COMMENTARY ON ARTICLE 7
CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention. It incorporates the basic principle that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State.

(Replaced on 22 July 2010; see HISTORY)

2. Article 5, which includes the definition of the concept of permanent establishment, is therefore relevant to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. That Article, however, does not itself allocate taxing rights: when an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, it is necessary to determine what, if any, are the profits that the other State may tax. Article 7 provides the answer to that question by determining that the other State may tax the profits that are attributable to the permanent establishment.

(Replaced on 22 July 2010; see HISTORY)

2.1 *(Renumbered and amended on 17 July 2008; see HISTORY)*

3. The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm's length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.

(Replaced on 22 July 2010; see HISTORY)

4. Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the

years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.[1] In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"[2] and to subsequent changes to the Commentary.

(Renumbered and amended on 22 July 2010; see HISTORY)

5. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[3] (the "OECD Transfer Pricing Guidelines"), it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*[4] (the "2008 Report").

(Renumbered and amended on 22 July 2010; see HISTORY)

6. The approach developed in the 2008 Report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade. When it approved the 2008 Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the

1 "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, OECD, Paris, 1984.

2 *Attribution of Income to Permanent Establishments*, Issues in International Taxation No. 5, OECD, Paris, 1994; reproduced in Volume II at page R(13)-1.

3 The original version of that report was approved by the Council of the OECD on 27 June 1995 and was updated a number of times since then. Published by the OECD as *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

4 Available at http://www.oecd.org/dataoecd/20/36/41031455.pdf.

2008 Report and the interpretation of Article 7 previously given in this Commentary.

(Amended on 22 July 2010; see HISTORY)

7. In order to provide maximum certainty on how profits should be attributed to permanent establishments, the Committee therefore decided that the 2008 Report's full conclusions should be reflected in a new version of Article 7, together with accompanying Commentary, to be used in the negotiation of future treaties and the amendment of existing treaties. In addition, in order to provide improved certainty for the interpretation of treaties that had already been concluded on the basis of the previous wording of Article 7, the Committee decided that a revised Commentary for that previous version of the Article should also be prepared, to take into account those aspects of the report that did not conflict with the Commentary as it read before the adoption of the 2008 Report.

(Replaced on 22 July 2010; see HISTORY)

8. The new version of the Article, which now appears in the Model Tax Convention, was adopted in 2010. At the same time, the Committee adopted a revised version of the 2008 Report in order to ensure that the conclusions of that report could be read harmoniously with the new wording and modified numbering of this new version of the Article. Whilst the conclusions and interpretations included in the revised report that was thus adopted in 2010[1] (hereinafter referred to as "the Report") are identical to those of the 2008 Report, that revised version takes account of the drafting of the Article as it now reads (the Annex to this Commentary includes, for historical reference, the text of the previous wording of Article 7 and that revised Commentary, as they read before the adoption of the current version of the Article).

(Replaced on 22 July 2010; see HISTORY)

9. The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it. The Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

(Renumbered and amended on 22 July 2010; see HISTORY)

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

II. Commentary on the provisions of the Article

Paragraph 1

10. Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (e.g. income derived by an enterprise in respect of personal activities of an entertainer or sportsperson).

(Replaced on 22 July 2010; see HISTORY)

10.1 *(Renumbered and amended on 17 July 2008; see HISTORY)*

11. The first principle underlying paragraph 1, *i.e.* that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.

(Renumbered and amended on 22 July 2010; see HISTORY)

12. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions

include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

(Renumbered and amended on 22 July 2010; see HISTORY)

12.1 *(Renumbered and amended on 17 July 2008; see HISTORY)*

12.2 *(Deleted on 17 July 2008; see HISTORY)*

13. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase "profits that are attributable to the permanent establishment" found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the

Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

(Replaced on 22 July 2010; see HISTORY)

14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

(Renumbered and amended on 22 July 2010; see HISTORY)

Paragraph 2

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

(Replaced on 22 July 2010; see HISTORY)

15.1 *(Renumbered and amended on 17 July 2008; see HISTORY)*

15.2 *(Deleted on 17 July 2008; see HISTORY)*

15.3 *(Deleted on 17 July 2008; see HISTORY)*

15.4 *(Deleted on 17 July 2008; see HISTORY)*

16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction

corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

(Replaced on 22 July 2010; see HISTORY)

17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

(Replaced on 22 July 2010; see HISTORY)

17.1 *(Renumbered on 17 July 2008; see HISTORY)*

17.2 *(Renumbered on 17 July 2008; see HISTORY)*

17.3 *(Renumbered on 17 July 2008; see HISTORY)*

17.4 *(Renumbered and amended on 17 July 2008; see HISTORY)*

17.5 *(Renumbered on 17 July 2008; see HISTORY)*

17.6 *(Renumbered on 17 July 2008; see HISTORY)*

17.7 *(Renumbered on 17 July 2008; see HISTORY)*

18. Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23 A or 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

(Replaced on 22 July 2010; see HISTORY)

18.1 *(Deleted on 17 July 2008; see HISTORY)*

18.2 *(Deleted on 17 July 2008; see HISTORY)*

18.3 *(Deleted on 17 July 2008; see HISTORY)*

19. As indicated in paragraphs 8 and 9 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2010. The Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose of the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.

(Replaced on 22 July 2010; see HISTORY)

20. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the OECD Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

(Replaced on 22 July 2010; see HISTORY)

21. Under the first step, a functional and factual analysis is undertaken which will lead to:

- — the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- — the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- — the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- — the identification of other functions of the permanent establishment;

— the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and

— the attribution of capital based on the assets and risks attributed to the permanent establishment.

(Replaced on 22 July 2010; see HISTORY)

22. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the OECD Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:

— the determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and

— the application by analogy of one of the Guidelines' methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

(Replaced on 22 July 2010; see HISTORY)

23. Each of these operations is discussed in greater detail in the Report, in particular as regards the attribution of profits to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (see Part II of the Report, which deals with permanent establishments of banks; Part III, which deals with permanent establishments of enterprises carrying on global trading, and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

(Replaced on 22 July 2010; see HISTORY)

24. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between

independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (e.g. the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to the permanent establishment to reflect what a separate and independent enterprise would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between State R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty.

(Replaced on 22 July 2010; see HISTORY)

25. Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist.

(Replaced on 22 July 2010; see HISTORY)

26. It is generally not intended that more burdensome documentation requirements be imposed in connection with such dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation referred to in the OECD Transfer Pricing Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances. Nevertheless, considering the uniqueness of the nature of a dealing, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful

starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

— the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;

— the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and

— the dealing presented in the taxpayer's documentation does not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions.

(Replaced on 22 July 2010; see HISTORY)

27. The opening words of paragraph 2 and the phrase "in each Contracting State" indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.

(Replaced on 22 July 2010; see HISTORY)

28. The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7.

Assume, for example, that the circumstances of a particular case justify considering that the economic ownership of a building used by the permanent establishment should be attributed to the head office (see paragraph 75 of Part I of the Report). In such a case, paragraph 2 could require the deduction of a notional rent in determining the profits of the permanent establishment. That fiction, however, could not be interpreted as creating income from immovable property for the purposes of Article 6. Indeed, the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise; it merely applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7, 23 A and 23 B. Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise. Clearly, however, if interest paid by an enterprise to a different person is paid on indebtedness incurred in connection with a permanent establishment of the enterprise and is borne by that permanent establishment, this real interest payment may, under paragraph 2 of Article 11, be taxed by the State in which the permanent establishment is located. Also, where a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States from taxing profits or gains from such a dealing as long as such taxation is in accordance with Article 7 (see paragraphs 4, 8 and 10 of the Commentary on Article 13).

(Replaced on 22 July 2010; see HISTORY)

29. Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in

accordance with such provisions only to the extent provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (*e.g.* a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.

(Replaced on 22 July 2010; see HISTORY)

30. Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 33 and 34 below).

(Replaced on 22 July 2010; see HISTORY)

31. Thus, for example, whilst domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2 or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2, rules that prevent the deduction of certain categories of expenses (*e.g.* entertainment expenses) or that provide when a particular expense should be deducted are not affected by paragraph 2. In making that distinction, however, some difficult questions may arise as in the case of domestic law restrictions based on when an expense or element of income is actually paid. Since, for instance, an internal dealing will not involve an actual transfer or payment between two different persons, the application of such domestic law restrictions should generally take into account the nature of the

dealing and, therefore, treat the relevant transfer or payment as if it had been made between two different persons.

(Replaced on 22 July 2010; see HISTORY)

32. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses will normally result in a different amount of taxable income in each State even though, for the purposes of the Convention, the amount of profits attributable to the permanent establishment will have been computed on the basis of paragraph 2 in both States (see also paragraphs 39 to 43 of the Commentary on Articles 23 A and 23 B). Thus, even though paragraph 2 applies equally to the Contracting State in which the permanent establishment is situated (for the purposes of paragraph 1) and to the other Contracting State (for the purposes of Articles 23 A or 23 B), it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given taxable period, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B. Also, to the extent that the difference results from domestic law variations concerning the types of expenses that are deductible, as opposed to timing differences in the recognition of these expenses, the difference will be permanent.

(Replaced on 22 July 2010; see HISTORY)

33. In taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether they are incurred for the purposes of a permanent establishment situated in a Contracting State or for the purposes of an enterprise of that State. As stated in paragraph 40 of the Commentary on Article 24:

> Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

(Replaced on 22 July 2010; see HISTORY)

34. The requirement imposed by paragraph 3 of Article 24 is the same regardless of how expenses incurred by an enterprise for the benefit of a permanent establishment are taken into account for the purposes of paragraph 2 of Article 7. In some cases, it will not be appropriate to consider that a dealing has taken place between different parts of the enterprise. In

such cases, expenses incurred by an enterprise for the purposes of the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment (*e.g.* the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment of a foreign enterprise). In other cases, expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment and an appropriate charge will be deducted in determining the profits attributable to the permanent establishment (*e.g.* overhead expenses related to administrative functions performed by the head office for the benefit of the permanent establishment). In both cases, paragraph 3 of Article 24 will require that, as regards the permanent establishment, the expenses be deductible under the same conditions as those applicable to an enterprise of that State. Thus, any expense incurred by the enterprise directly or indirectly for the benefit of the permanent establishment must not, for tax purposes, be treated less favourably than a similar expense incurred by an enterprise of that State. That rule will apply regardless of whether or not, for the purposes of paragraph 2 of this Article 7, the expense is directly attributed to the permanent establishment (first example) or is attributed to another part of the enterprise but reflected in a notional charge to the permanent establishment (second example).

(Replaced on 22 July 2010; see HISTORY)

35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing profits to them under Article 7.

(Amended on 15 July 2014; see HISTORY)

36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that profits are attributable to a permanent establishment only with respect to activities carried on by the enterprise through that permanent establishment.

