originally considered the problems of *transfer pricing* and the problems of the *attribution of profits to permanent establishments* already had three possible solutions in mind with regard to the attribution of profits. All those three approaches could be developed further to provide guidelines for agreed principles for the attribution of profits to permanent establishments. In so doing, the work that was begun in the 1930s would be continued and brought up to date in the light of developments and understandings since that time. In the author's opinion, it is far better to do that than to continue "flogging the dead horse" of the AOA.

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[18] Draft Convention, above fn.4, Art.3.
[19] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (current edition) (Paris: OECD Publishing, 2017).

Attribution rules; International taxation; Legal history; OECD; Permanent establishment; Profits; Treaties