(Amended on 15 July 2014; see HISTORY)

37. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

(Replaced on 22 July 2010; see HISTORY)

38. Article 7, as it read before 2010, included the following paragraph 3:

> In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Whilst that paragraph was originally intended to clarify that paragraph 2 required expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account in determining the profits of the permanent establishment even if these expenses had been incurred outside the State in which the permanent establishment was located, it had sometimes been read as limiting the deduction of expenses that indirectly benefited the permanent establishment to the actual amount of the expenses.

(Replaced on 22 July 2010; see HISTORY)

39. This was especially the case of general and administrative expenses, which were expressly mentioned in that paragraph. Under the previous version of paragraph 2, as interpreted in the Commentary, this was generally not a problem since a share of the general and administrative expenses of the enterprise could usually only be allocated to a permanent establishment on a cost-basis.

(Replaced on 22 July 2010; see HISTORY)

40. As now worded, however, paragraph 2 requires the recognition and arm's length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (*e.g.* through the provision of assistance in day-to-day management). The deduction of an arm's length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all

relevant expenses of the enterprise, wherever incurred, be taken into account. Depending on the circumstances, this will be done through the deduction of all or part of the expenses or through the deduction of an arm's length charge in the case of a dealing between the permanent establishment and another part of the enterprise.

(Replaced on 22 July 2010; see HISTORY)

40.1 *(Renumbered and amended on 17 July 2008; see HISTORY)*

40.2 *(Renumbered and amended on 17 July 2008; see HISTORY)*

40.3 *(Renumbered and amended on 17 July 2008; see HISTORY)*

41. Article 7, as it read before 2010, also included a provision that allowed the attribution of profits to a permanent establishment to be done on the basis of an apportionment of the total profits of the enterprise to its various parts. That method, however, was only to be applied to the extent that its application had been customary in a Contracting State and that the result was in accordance with the principles of Article 7. For the Committee, methods other than an apportionment of total profits of an enterprise can be applied even in the most difficult cases. The Committee therefore decided to delete that provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle.

(Replaced on 22 July 2010; see HISTORY)

42. At the same time, the Committee also decided to eliminate another provision that was found in the previous version of the Article and according to which the profits to be attributed to the permanent establishment were to be "determined by the same method year by year unless there is good and sufficient reason to the contrary." That provision, which was intended to ensure continuous and consistent treatment, was appropriate as long as it was accepted that the profits attributable to a permanent establishment could be determined through direct or indirect methods or even on the basis of an apportionment of the total profits of the enterprise to its various parts. The new approach developed by the Committee, however, does not allow for the application of such fundamentally different methods and therefore avoids the need for such a provision.

(Replaced on 22 July 2010; see HISTORY)

43. A final provision that was deleted from the Article at the same time provided that "[n]o profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." Subparagraph 4 *d)* of Article 5 recognises that where an enterprise of a Contracting State maintains in the other State a fixed

place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justifies taxation in that other State. Where, however, subparagraph 4 d) is not applicable because other activities are carried on by the enterprise through that place of business, which therefore constitutes a permanent establishment, it is appropriate to attribute profits to all the functions performed at that location. Indeed, if the purchasing activities were performed by an independent enterprise, the purchaser would be remunerated on an arm's length basis for its services. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise would require that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the permanent establishment, such an exemption would raise administrative problems. The Committee therefore considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.

(Replaced on 22 July 2010; see HISTORY)

Paragraph 3

44. The combination of Articles 7 (which restricts the taxing rights of the State in which the permanent establishment is situated) and 23 A and 23 B (which oblige the other State to provide relief from double taxation) ensures that there is no unrelieved double taxation of the profits that are properly attributable to the permanent establishment. This result may require that the two States resolve differences based on different interpretations of paragraph 2 and it is important that mechanisms be available to resolve all such differences to the extent necessary to eliminate double taxation.

(Replaced on 22 July 2010; see HISTORY)

45. As already indicated, the need for the two Contracting States to reach a common understanding as regards the application of paragraph 2 in order to eliminate risks of double taxation has led the Committee to develop detailed guidance on the interpretation of that paragraph. This guidance is reflected in the Report, which draws on the principles of the OECD Transfer Pricing Guidelines.

(Replaced on 22 July 2010; see HISTORY)

46. Risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, which will ensure the same result for the

purposes of Articles 7 and 23 A or 23 B (see, however, paragraph 66). Insofar as each State agrees that the taxpayer has done so, it should refrain from adjusting the profits in order to reach a different result under paragraph 2. This is illustrated in the following example.

(Replaced on 22 July 2010; see HISTORY)

47. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, the Report provides that a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm's length price of 100 has been used to determine the profits attributable to the permanent establishment. Both States agree that the recognition of the dealing and the price used by the taxpayer are in conformity with the principles of the Report and of the OECD Transfer Pricing Guidelines. In this case, both States should refrain from adjusting the profits on the basis that a different arm's length price should have been used; as long as there is agreement that the taxpayer has conformed with paragraph 2, the tax administrations of both States cannot substitute their judgment for that of the taxpayer as to what are the arm's length conditions. In this example, the fact that the same arm's length price has been used in both States and that both States will recognise that price for the purposes of the application of the Convention will ensure that any double taxation related to that dealing will be eliminated under Article 23 A or 23 B.

(Replaced on 22 July 2010; see HISTORY)

48. In the previous example, both States agreed that the recognition of the dealing and the price used by the taxpayer were in conformity with the principles of the Report and of the OECD Transfer Pricing Guidelines. The Contracting States, however, may not always reach such an agreement. In some cases, the Report and the OECD Transfer Pricing Guidelines may allow different interpretations of paragraph 2 and, to the extent that double taxation would otherwise result from these different interpretations, it is essential to ensure that such double taxation is relieved. Paragraph 3 provides the mechanism that guarantees that outcome.

(Replaced on 22 July 2010; see HISTORY)

49. For example, as explained in paragraphs 105 to 171 of Part I of the Report, paragraph 2 permits different approaches for determining, on the basis of the attribution of "free" capital to a permanent establishment, the interest expense attributable to that permanent establishment. The Committee recognised that this could create problems, in particular for financial institutions. It concluded that in this and other cases where the two Contracting States have interpreted paragraph 2 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated.

(Replaced on 22 July 2010; see HISTORY)

50. Paragraph 3 will ensure that this result is achieved. It is important to note, however, that the cases where it will be necessary to have recourse to that paragraph are fairly limited.

(Replaced on 22 July 2010; see HISTORY)

51. First, as explained in paragraph 46 above, where the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and both States agree that the taxpayer has done so in accordance with paragraph 2 as interpreted by the Report, no adjustments should be made to the profits in order to reach a different result under paragraph 2.

(Replaced on 17 July 2008; see HISTORY)

52. Second, paragraph 3 is not intended to limit in any way the remedies already available to ensure that each Contracting State conforms with its obligations under Articles 7 and 23 A or 23 B. For example, if the determination, by a Contracting State, of the profits attributable to a permanent establishment situated in that State is not in conformity with paragraph 2, the taxpayer will be able to use the available domestic legal remedies and the mutual agreement procedure provided for by Article 25 to address the fact that the taxpayer has not been taxed by that State in accordance with the Convention. Similarly, these remedies will also be available if the other State does not, for the purposes of Article 23 A or 23 B, determine the profits attributable to the permanent establishment in conformity with paragraph 2 and therefore does not comply with the provisions of this Article.

(Replaced on 22 July 2010; see HISTORY)

53. Where, however, the taxpayer has not determined the profits attributable to the permanent establishment in conformity with paragraph 2, each State is entitled to make an adjustment in order to ensure conformity

with that paragraph. Where one State makes an adjustment in conformity with paragraph 2, that paragraph certainly permits the other State to make a reciprocal adjustment so as to avoid any double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State (*e.g.* the State where the permanent establishment is located) may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. It may also be that, as indicated above, the two Contracting States will adopt different interpretations of paragraph 2 and it is not possible to conclude that either interpretation is not in accordance with paragraph 2.

(Replaced on 22 July 2010; see HISTORY)

54. Such concerns are addressed by paragraph 3. The following example illustrates the application of that paragraph.

(Replaced on 22 July 2010; see HISTORY)

55. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional price of 90 has been used to determine the profits attributable to the permanent establishment. State S accepts the amount used by the taxpayer but State R considers that the amount is below what is required by its domestic law and the arm's length principle of paragraph 2. It considers that the appropriate arm's length price that should have been used is 110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of the exemption (Article 23 A) or the credit (Article 23 B) claimed by the taxpayer with respect to the profits attributable to the permanent establishment. In that situation, since the price of the same dealing will have been determined as 90 in State S and 110 in State R, profits of 20 may be subject to double taxation. Paragraph 3 will address that situation by requiring State S, to the extent that there is indeed double taxation and that the adjustment made by State R is in conformity with paragraph 2, to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States.

(Replaced on 22 July 2010; see HISTORY)

56. If State S, however, does not agree that the adjustment by State R was warranted by paragraph 2, it will not consider that it has to make the adjustment. In such a case, the issue of whether State S should make the adjustment under paragraph 3 (if the adjustment by State R is justified under paragraph 2) or whether State R should refrain from making the initial adjustment (if it is not justified under paragraph 2) will be solved under a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25 (since it involves the question of whether the actions of one or both of the Contracting States have resulted or will result for the taxpayer in taxation not in accordance with the Convention). Through that procedure, the two States will be able to agree on the same arm's length price, which may be one of the prices put forward by the taxpayer and the two States or a different one.

(Replaced on 22 July 2010; see HISTORY)

57. As shown by the example in paragraph 55, paragraph 3 addresses the concern that the Convention might not provide adequate protection against double taxation in some situations where the two Contracting States adopt different interpretations of paragraph 2 of Article 7 and each State could be considered to be taxing "in accordance with" the Convention. Paragraph 3 ensures that relief of double taxation will be provided in such a case, which is consistent with the overall objectives of the Convention.

(Replaced on 22 July 2010; see HISTORY)

58. Paragraph 3 shares the main features of paragraph 2 of Article 9. First, it applies to each State with respect to an adjustment made by the other State. It therefore applies reciprocally whether the initial adjustment has been made by the State where the permanent establishment is situated or by the other State. Also, it does not apply unless there is an adjustment by one of the States.

(Replaced on 22 July 2010; see HISTORY)

59. As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under paragraph 3 simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The corresponding adjustment is required only if the other State considers that the adjusted profits conform with paragraph 2. In other words, paragraph 3 may not be invoked and should not be applied where the profits attributable to the permanent establishment are adjusted to a level that is different from what they would have been if they had been correctly computed in accordance with the principles of paragraph 2. Regardless of which State makes the initial adjustment, the other State is obliged to make an appropriate corresponding adjustment only if it considers that the

adjusted profits correctly reflect what the profits would have been if the permanent establishment's dealings had been transactions at arm's length. The other State is therefore committed to make such a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount.

(Replaced on 22 July 2010; see HISTORY)

60. Paragraph 3 does not specify the method by which a corresponding adjustment is to be made. Where the initial adjustment is made by the State in which the permanent establishment is situated, the adjustment provided for by paragraph 3 could be granted in the other State through the adjustment of the amount of income that must be exempted under Article 23 A or of the credit that must be granted under Article 23 B. Where the initial adjustment is made by that other State, the adjustment provided for by paragraph 3 could be made by the State in which the permanent establishment is situated by re-opening the assessment of the enterprise of the other State in order to reduce the taxable income by an appropriate amount.

(Replaced on 22 July 2010; see HISTORY)

61. The issue of so-called "secondary adjustments", which is discussed in paragraph 8 of the Commentary on Article 9, does not arise in the case of an adjustment under paragraph 3. As indicated in paragraph 28 above, the determination of the profits attributable to a permanent establishment is only relevant for the purposes of Articles 7 and 23 A and 23 B and does not affect the application of other Articles of the Convention.

(Replaced on 22 July 2010; see HISTORY)

62. Like paragraph 2 of Article 9, paragraph 3 leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text of either paragraph 2 of Article 9 or paragraph 3 but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25).

(Replaced on 22 July 2010; see HISTORY)

63. There may be cases where the initial adjustment made by one State will not immediately require a corresponding adjustment to the amount of tax charged on profits in the other State (*e.g.* where the initial adjustment by one State of the profits attributable to the permanent establishment will affect the determination of the amount of a loss attributable to the rest of the enterprise in the other State). The competent authorities may, in accordance with the second sentence of paragraph 3, determine the future impact that the initial adjustment will have on the tax that will be payable in the other State before that tax is actually levied; in fact, in order to avoid the problem described in the preceding paragraph, competent authorities may wish to use the mutual agreement procedure at the earliest opportunity in order to determine to what extent a corresponding adjustment may be required in the other State at a later stage.

(Replaced on 22 July 2010; see HISTORY)

64. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the example in paragraph 55 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention (the arbitration provision of paragraph 5 of Article 25 will play a critical role in cases where the competent authorities would otherwise be unable to agree as it will ensure that the issues that prevent an agreement are resolved through arbitration).

(Replaced on 22 July 2010; see HISTORY)

65. Paragraph 3 only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment. Assume, for instance, that the State where the permanent establishment is situated adjusts the profits that the taxpayer attributed to the permanent establishment to reflect the fact that the price of a dealing between the permanent establishment and the rest of the enterprise did not conform with the arm's length principle. Assume that the other State also agrees that the price used by the taxpayer was not at arm's length. In that case, the combined application of paragraph 2 and of Article 23 A or 23 B will require that other State to attribute to the permanent establishment, for the purposes of providing relief of double taxation,

adjusted profits that would reflect an arm's length price. In such a case, paragraph 3 will only be relevant to the extent that States adopt different interpretations of what the correct arm's length price should be.

(Replaced on 22 July 2010; see HISTORY)

66. Paragraph 3 only applies with respect to differences in the determination of the profits attributed to a permanent establishment that result in the same part of the profits being attributed to different parts of the enterprise in conformity with the Article. As already explained (see paragraphs 30 and 31 above), Article 7 does not deal with the computation of taxable income but, instead, with the attribution of profits for the purpose of the allocation of taxing rights between the two Contracting States. The Article therefore only serves to allocate revenues and expenses for the purposes of allocating taxing rights and does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law as long as there is conformity with paragraph 2. Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable income on which tax will be levied in each State for a given taxable period may be different given differences in domestic law rules, *e.g.* for the recognition of income and the deduction of expenses. Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3.

(Replaced on 22 July 2010; see HISTORY)

67. Also, paragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State's tax under the domestic law of that other State and in accordance with Article 23 A or 23 B.

(Replaced on 22 July 2010; see HISTORY)

68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State's preferred position as to the arm's length price or method. These States would

therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm's length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:

> Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

(Amended on 15 July 2014; see HISTORY)

69. This alternative version is intended to ensure that the State being asked to give a corresponding adjustment would always be able to require that to be done through the mutual agreement procedure. This version differs significantly from paragraph 3 in that it does not create a legal obligation on that State to agree to give a corresponding adjustment, even where it considers the adjustment made by the other State to have been made in accordance with paragraph 2. The provision would always give the possibility for a State to negotiate with the other State over what is the most appropriate arm's length price or method. Where the State in question does not unilaterally agree to make the corresponding adjustment, this version of paragraph 3 would ensure that the taxpayer has the right to access the mutual agreement procedure to have the case resolved. Moreover, where the mutual agreement procedure is triggered in such a case, the provision imposes a reciprocal legal obligation on the Contracting States to eliminate the double taxation by mutual agreement even though it does not provide a substantive standard to govern which State has the obligation to compromise its position to achieve that mutual agreement. If the two Contracting States do not reach an agreement to eliminate the double taxation, they will both be in violation of their treaty obligation. The obligation to eliminate such cases of double taxation by mutual agreement is therefore stronger than the standard of paragraph 2 of Article 25, which merely requires the competent authorities to "endeavour" to resolve a case by mutual agreement.

(Replaced on 22 July 2010; see HISTORY)

70. If Contracting States agree bilaterally to replace paragraph 3 by the alternative above, the comments made in paragraphs 66 and 67 as regards paragraph 3 will also apply with respect to that provision.

(Replaced on 22 July 2010; see HISTORY)

Paragraph 4

71. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries.

(Renumbered on 22 July 2010; see HISTORY)

72. Absent paragraph 4, this interpretation of the term "profits" could have given rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are dealt with separately in other Articles of the Convention, *e.g.* dividends, the question would have arisen as to which Article should apply to these categories of income, *e.g.* in the case of dividends, this Article or Article 10.

(Added on 22 July 2010; see HISTORY)

73. To the extent that the application of this Article and of the relevant other Article would result in the same tax treatment, there is little practical significance to this question. Also, other Articles of the Convention deal specifically with this question with respect to some types of income (*e.g.* paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 17 and paragraph 2 of Article 21).

(Renumbered and amended on 22 July 2010; see HISTORY)

74. The question, however, could arise with respect to other types of income and it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to specific categories of income will have priority over Article 7. It follows from this rule that Article 7 will be applicable to business profits which do not belong to categories of income covered by these other Articles, and, in addition, to income which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within Article 7. This rule does not, however, govern the manner in which the income will be classified for the purposes of domestic law; thus, if a Contracting State may tax an item of income pursuant to other Articles of this Convention, that State may, for its own domestic tax purposes, characterise such income as it wishes (*i.e.* as business profits or as a specific category of income) provided that the tax treatment of that item of income is in

accordance with the provisions of the Convention. It should also be noted that where an enterprise of a Contracting State derives income from immovable property through a permanent establishment situated in the other State, that other State may not tax that income if it is derived from immovable property situated in the first-mentioned State or in a third State (see paragraph 4 of the Commentary on Article 21 and paragraphs 9 and 10 of the Commentary on Articles 23 A and 23 B).

(Renumbered and amended on 22 July 2010; see HISTORY)

75. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the Articles on dividends, interest and royalties.

(Renumbered and amended on 22 July 2010; see HISTORY)

75.1 Emissions trading programmes have been implemented in a number of countries as part of an international strategy for addressing global warming. Under such programmes, emissions permits may be required in order to perform certain economic activities that generate greenhouse gases and credits issued with respect to emission-reduction or emissions removal projects in other countries may be recognised. Given the multinational character of certain emissions trading programmes (such as the European Union Emissions Trading System), these programmes present specific issues under the Model Tax Convention, most notably the treatment of income from the issuance and trading of emissions permits and credits. These issues are examined in the Committee's report "Tax treaty issues related to emissions permits/credits".[1] As explained in that report, income derived from the issuance or trading of emissions permits and credits is generally covered by Article 7 and Article 13. Under certain circumstances, however, such income may be covered by Article 6, 8 or 21 (see paragraph 2.1 of the Commentary on Article 6 and paragraph 14.1 of the Commentary on Article 8).

(Added on 15 July 2014; see HISTORY)

76. Finally, it should be noted that two categories of profits that were previously covered by other Articles of the Convention are now covered by Article 7. First, whilst the definition of "royalties" in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial, or scientific equipment", the reference to these payments was subsequently deleted from

1 Reproduced in Volume II at page R(25)-1.

that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 or Article 8 (see paragraph 9 of the Commentary on that Article), as the case may be, rather than under those of Article 12, a result that the Committee on Fiscal Affairs considers appropriate given the nature of such income.

(Renumbered and amended on 22 July 2010; see HISTORY)

77. Second, before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but Article 14 used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition, in Article 3, of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.

(Renumbered and amended on 22 July 2010; see HISTORY)

Observations on the Commentary

78. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 77 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, *i.e.* by the elimination of Article 14.

(Renumbered on 17 July 2008; see HISTORY)

79. *Belgium* cannot share the views expressed in paragraph 14 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 1 of Article 7. This is especially the case where a Contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by

that resident but by a foreign entity which is not taxable in that State in accordance with paragraph 1 of Article 7. That Contracting State thus disregards the legal personality of the foreign entity and acts contrary to paragraph 1 of Article 7.

(Renumbered and amended on 22 July 2010; see HISTORY)

80. *Luxembourg* does not share the interpretation in paragraph 14 which provides that paragraph 1 of Article 7 does not restrict a Contracting State's right to tax its own residents under controlled foreign companies provisions found in its domestic law as this interpretation challenges the fundamental principle contained in paragraph 1 of Article 7.

(Renumbered and amended on 22 July 2010; see HISTORY)

81. With reference to paragraph 14, *Ireland* notes its general observation in paragraph 27.5 of the Commentary on Article 1.

(Renumbered and amended on 22 July 2010; see HISTORY)

82. *Sweden* wishes to clarify that it does not consider that the different approaches for attributing "free" capital that are included in the Report *Attribution of Profits to Permanent Establishments* will necessarily lead to a result in accordance with the arm's length principle. Consequently, Sweden would, when looking at the facts and circumstances of each case, in many cases not consider that the amount of interest deduction resulting from the application of these approaches conforms to the arm's length principle. When the different views on attributing "free" capital will lead to double taxation, the mutual agreement procedure provided for in Article 25 will have to be used.

(Replaced on 22 July 2010; see HISTORY)

83. With reference to paragraphs 27 and 65, the *United States* wishes to clarify how it will relieve double taxation arising due to the application of paragraph 2 of Article 7. Where a taxpayer can demonstrate to the competent authority of the United States that such double taxation has been left unrelieved after the application of mechanisms under the United States' domestic law such as the utilisation of foreign tax credit limitation created by other transactions, the United States will relieve such additional double taxation.

(Replaced on 22 July 2010; see HISTORY)

84. *Turkey* does not share the views expressed in paragraph 28 of the Commentary on Article 7.

(Added on 22 July 2010; see HISTORY)

Reservations on the Article

85. *Australia* reserves the right to include a provision that will permit its domestic law to apply in relation to the taxation of profits from any form of insurance.

(Renumbered and amended on 22 July 2010; see HISTORY)

86. *Australia* reserves the right to include a provision clarifying its right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian tax purposes) from the carrying on of a business in Australia through a permanent establishment.

(Renumbered and amended on 22 July 2010; see HISTORY)

87. *Korea* and *Portugal* reserve the right to tax persons performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a permanent establishment (or a fixed base) available to them for the purpose of performing such services or activities.

(Renumbered on 22 July 2010; see HISTORY)

88. *Italy*, *Portugal* and *Turkey* reserve the right to tax persons performing independent personal services under a separate article which corresponds to Article 14 as it stood before its elimination in 2000. In the case of Turkey, the question of whether persons other than individuals should be included in that article shall be determined by bilateral negotiations.

(Amended on 15 July 2014; see HISTORY)

89. The *United States* reserves the right to amend Article 7 to provide that, in applying paragraphs 1 and 2 of the Article, any income or gain attributable to a permanent establishment during its existence may be taxable by the Contracting State in which the permanent establishment exists even if the payments are deferred until after the permanent establishment has ceased to exist. The United States also wishes to note that it reserves the right to apply such a rule, as well, under Articles 11, 12, 13 and 21.

(Renumbered on 22 July 2010; see HISTORY)

90. *Turkey* reserves the right to subject income from the leasing of containers to a withholding tax at source in all cases. In case of the application of Articles 5 and 7 to such income, Turkey would like to apply the permanent

establishment rule to the simple depot, depot-agency and operational branch cases.

(Renumbered on 22 July 2010; see HISTORY)

91. *Norway* and the *United States* reserve the right to treat income from the use, maintenance or rental of containers used in international traffic under Article 8 in the same manner as income from shipping and air transport.

(Renumbered on 22 July 2010; see HISTORY)

92. *Australia* and *Portugal* reserve the right to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

(Renumbered on 22 July 2010; see HISTORY)

93. *Mexico* reserves the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise carried out directly by its home office situated in the other Contracting State, provided that those goods and merchandise are of the same or similar kind as the ones sold through that permanent establishment. The Government of Mexico will apply this rule only as a safeguard against abuse and not as a general "force of attraction" principle; thus, the rule will not apply when the enterprise proves that the sales have been carried out for reasons other than obtaining a benefit under the Convention.

(Renumbered on 22 July 2010; see HISTORY)

94. The *Czech Republic* reserves the right to add to paragraph 3 a provision limiting the potential corresponding adjustments to *bona fide* cases.

(Added on 22 July 2010; see HISTORY)

95. *New Zealand* reserves the right to use the previous version of Article 7 taking into account its observation and reservations on that version (*i.e.* the version included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention) because it does not agree with the approach reflected in Part I of the 2010 Report *Attribution of Profits to Permanent Establishments*. It does not, therefore, endorse the changes to the Commentary on the Article made through that update.

(Added on 22 July 2010; see HISTORY)

96. *Chile*, *Greece*, *Mexico*, the *Slovak Republic* and *Turkey* reserve the right to use the previous version of Article 7, *i.e.* the version that was included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention. They do not, therefore, endorse the changes to the Commentary on the Article made through that update.

(Amended on 15 July 2014; see HISTORY)

97. *Portugal* reserves its right to continue to adopt in its conventions the text of the Article as it read before 2010 until its domestic law is adapted in order to apply the new approach.

(Added on 22 July 2010; see HISTORY)

98. *Slovenia* reserves the right to specify that a potential adjustment will be made under paragraph 3 only if it is considered justified.

(Added on 22 July 2010; see HISTORY)

ANNEX

PREVIOUS VERSION OF ARTICLE 7 AND ITS COMMENTARY

The following is the text of Article 7 and its Commentary as they read before 22 July 2010. That previous version of the Article and Commentary is provided below for historical reference as it will continue to be relevant for the application and interpretation of bilateral tax conventions concluded before that date.

ARTICLE 7
BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. 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 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.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

COMMENTARY ON ARTICLE 7 CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules by reference to which the profits attributable to the permanent establishment are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are associated are dealt with in Article 9.

2. Articles 7 and 9 are not particularly detailed and were not strikingly novel when they were adopted by the OECD. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between associated enterprises, has had to be dealt with in a large number of double taxation conventions and in various models developed by the League of Nations before the OECD first dealt with it and the solutions adopted have generally conformed to a standard pattern.

3. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and, when the OECD first examined that question, it was thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise.

4. It must be acknowledged, however, that there has been considerable variation in the interpretation of the general directives of Article 7 and of the provisions of earlier conventions and models on which the wording of the Article is based. This lack of a common interpretation of Article 7 can lead to problems of

double taxation and non-taxation. For that reason, it is important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25.

5. Over the years, the Committee on Fiscal Affairs has therefore spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.[1] In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"[2] and to subsequent changes to the Commentary.

6. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*. The approach developed in that report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade.

7. The approach put forward in that Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities). The Committee considers that the guidance included in the Report represents a better approach to attributing profits to permanent establishments than has previously been available. It does recognise, however, that there are differences between some of the conclusions of the Report and the interpretation of the Article previously given in this Commentary. For that reason, this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in others. The Report therefore represents internationally agreed principles and, to the extent that it does not conflict with this Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article.

1 "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises Three Taxation Issues*, OECD, Paris, 1984.
2 Reproduced in Volume II at page R(13)-1.

8. Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.

II. Commentary on the provisions of the Article

Paragraph 1

9. This paragraph is concerned with two questions. First, it restates 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. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

10. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and

more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods or manufactures in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

11. When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph 2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, *e.g.* by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole. Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting State to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the phrase "profits attributable to a permanent establishment". In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

12. Clearly, however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise

of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

Paragraph 2

14. This paragraph contains the central directive on which the attribution of profits to a permanent establishment is intended to be based. The paragraph incorporates the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.

15. The paragraph requires that this principle be applied in each Contracting State. Clearly, this does not mean that the amount on which the enterprise will be taxed in the source State will, for a given period of time, be exactly the same as the amount of income with respect to which the other State will have to provide relief pursuant to Article 23 A or 23 B. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses that are in accordance with paragraph 3 of this Article will normally result in a different amount of taxable income in each State.

16. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 51 to 55 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of profits that are properly attributable to the permanent establishment under the directive contained in paragraph 2. It should perhaps be emphasised that this directive is no justification to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. As noted in paragraph 19 below and as explained in paragraph 39 of Part I of the Report *Attribution of Profits to Permanent Establishments*, however, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation.

17. In order to determine whether such an adjustment is required by paragraph 2, it will be necessary to determine the profits that would have been realised if the permanent establishment had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the rest of the enterprise. Sections D-2 and D-3 of Part I of the Report *Attribution of Profits to Permanent Establishments* describe the two-step approach through which this should be done. This approach will allow the calculation of the profits attributable to all the

activities carried on through the permanent establishment, including transactions with other independent enterprises, transactions with associated enterprises and dealings (*e.g.* the internal transfer of capital or property or the internal provision of services — see for instance paragraphs 31 and 32) with other parts of the enterprise (under the second step referred to above), in accordance with the directive of paragraph 2.

18. The first step of that approach requires the identification of the activities carried on through the permanent establishment. This should be done through a functional and factual analysis (the guidance found in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[1] will be relevant for that purpose). Under that first step, the economically significant activities and responsibilities undertaken through the permanent establishment will be identified. This analysis should, to the extent relevant, consider the activities and responsibilities undertaken through the permanent establishment in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the permanent establishment. Under the second step of that approach, the remuneration of any such dealings will be determined by applying by analogy the principles developed for the application of the arm's length principle between associated enterprises (these principles are articulated in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*) by reference to the functions performed, assets used and risk assumed by the enterprise through the permanent establishment and through the rest of the enterprise.

19. A question that may arise is to what extent accounting records should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. Accounts should not be regarded as prepared symmetrically, however, unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. Also, as explained in paragraph 16, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation. For example, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. One such case would be where a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was

1 The original version of that report was approved by the Council of the OECD on 27 June 1995. Published in a loose-leaf format as *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995.

nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal.

20. It may therefore be concluded that accounting records and contemporaneous documentation that meet the above-mentioned requirements constitute a useful starting point for the purposes of attributing profits to a permanent establishment. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies. Section D-2 *(vi)b)* of Part I of the Report *Attribution of Profits to Permanent Establishments* discusses the conditions under which tax administrations would give effect to such documentation.

21. There may be a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within a State's territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows the former State to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.

22. Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or — in the event that it is wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation.

23. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7.

24. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is

necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment.

25. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

26. Where, under paragraph 5 of Article 5, a permanent establishment of an enterprise of a Contracting State is deemed to exist in the other Contracting State by reason of the activities of a so-called dependent agent (see paragraph 32 of the Commentary on Article 5), the same principles used to attribute profits to other types of permanent establishment will apply to attribute profits to that deemed permanent establishment. As a first step, the activities that the dependent agent undertakes for the enterprise will be identified through a functional and factual analysis that will determine the functions undertaken by the dependent agent both on its own account and on behalf of the enterprise. The dependent agent and the enterprise on behalf of which it is acting constitute two separate potential taxpayers. On the one hand, the dependent agent will derive its own income or profits from the activities that it performs on its own account for the enterprise; if the agent is itself a resident of either Contracting State, the provisions of the Convention (including Article 9 if that agent is an enterprise associated to the enterprise on behalf of which it is acting) will be relevant to the taxation of such income or profits. On the other hand, the deemed permanent establishment of the enterprise will be attributed the assets and risks of the enterprise relating to the functions performed by the dependent agent on behalf of that enterprise (*i.e.* the activities that the dependent agent undertakes for that enterprise), together with sufficient capital to support those assets and risks. Profits will then be attributed to the deemed permanent establishment on the basis of those assets, risks and capital; these profits will be separate from, and will not include, the income or profits that are properly attributable to the dependent agent itself (see section D-5 of Part I of the Report *Attribution of Profits to Permanent Establishments*).

Paragraph 3

27. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent

establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

28. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element.

29. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

30. Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article).

31. In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the

basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, *i.e.* by normally including in the sale price an appropriate profit.

32. On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.[1]

33. Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material *e.g.* in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (subparagraph 4 *d*) of Article 5) so that no question of attribution of profit arises in such circumstances.

34. In the case of intangible rights, the rules concerning the relations between enterprises of the same group (*e.g.* payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights, as well as the costs subsequently incurred with respect to these intangible rights, without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development

1 Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have been dealt with in Parts II and III of the Report *Attribution of Profits to Permanent Establishments*.

activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge.

35. The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer.

36. Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case.

37. However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.

38. The treatment of services performed in the course of the general management of an enterprise raises the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skillful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be

taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

39. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 38 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

40. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

41. The treatment of interest charges raises particular issues. First, there might be amounts which, under the name of interest, are charged by a head office to its permanent establishment with respect to internal "loans" by the former to the latter. Except for financial enterprises such as banks, it is generally agreed that such internal "interest" need not be recognised. This is because:

— From the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment.

— From the economic standpoint, internal debts and receivables may prove to be non existent, since if an enterprise is solely or predominantly equity funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. Whilst, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

42. For these reasons, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special situation of banks, as mentioned below.

43. A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment.

44. The approach suggested in this Commentary before 1994, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or

of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality, in particular the fact that an independent enterprise would normally be expected to have a certain level of "free" capital.

45. Consequently, the majority of member countries consider that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. This appropriate capital structure will take account of the fact that in order to carry out its activities, the permanent establishment requires a certain amount of funding made up of "free" capital and interest bearing debt. The objective is therefore to attribute an arm's length amount of interest to the permanent establishment after attributing an appropriate amount of "free" capital in order to support the functions, assets and risks of the permanent establishment. Under the arm's length principle a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors.

46. As explained in section D-2 *(v)b)* of Part I of the Report *Attribution of Profits to Permanent Establishments*, there are different acceptable approaches for attributing "free" capital that are capable of giving an arm's length result. Each approach has its own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of "free" capital attributable to a permanent establishment, which either put more emphasis on the actual structure of the enterprise of which the permanent establishment is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing "free" capital is to recognise:

— the existence of strengths and weaknesses in any approach and when these are likely to be present;

— that there is no single arm's length amount of "free" capital, but a range of potential capital attributions within which it is possible to find an amount of "free" capital that can meet the basic principle set out above.

47. It is recognised, however, that the existence of different acceptable approaches for attributing "free" capital to a permanent establishment which are capable of giving an arm's length result can give rise to problems of double taxation. The main concern, which is especially acute for financial institutions, is that if the domestic law rules of the State where the permanent establishment is located and of the State of the enterprise require different acceptable approaches for attributing an arm's length amount of free capital to the permanent establishment, the amount of profits calculated by the State of the permanent establishment may be higher than the amount of profits calculated by the State of the enterprise for purposes of relief of double taxation.

48. Given the importance of that issue, the Committee has looked for a practical solution. OECD member countries have therefore agreed to accept, for the purposes of determining the amount of interest deduction that will be used in computing double taxation relief, the attribution of capital derived from the application of the approach used by the State in which the permanent establishment is located if the following two conditions are met: first, if the difference in capital attribution between that State and the State of the enterprise results from conflicting domestic law choices of capital attribution methods, and second, if there is agreement that the State in which the permanent establishment is located has used an authorised approach to the attribution of capital and there is also agreement that that approach produces a result consistent with the arm's length principle in the particular case. OECD member countries consider that they are able to achieve that result either under their domestic law, through the interpretation of Articles 7 and 23 or under the mutual agreement procedure of Article 25 and, in particular, the possibility offered by that Article to resolve any issues concerning the application or interpretation of their tax treaties.

49. As already mentioned, special considerations apply to internal interest charges on advances between different parts of a financial enterprise (*e.g.* a bank), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the application of Article 7 to the permanent establishments of banks and enterprises carrying on global trading, is discussed in Parts II and III of the *Report Attribution of Profits to Permanent Establishments*.

50. The determination of the investment assets attributable to a permanent establishment through which insurance activities are carried on also raises particular issues, which are discussed in Part IV of the Report.

51. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, *e.g.* by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not

been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits based on other methods.

Paragraph 4

52. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasised, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

53. It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

54. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in vacuo* that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some

enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

55. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.

Paragraph 5

56. In paragraph 4 of Article 5 there are listed a number of examples of activities which, even though carried on at a fixed place of business, are deemed not to be included in the term "permanent establishment". In considering rules for the allocation of profits to a permanent establishment the most important of these examples is the activity mentioned in paragraph 5 of this Article, *i.e.* the purchasing office.

57. Paragraph 5 is not, of course, concerned with the organisation established solely for purchasing; such an organisation is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which, although carrying on other business, also carries on purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities will also be excluded in calculating the taxable profits of the permanent establishment.

Paragraph 6

58. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is

dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

Paragraph 7

59. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries.

60. This interpretation of the term "profits", however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, *e.g.* dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

61. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

62. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discuss the principles governing whether, in the particular case of computer software, payments should be classified as business profits within Article 7 or as a capital gain within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.

63. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term "profits" includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits.

64. It should also be noted that, whilst the definition of "royalties" in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial, or scientific equipment", the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers to be appropriate given the nature of such income.

Observations on the Commentary

65. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 8 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, *i.e.* by the elimination of Article 14.

66. *Belgium* cannot share the views expressed in paragraph 13 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 1 of Article 7. This is especially the case where a Contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with paragraph 1 of Article 7. That Contracting State thus disregards the legal personality of the foreign entity and acts contrary to paragraph 1 of Article 7.

67. *Luxembourg* does not share the interpretation in paragraph 13 which provides that paragraph 1 of Article 7 does not restrict a Contracting State's right to tax its own residents under controlled foreign companies provisions found in its domestic law as this interpretation challenges the fundamental principle contained in paragraph 1 of Article 7.

68. With reference to paragraph 13, *Ireland* notes its general observation in paragraph 27.5 of the Commentary on Article 1.

69. With regard to paragraph 45, *Greece* notes that the Greek internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. Concerning loans contracted by an enterprise that relate in whole or in part to the activities of the permanent establishment, Greece allows as deduction the part of the interest which corresponds to the amount of a loan contracted by the head office and actually remitted to the permanent establishment.

70. *Portugal* wishes to reserve its right not to follow the position expressed in paragraph 45 of the Commentary on Article 7 except whenever there are specific domestic provisions foreseeing certain levels of "free" capital for permanent establishments.

71. With regard to paragraph 46, *Sweden* wishes to clarify that it does not consider that the different approaches for attributing "free" capital that the paragraph refers to as being "acceptable" will necessarily lead to a result in accordance with the arm's length principle. Consequently, when looking at the

facts and circumstances of each case in order to determine whether the amount of interest deduction resulting from the application of these approaches conforms to the arm's length principle, Sweden in many cases would not consider that the other States' approach conforms to the arm's length principle. Sweden is of the opinion that double taxation will therefore often occur, requiring the use of the mutual agreement procedure.

72. *Portugal* wishes to reserve its right not to follow the "symmetry" approach described in paragraph 48 of the Commentary on Article 7, insofar as the Portuguese internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. In eliminating double taxation according to Article 23, Portugal, as the home country, determines the amount of profits attributable to a permanent establishment according to the domestic law.

73. *Germany*, *Japan* and the *United States*, whilst agreeing to the practical solution described in paragraph 48, wish to clarify how this agreement will be implemented. Neither Germany, nor Japan, nor the United States can automatically accept for all purposes all calculations by the State in which the permanent establishment is located. In cases involving Germany or Japan, the second condition described in paragraph 48 has to be satisfied through a mutual agreement procedure under Article 25. In the case of Japan and the United States, a taxpayer who seeks to obtain additional foreign tax credit limitation must do so through a mutual agreement procedure in which the taxpayer would have to prove to the Japanese or the United States competent authority, as the case may be, that double taxation of the permanent establishment profits which resulted from the conflicting domestic law choices of capital attribution methods has been left unrelieved after applying mechanisms under their respective domestic tax law such as utilisation of foreign tax credit limitation created by other transactions.

74. With reference to paragraphs 6 and 7, *New Zealand* notes that it does not agree with the approach put forward on the attribution of profits to permanent establishments in general, as reflected in Part I of the Report *Attribution of Profits to Permanent Establishments*.

Reservations on the Article

75. *Australia*, *Chile*[1] and *New Zealand* reserve the right to include a provision that will permit their domestic law to apply in relation to the taxation of profits from any form of insurance.

76. *Australia* and *New Zealand* reserve the right to include a provision clarifying their right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian and New Zealand tax purposes) from the carrying on of a business in Australia or New Zealand, as the case may be, through a permanent establishment.

77. *Korea* and *Portugal* reserve the right to tax persons performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve

1 Chile was added to this reservation when it joined the OECD in 2010.

month period, even if they do not have a permanent establishment (or a fixed base) available to them for the purpose of performing such services or activities.

78. *Chile,*[1] *Italy* and *Portugal* reserve the right to tax persons performing independent personal services under a separate article which corresponds to Article 14 as it stood before its elimination in 2000.

79. The *United States* reserves the right to amend Article 7 to provide that, in applying paragraphs 1 and 2 of the Article, any income or gain attributable to a permanent establishment during its existence may be taxable by the Contracting State in which the permanent establishment exists even if the payments are deferred until after the permanent establishment has ceased to exist. The United States also wishes to note that it reserves the right to apply such a rule, as well, under Articles 11, 12, 13 and 21.

80. *Turkey* reserves the right to subject income from the leasing of containers to a withholding tax at source in all cases. In case of the application of Articles 5 and 7 to such income, Turkey would like to apply the permanent establishment rule to the simple depot, depot-agency and operational branches cases.

81. *Norway* and the *United States* reserve the right to treat income from the use, maintenance or rental of containers used in international traffic under Article 8 in the same manner as income from shipping and air transport.

82. *Australia* and *Portugal* reserve the right to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

83. *Mexico* reserves the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise carried out directly by its home office situated in the other Contracting State, provided that those goods and merchandise are of the same or similar kind as the ones sold through that permanent establishment. The Government of Mexico will apply this rule only as a safeguard against abuse and not as a general "force of attraction" principle; thus, the rule will not apply when the enterprise proves that the sales have been carried out for reasons other than obtaining a benefit under the Convention.

1 Chile was added to this reservation when it joined the OECD in 2010.

HISTORY

Paragraph 1: Replaced on 22 July 2010 when paragraph 1 was deleted and a new paragraph was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 1 read as follows:

> "1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules by reference to which the profits attributable to the permanent establishment are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are associated are dealt with in Article 9."

Paragraph 1 was amended on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. In the 1977 Model Convention and until 17 July 2008, paragraph 1 read as follows:

> "1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9."

Paragraph 1 and the heading preceding it were previously amended when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963

Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 1 and the heading preceding it read as follows:

> "GENERAL INTRODUCTION
>
> 1. Article 7 on business profits is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation Conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise; the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9."

Paragraph 2: Replaced on 22 July 2010 when paragraph 2 was deleted and a new paragraph was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 2 read as follows:

> "2. Articles 7 and 9 are not particularly detailed and were not strikingly novel when they were adopted by the OECD. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between associated enterprises, has had to be dealt with in a large number of double taxation conventions and in various models developed by the League of Nations before the OECD first dealt with it and the solutions adopted have generally conformed to a standard pattern."

Paragraph 2 was amended on 17 July 2008, by incorporating the third, fourth, fifth and sixth sentences into paragraph 3, by incorporating the penultimate sentence into paragraph 4 and by amending the remaining first and second sentences of paragraph 2 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 2 read as follows:

> "2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater

clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. However, since such problems may result in unrelieved double taxation or non taxation of certain profits, it is more important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25, than to adopt unilateral interpretations of basic principles to be adhered to despite differences of opinion with other States. In this respect, the methods for solving some of the problems most often encountered are discussed below."

Paragraph 2 was previously amended on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). In the 1977 Model Convention and until 31 March 1994, paragraph 2 read as follows:

"2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

Paragraph 2 was previously amended when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 2 read as follows:

"2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives.

They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation Convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance. If there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

Paragraph 2.1: Amended and renumbered as paragraph 8 (see history of paragraph 77) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 3: Replaced on 22 July 2010 when paragraph 3 was deleted and a new paragraph was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 3 read as follows:

"3. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and, when the OECD first examined that question, it was thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise."

Paragraph 3 as it read after 17 July 2008 corresponded to the third, fourth, fifth and sixth sentences of paragraph 2. On 17 July 2008, paragraph 3 was renumbered as paragraph 9 (see history of paragraph 11), the headings preceding paragraph 3 were moved with it and the third, fourth, fifth and sixth sentences of paragraph 2, with amendments, were incorporated into paragraph 3 (see history of paragraph 2) by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 4: Corresponds to paragraph 5, as it read before 22 July 2010. On that date paragraph 4 was deleted and paragraph 5 was amended and renumbered as paragraph 4 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 5 read as follows:

"5. Over the years, the Committee on Fiscal Affairs has therefore spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.[1] In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"[2] and to subsequent changes to the Commentary.

1 The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises Three Taxation Issues*, OECD, Paris, 1984.

2 Reproduced in Volume II at page R(13)-1."

Paragraph 5 was replaced on 17 July 2008 when it was deleted and a new paragraph 5 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 5 read as follows:

> "5. The second and more important point is that it is laid down — in the second sentence — 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. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other Articles."

C (7)

Paragraph 5 as it read after 23 July 1992 corresponded to paragraph 4 of the 1963 Draft Convention, adopted by the OECD Council on 30 July 1963. On 23 July 1992 paragraph 5 of the 1963 Draft Convention was renumbered as paragraph 6 (see history of paragraph 6) and paragraph 4 was renumbered as paragraph 5 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 4, as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

> "4. It must be acknowledged, however, that there has been considerable variation in the interpretation of the general directives of Article 7 and of the provisions of earlier conventions and models on which the wording of the Article is based. This lack of a common interpretation of Article 7 can lead to problems of double taxation and non-taxation. For that reason, it is important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25."

Paragraph 4 as it read after 17 July 2008 corresponded in part to the penultimate sentence of paragraph 2. On 17 July 2008 paragraph 4 was deleted and the penultimate sentence of paragraph 2, with amendments, was incorporated into a new paragraph 4 (see history of paragraph 2) by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 4 read as follows:

> "4. There have been, since the 1950s, rapid developments of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, industrial activities being carried out in space, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions,

would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisage extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any new risks of double taxation. Secondly, if there are double taxation problems, the Model Convention, by giving a ruling on the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting State has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure."

Paragraph 4 was previously amended on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994. After 23 July 1992 and until 31 March 1994, paragraph 4 read as follows:

"4. There have been, over the last decades, rapid developments of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, the prospect in the fairly near future of industrial activities being carried out in satellites, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions, would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisage extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any new risks of double taxation. Secondly, if there are double taxation problems, the Model Convention, by giving a ruling on the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting State has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure."

Paragraph 4 of the 1977 Model Convention was replaced on 23 July 1992 when it was renumbered as paragraph 5 (see history of paragraph 5 as it read before 22 July 2010 in paragraph 4) and a new paragraph 4 was added by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 5: Corresponds to the first three sentences of paragraph 6, as they read before 22 July 2010. Paragraph 5, was amended and renumbered as paragraph 4 (see history of paragraph 4) and the first three sentences of paragraph 6 were amended and incorporated into paragraph 5 (see history of paragraph 6) by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

Paragraph 6: Amended on 22 July 2010 and the first three sentences of paragraph 6 were incorporated into paragraph 5, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 6 read as follows:

"6. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*. The approach developed in that report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade."

Paragraph 6 was replaced on 17 July 2008 when it was deleted and a new paragraph was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 6 read as follows:

"6. On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view."

Paragraph 6 as it read after 23 July 1992 corresponded to paragraph 5 of the 1963 Draft Convention, adopted by the OECD Council on 30 July 1963. On 23 July 1992 paragraph 6 of the 1963 Draft Convention was renumbered as paragraph 7 (see history of paragraph 9) and paragraph 5 of the 1963 Draft Convention was renumbered as paragraph 6 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 7: Replaced paragraph 7 as it read before 22 July 2010 when paragraph 7 was amended and renumbered as paragraph 9 (see history of paragraph 9) and a new paragraph 7 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 8: Replaced paragraph 8 as it read before 22 July 2010 when paragraph 8 was renumbered as paragraph 77 (see history of paragraph 77) and a new paragraph 8 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 9: Corresponds to paragraph 7 as it read before 22 July 2010. On that date paragraph 9 was amended and renumbered as paragraph 11 (see history of paragraph 11), the headings preceding paragraph 9 were moved immediately before paragraph 10 and paragraph 7 was amended and renumbered as paragraph 9 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 7 read as follows:

"7. The approach put forward in that Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities). The Committee considers that the guidance included in the Report represents a better approach to attributing profits to permanent establishments than has previously been available. It does recognise, however, that there are differences between some of the conclusions of the Report and the interpretation of the Article previously given in this Commentary. For that reason, this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in others. The Report therefore represents internationally agreed principles and, to the extent that it does not conflict with this Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article."

Paragraph 7 was replaced on 17 July 2008 when it was deleted and a new paragraph 7 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 7 read as follows:

"7. Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result."

Paragraph 7 as it read after 23 July 1992 corresponded to paragraph 6 of the 1963 Convention, adopted by the OECD Council on 30 July 1963. On 23 July 1992 paragraph 7 of the 1963 Draft Convention was renumbered as paragraph 8 (see history of paragraph 77) and paragraph 6 of the 1963 Draft Convention was renumbered as paragraph 7 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 10: Replaced paragraph 10 as it read before 22 July 2010 when paragraph 10 was amended and renumbered as paragraph 12 (see history of paragraph 12) and a new paragraph 10 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. At the same time, the headings preceding paragraph 9 were moved immediately before paragraph 10.

Paragraph 10.1: Amended and renumbered as paragraph 13 (see history of paragraph 14) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 11: Corresponds to paragraph 9 as it read before 22 July 2010. On that date paragraph 11 was deleted and paragraph 9 was amended and renumbered as paragraph 11 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 9 read as follows:

"9. This paragraph is concerned with two questions. First, it restates 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. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other

State to such an extent that it comes within the jurisdiction of that other State's taxing rights."

Paragraph 9 as it read after 17 July 2008 corresponded to paragraph 3 of the 1963 Draft Convention, adopted by the OECD Council on 30 July 1963. On 17 July 2008 paragraph 9 as it read before 17 July 2008 was deleted and paragraph 3 of the 1963 Draft Convention was renumbered as paragraph 9 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. At the same time, the headings preceding paragraph 3 were moved with it.

The heading preceding paragraph 3, "II. COMMENTARY ON THE PROVISIONS OF THE ARTICLE", was added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 9, as it read after 31 March 1994 and until it was deleted on 17 July 2008, read as follows:

> "9. It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion."

Paragraph 9 as it read after 23 July 1992 corresponded to paragraph 8 of the 1963 Draft Convention, adopted by the OECD Council on 30 July 1963. Paragraph 9 of the 1963 Draft Convention was renumbered as paragraph 10 (see history of paragraph 12) and paragraph 8 of the 1963 Draft Convention was renumbered as paragraph 9 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 11 as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

> "11. When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph 2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole. Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting State to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the phrase "profits attributable to a permanent establishment". In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits."

Paragraph 11 was replaced on 17 July 2008 when it was renumbered as paragraph 14 (see history of paragraph 14), the heading preceding paragraph 11 was moved with it and a new paragraph 11 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 12: Corresponds to paragraph 10, as it read before 22 July 2010. On that date paragraph 12 was deleted and paragraph 10 was amended and renumbered as paragraph 12 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 10 read as follows:

> "10. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods or manufactures in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention."

Paragraph 10 was replaced on 17 July 2008 when it was deleted and a new paragraph 10 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 10 read as follows:

> "10. For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organisation and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous."

Paragraph 10 as it read after 23 July 1992 corresponded to paragraph 9 of the 1963 Draft Convention, adopted by the OECD Council on 30 July 1963. On 23 July 1992 paragraph 10 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 14), the heading preceding paragraph 10 was moved with it and paragraph 9 of the 1963 Draft Convention was renumbered as paragraph 10 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 12, as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

> "12. Clearly, however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise."

Paragraph 12 was replaced on 17 July 2008 when it was renumbered as paragraph 16 (see history of paragraph 16) and a new paragraph 12 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 12.1: Amended and renumbered as paragraph 19 (see history of paragraph 19) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 12.2: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 12.2 read as follows:

> "12.2 In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 17.1ff. below)."

Paragraph 12.2 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 13: Replaced on 22 July 2010 when paragraph 13 was amended and renumbered as paragraph 14 (see history of paragraph 14) and a new paragraph 13 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 14: Corresponds to paragraph 13 as it read before 22 July 2010. On that date paragraph 14 was deleted and paragraph 13 was amended and renumbered as paragraph 14 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 14 was moved immediately before paragraph 15. After 17 July 2008 and until 22 July 2010, paragraph 13 read as follows:

> "13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so

levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10)."

Paragraph 13 as it read after 17 July 2008 corresponded to paragraph 10.1. On 17 July 2008 paragraph 13 was deleted and paragraph 10.1 was amended and renumbered as paragraph 13 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 28 January 2003 and until 17 July 2008, paragraph 10.1 read as follows:

"10.1 The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10)."

Paragraph 10.1 was added on 28 January 2003 by the report entitled "The 2002 Update to the Model Tax Convention", adopted by the OECD Council on 28 January 2003.

Paragraph 13 as it read before 17 July 2008 was deleted by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 13 read as follows:

"13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's length principle (cf. paragraph 2 above). Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa."

Paragraph 13 as it read before 31 March 1994 was replaced when it was deleted and a new paragraph 13 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 13 read as follows:

"13. Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts, in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa."

Paragraph 13 as it read after 23 July 1992 corresponded to paragraph 12 of the 1977 Model Convention. On 23 July 1992 paragraph 13 of the 1977 Model Convention was renumbered as paragraph 14 (see history of paragraph 14 (below)) and paragraph 12 of the 1977 Model Convention was renumbered as paragraph 13 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 12 of the 1977 Model Convention corresponded to paragraph 11 of the 1963 Draft Convention. Paragraph 12 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963), was amended and renumbered as paragraph 13 (see history of paragraph 14 (below)) and paragraph 11 of the 1963 Draft Convention was renumbered as paragraph 12 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 14, as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

> "14. This paragraph contains the central directive on which the attribution of profits to a permanent establishment is intended to be based. The paragraph incorporates the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy."

Paragraph 14 as it read after 17 July 2008 corresponded to paragraph 11. On 17 July 2008 paragraph 14 was deleted, paragraph 11 was amended and renumbered as paragraph 14 and the heading preceding paragraph 11 was moved with it and by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 11 read as follows:

> "11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. The arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions or amend paragraph 2 to read as follows:
>
>> "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 be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.""

Paragraph 11, as it read before 31 March 1994, was replaced when it was deleted and a new paragraph 11 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 11 read as follows:

"11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions."

Paragraph 11, as it read after 23 July 1992, corresponded to paragraph 10 of the 1977 Model Convention. On 23 July 1992 paragraph 11 of the 1977 Model Convention was amended and renumbered as paragraph 12 (see history of paragraph 16), paragraph 10 of the 1977 Model Convention was renumbered as paragraph 11 and the heading preceding paragraph 10 was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 10 of the 1977 Model Convention (adopted by the OECD Council on 11 April 1977), included the first three sentences of paragraph 10 as they read in the 1963 Draft Convention. Paragraph 10 was amended and divided between paragraphs 10 and 11 when the 1977 Model Convention was adopted. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 10 read as follows:

"10. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral Conventions that have been concluded since the war, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, this would be the same profit that one would expect to be reached by the ordinary processes of good business accountancy. In the great majority of cases, therefore, trading accounts of the permanent establishment -- which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches -- will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally, there may be no separate accounts (see paragraphs 21 to 25 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce."

Paragraph 14 as it read after 23 July 1992 and until 17 July 2008 was deleted by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 14 read as follows:

"14. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market."

Paragraph 14 as it read after 23 July 1992 corresponded to paragraph 13 of the 1977 Model Convention. On 23 July 1992 paragraph 14 of the 1977 Model Convention was amended and renumbered as paragraph 15 (see history of paragraph 21) and paragraph 13 was renumbered as paragraph 14 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 13 of the 1977 Model Convention corresponded to paragraph 12 of the 1963 Draft Convention. Paragraph 13 of the 1963 Draft Convention was amended and renumbered as paragraph 15 (see history of paragraph 27) and the preceding heading was moved with it when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 12 of the 1963 Draft Convention was amended and renumbered as paragraph 13 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 12 read as follows:

"12. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. (Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used). It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price and it is thought that the figures in the accounts are unsatisfactory it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones re-written, and for this purpose the figures to be used will be those prevailing in the open market."

Paragraph 15: Replaced on 22 July 2010 when paragraph 15 was deleted and a new paragraph 15 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 14 was moved immediately before paragraph 15. After 17 July 2008 and until 22 July 2010, paragraph 15 read as follows:

"15. The paragraph requires that this principle be applied in each Contracting State. Clearly, this does not mean that the amount on which the enterprise will be taxed in the source State will, for a given period of time, be exactly the same as the amount of income with respect to which the other State will have to provide relief pursuant to Articles 23 A or 23 B. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses that are in accordance with paragraph 3 of this Article will normally result in a different amount of taxable income in each State."

Paragraph 15 was previously replaced on 17 July 2008 when it was amended and renumbered as paragraph 21 (see history of paragraph 21) and a new paragraph 15 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 15.1: Amended and renumbered as paragraph 22 (see history of paragraph 22) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 15.2: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 15.2 read as follows:

"15.2 Another significant problem concerning the transfer of assets, such as bad loans, arises in relation to international banking. Debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Such transfers should not be recognised where it cannot be reasonably considered that they take place for valid commercial reasons or that they would have taken place between independent enterprises, for instance where they are undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, the transfers would not have been expected to take place between wholly independent enterprises and therefore would not have affected the amount of profits which such an independent enterprise might have been expected to make in independent dealing with the enterprise of which it is a permanent establishment."

Paragraph 15.2 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 15.3: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 15.3 read as follows:

"15.3 However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks. An instance of such a transfer might be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values (this question is further discussed in the report of the Committee on Fiscal Affairs entitled "Attribution of Income to Permanent Establishments"[1]).

1 *Attribution of Income to Permanent Establishments*, reproduced in Volume II at page R(13)-1."

Paragraph 15.3 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 15.4: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 15.4 read as follows:

"15.4 Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgment as to the debtor's solvency or whether the value at that date reflected an appropriate judgment of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country."

Paragraph 15.4 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 16: Replaced on 22 July 2010 when paragraph 16 was deleted and a new paragraph 16 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 16 read as follows:

> "16. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 51 to 55 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of profits that are properly attributable to the permanent establishment under the directive contained in paragraph 2. It should perhaps be emphasized that this directive is no justification to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. As noted in paragraph 19 below and as explained in paragraph 39 of Part I of the Report *Attribution of Profits to Permanent Establishments*, however, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation."

Paragraph 16 as it read after 17 July 2008 corresponded to paragraph 12. On 17 July 2008 paragraph 16 was renumbered as paragraph 27 (see history of paragraph 27), the heading preceding paragraph 16 was moved with it and paragraph 12 was amended and renumbered as paragraph 16 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 12 read as follows:

> "12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 24 to 28 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce."

Paragraph 12 was replaced on 31 March 1994 when it was deleted and a new paragraph 12 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 12 read as follows:

> "12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 24 to 28 below). But where there are such

accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 17 below and following)."

Paragraph 12 as it read after 23 July 1992 corresponded to paragraph 11 of the 1977 Model Convention. On 23 July 1992 paragraph 12 of the 1977 Model Convention was renumbered as paragraph 13 (see history of paragraph 14) and paragraph 11 of the 1977 Model Convention was renumbered as paragraph 12 and amended, by replacing the reference therein to paragraphs 16 and 23 to 27 by a reference to paragraphs 17 and 24 to 28, by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992. In the 1977 Model Convention and until 23 July 1992, paragraph 11 read as follows:

"11. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 23 to 27 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 16 below and following)."

Paragraph 11 of the 1977 Model Convention corresponded to part of paragraph 10 of the 1963 Draft Convention. Paragraph 11 of the 1963 Draft Convention was amended and renumbered as paragraph 12 (see history of paragraph 14) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, the forth and subsequent sentences of paragraph 10 of the 1963 Draft Convention were incorporated into paragraph 11 of the 1977 Model Convention (see history of paragraph 14).

Paragraph 17: Replaced on 22 July 2010 when paragraph 17 was deleted and a new paragraph 17 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 17 read as follows:

"17. In order to determine whether such an adjustment is required by paragraph 2, it will be necessary to determine the profits that would have been realized if the permanent establishment had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the rest of the enterprise. Sections D-2 and D-3 of Part I of the Report Attribution of Profits to Permanent Establishments describe the two-step approach through which this should be done. This approach will allow the calculation of the profits attributable to all the activities carried on through the permanent establishment, including transactions with other independent enterprises, transactions with associated enterprises and dealings (e.g. the internal transfer of capital or property or the internal provision of services – see for instance paragraphs 31 and 32) with other parts of the enterprise (under the second step referred to above), in accordance with the directive of paragraph 2."

Paragraph 17 was previously replaced on 17 July 2008 when the first sentence of paragraph 17 was incorporated into paragraph 28, the second and subsequent sentences of paragraph 17 were incorporated into paragraph 29 (see history of paragraph 28) and a new paragraph 17 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.1: Renumbered as paragraph 31 (see history of paragraph 31) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.2: Renumbered as paragraph 32 (see history of paragraph 32) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.3: Renumbered as paragraph 33 (see history of paragraph 33) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.4: Amended and renumbered as paragraph 34 (see history of paragraph 34) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.5: Renumbered as paragraph 35 (see history of paragraph 35) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.6: Renumbered as paragraph 36 (see history of paragraph 36) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.7: Renumbered as paragraph 37 (see history of paragraph 37) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 18: Replaced on 22 July 2010 when paragraph 18 was deleted and a new paragraph 18 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 18 read as follows:

"18. The first step of that approach requires the identification of the activities carried on through the permanent establishment. This should be done through a functional and factual analysis (the guidance found in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* will be relevant for that purpose). Under that first step, the economically significant activities and responsibilities undertaken through the permanent establishment will be identified. This analysis should, to the extent relevant, consider the activities and responsibilities undertaken through the permanent establishment in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the permanent establishment. Under the second step of that approach, the remuneration of any such dealings will be determined by applying by analogy the principles developed for the application of the arm's length principle between associated enterprises (these principles are articulated in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*) by reference to the functions performed, assets used and risk assumed by the enterprise through the permanent establishment and through the rest of the enterprise.

1 The original version of that report was approved by the Council of the OECD on 27 June 1995. Published in a loose-leaf format as *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995."

Paragraph 18 was previously replaced on 17 July 2008 when it was deleted and a new paragraph 18 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 18 read as follows:

"18. Special considerations apply to payments which, under the name of interest, are made to a head office by its permanent establishment with respect to loans made by the former to the latter. In that case, the main issue is not so much whether a debtor/creditor relationship should be recognised within the same legal entity as whether an arm's length interest rate should be charged. This is because:

— from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment;

— from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed."

Paragraph 18 was previously replaced on 31 March 1994 when it was deleted and a new paragraph 18 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 18 read as follows:

"18. The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (*e.g.* a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment."

Paragraph 18, as it read after 23 July 1992, corresponded to paragraph 17 of the 1977 Model Convention. On 23 July 1992 paragraph 18 of the 1977 Model Convention was renumbered as paragraph 19 (see history of paragraph 19) and paragraph 17 of the 1977 Model Convention was renumbered as paragraph 18 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 17 of the 1977 Model Convention corresponded to paragraph 15 of the 1963 Draft Convention. Paragraph 17 of the 1963 Draft Convention was amended and renumbered as paragraph 19 (see history of paragraph 20) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 15 of the 1963 Draft Convention was amended and renumbered as paragraph 17 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 15 read as follows:

> "15. The first of these cases relates to interest, royalties and other similar payments made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. (Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits.) It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (*e.g.* a bank) to each other on advances, etc., (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc., to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment."

Paragraph 18.1: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 18.1 read as follows:

> "18.1 If debts incurred by the head office of an enterprise were used solely to finance its activity or clearly and exclusively the activity of a particular permanent establishment, the problem would be reduced to one of thin capitalisation of the actual user of such loans. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments."

Paragraph 18.1 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 18.2: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 18.2 read as follows:

> "18.2 The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of

total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality."

Paragraph 18.2 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 18.3: Deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 18.3 read as follows:

"18.3 Consequently, the majority of member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below (this question is further discussed in the reports of the Committee entitled "Attribution of Income to Permanent Establishment" and "Thin Capitalisation")."

Paragraph 18.3 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 19: Replaced on 22 July 2010 when paragraph 19 was deleted and a new paragraph 19 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 19 read as follows:

"19. A question that may arise is to what extent accounting records should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. Accounts should not be regarded as prepared symmetrically, however, unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. Also, as explained in paragraph 16, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation. For example, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. One such case would be where a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal."

Paragraph 19 as it read after 17 July 2008 corresponded to paragraph 12.1. On 17 July 2008 paragraph 19 was deleted and paragraph 12.1 was amended and renumbered as paragraph 19 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 12.1 read as follows:

> "12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal."

Paragraph 12.1 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 19 as it read after 31 March 1994 and until 17 July 2008 was deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 19 read as follows:

> "19. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (*e.g.* a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the transfer of financial assets, are considered in the report on multinational banking enterprises included in the OECD 1984 publication entitled *Transfer Pricing and Multinational Enterprises — Three Taxation Studies*. This Commentary does not depart from the positions expressed in the report on this topic. One issue not discussed in the report relates to the transfer of debts by bankers from one part of the bank to another; this is discussed in paragraphs 15.2 to 15.4 above."

Paragraph 19 was replaced on 31 March 1994 when it was deleted and a new paragraph 19 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 19 read as follows:

"19. The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact, if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment."

Paragraph 19 as it read after 23 July 1992 corresponded to paragraph 18 of the 1977 Model Convention. On 23 July 1992 paragraph 19 of the 1977 Model Convention was renumbered as paragraph 20 (see history of paragraph 20) and paragraph 18 of the 1977 Model Convention was renumbered as paragraph 19 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 18 of the 1977 Model Convention corresponded to paragraph 16 of the 1963 Draft Convention. Paragraph 18 of the 1963 Draft Convention was renumbered as paragraph 20 (see history of paragraph 38) and paragraph 16 of the 1963 Draft Convention was amended and renumbered as paragraph 18 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 16 read as follows:

"16. The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office (or vice versa). Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). But if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment."

Paragraph 20: Replaced on 22 July 2010 when paragraph 20 was deleted and a new paragraph 20 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 20 read as follows:

> "20. It may therefore be concluded that accounting records and contemporaneous documentation that meet the above-mentioned requirements constitute a useful starting point for the purposes of attributing profits to a permanent establishment. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies. Section D-2 *(vi)b)* of Part I of the Report *Attribution of Profits to Permanent Establishments* discusses the conditions under which tax administrations would give effect to such documentation."

Paragraph 20 was previously replaced on 17 July 2008 when it was deleted and a new paragraph 20 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 20 read as follows:

> "20. The above-mentioned report also addresses the issue of the attribution of capital to the permanent establishment of a bank in situations where actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of member countries on these questions and the present Commentary can only emphasise the desirability of agreement on mutually consistent methods of dealing with these problems."

Paragraph 20 was previously replaced on 31 March 1994 when it was deleted and a new paragraph 20 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 20 read as follows:

> "20. After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a "commission" figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional "commission". In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any credit for "commission". If as a general rule the "separate enterprise" test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional "commission" profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no "commission" element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no "commission" element should be deducted in determining the profits of the permanent establishment."

Paragraph 20 as it read after 23 July 1992 corresponded to paragraph 19 of the 1977 Model Convention. On 23 July 1992, paragraph 20 of the 1977 Model Convention was renumbered as paragraph 21 (see history of paragraph 38) and paragraph 19 of the 1977 Model Convention was renumbered as paragraph 20 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 19 of the 1977 Model Convention corresponded to paragraph 17 of the 1963 Draft Convention. Paragraph 19 of the 1963 Draft Convention was amended and renumbered as paragraph 21 (see history of paragraph 39) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 17 of the 1963 Draft Convention was amended and renumbered as paragraph 19 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 17 read as follows:

> "17. After careful consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a commission figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional commission. In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration the actual expenses incurred; in other words they would not normally include any credit for commission. If as a general rule the "separate enterprise" test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional "commission" profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no "commission" element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment) no "commission" element should be deducted in determining the profits of the permanent establishment."

Paragraph 21: Replaced on 22 July 2010 when paragraph 21 was deleted and a new paragraph was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 21 read as follows:

> "21. There may be a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within a State's territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows the former State to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law."

Paragraph 21 as it read after 17 July 2008 corresponded to paragraph 15. On 17 July 2008 paragraph 21 was amended and renumbered as paragraph 38 (see history of paragraph 38) and paragraph 15 was amended and renumbered as paragraph 21 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 15 read as follows:

> "15. Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law."

Paragraph 15 was replaced on 31 March 1994 when it was deleted and a new paragraph 15 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 15 read as follows:

> "15. Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated in paragraphs 11 to 14 above."

Paragraph 15 as it read after 23 July 1992 corresponded to paragraph 14 of the 1977 Model Convention. On 23 July 1992 paragraph 15 of the 1977 Model Convention was renumbered as paragraph 16 (see history of paragraph 27), the heading preceding paragraph 15 was moved with it and paragraph 14 of the 1977 Model Convention was renumbered as paragraph 15 and amended by replacing the reference therein to "paragraphs 10 to 13" by a reference to "paragraphs 11 to 14" by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992. In the 1977 Model Convention and until 23 July 1992, paragraph 14 read as follows:

> "14. Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated in paragraphs 10 to 13 above."

Paragraph 14 of the 1963 Draft Convention was replaced when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At that time, paragraph 14 of the 1963 Draft Convention was amended and renumbered as paragraph 16 (see history of paragraph 28) and a new paragraph 14 was added.

Paragraph 22: Replaced on 22 July 2010 when paragraph 22 was deleted and a new paragraph 22 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 22 read as follows:

> "22. Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or — in the event that it is wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation."

Paragraph 22 as it read after 17 July 2008 corresponded to paragraph 15.1. On 17 July 2008 paragraph 22 was amended and renumbered as paragraph 39 (see history of paragraph 39) and paragraph 15.1 was renumbered as paragraph 22 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 15.1 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 23: Replaced on 22 July 2010 when paragraph 23 was deleted and a new paragraph 23 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 23 read as follows:

> "23. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7."

Paragraph 23 was previously replaced on 17 July 2008 when it was renumbered as paragraph 40 (see history of paragraph 40) and a new paragraph 23 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 24: Replaced on 22 July 2010 when paragraph 24 was deleted and a new paragraph 24 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 24 read as follows:

> "24. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment."

Paragraph 24 was previously replaced on 17 July 2008 when it was amended and renumbered as paragraph 51 (see history of paragraph 51) and a new paragraph 24 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 25: Replaced on 22 July 2010 when paragraph 25 was deleted and a new paragraph 25 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 25 read as follows:

> "25. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it."

Paragraph 25 was previously replaced on 17 July 2008 when it was renumbered as paragraph 52 (see history of paragraph 52), the heading preceding paragraph 25 was moved with it and a new paragraph 25 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 26: Replaced on 22 July 2010 when paragraph 26 was deleted and a new paragraph 26 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 26 read as follows:

> "26. Where, under paragraph 5 of Article 5, a permanent establishment of an enterprise of a Contracting State is deemed to exist in the other Contracting State by reason of the activities of a so-called dependent agent (see paragraph 32 of the Commentary on Article 5), the same principles used to attribute profits to other types of permanent establishment will apply to attribute profits to that deemed permanent establishment. As a first step, the activities that the dependent agent undertakes for the enterprise will be identified through a functional and factual analysis that will determine the functions undertaken by the dependent agent both on its own account and on behalf of the enterprise. The dependent agent and the enterprise on behalf of which it is acting constitute two separate potential taxpayers. On the one hand, the dependent agent will derive its own income or profits from the activities that it performs on its own account for the enterprise; if the agent is itself a resident of either Contracting State, the provisions of the Convention (including Article 9 if that agent is an enterprise associated to the enterprise on behalf of which it is acting) will be relevant to the taxation of such income or profits. On the other hand, the deemed permanent establishment of the enterprise will be attributed the assets and risks of the enterprise relating to the functions performed by the dependent agent on behalf of that enterprise (*i.e.* the activities that the dependent agent undertakes for that enterprise), together with sufficient capital to support those assets and risks. Profits will then be attributed to the deemed permanent establishment on the basis of those assets, risks and capital; these profits will be separate from, and will not include, the income or profits that are properly attributable to the dependent agent itself (see section D-5 of Part I of the Report *Attribution of Profits to Permanent Establishments*)."

Paragraph 26 was previously replaced on 17 July 2008 when it was renumbered as paragraph 53 (see history of paragraph 53) and a new paragraph 26 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 27: Replaced on 22 July 2010 when paragraph 27 was deleted and a new paragraph 27 was added by the report entitled "The 2010 Update to the Model Tax

Convention", adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 27 was moved immediately before paragraph 44. After 17 July 2008 and until 22 July 2010, paragraph 27 read as follows:

> "27. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment."

Paragraph 27 as it read after 17 July 2008 corresponded to paragraph 16. On 17 July 2008 paragraph27 was renumbered as paragraph 54 (see history of paragraph 54), paragraph 16 was renumbered as paragraph 27 and the heading preceding paragraph 16 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 16, as it read after 23 July 1992 corresponded to paragraph 15 of the 1977 Model Convention. On 23 July 1992 paragraph 16 of the 1977 Model Convention was renumbered as paragraph 17 (see history of paragraph 28), paragraph 15 was renumbered as paragraph 16 and the heading preceding paragraph 15 was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 15 of the 1977 Model Convention corresponded to paragraph 13 of the 1963 Draft Convention. Paragraph 15 of the 1963 Draft Convention was amended and renumbered as paragraph 17 (see history of paragraph 18) and paragraph 13 of the 1963 Draft Convention was amended and renumbered as paragraph 15 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, the heading preceding paragraph 13 of the 1963 Draft Convention was moved with it. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 13 read as follows:

> "13. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. It is valuable to include paragraph 3 if only for the sake of removing doubts. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred."

Paragraph 28: Replaced on 22 July 2010 when paragraph 28 was deleted and a new paragraph 28 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 28 read as follows:

"28. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element."

Paragraph 28 as it read after 17 July 2008 corresponded to the first sentence of paragraph 17. On 17 July 2008 paragraph 28 was renumbered as paragraph 55 (see history of paragraph 55), the first sentence of paragraph 17 was incorporated into paragraph 28 and the second and subsequent sentences of paragraph 17 were incorporated into paragraph 29 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 17 read as follows:

"17. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made."

Paragraph 17 was replaced on 31 March 1994 when it was deleted and a new paragraph 17 was added by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 17 read as follows:

"17. Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply."

Paragraph 17 as it read after 23 July 1992 corresponded to paragraph 16 of the 1977 Model Convention. On 23 July 1992 paragraph 17 of the 1977 Model Convention was renumbered as paragraph 18 (see history of paragraph 18) and paragraph 16 of the 1977 Model Convention was renumbered as paragraph 17 by the report entitled “The Revision of the Model Convention”, adopted by the OECD Council on 23 July 1992.

Paragraph 16 of the 1977 Model Convention corresponded to paragraph 14 of the 1963 Draft Convention. Paragraph 16 of the 1963 Draft Convention was amended and renumbered as paragraph 18 (see history of paragraph 19) and paragraph 14 of the 1963 Draft Convention was amended and renumbered as paragraph 16 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 14 read as follows:

> “14. Apart from what may be regarded as ordinary expenses, there are some classes of payment between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next five paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.”

Paragraph 29: Replaced on 22 July 2010 when paragraph 29 was deleted and a new paragraph 29 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 29 read as follows:

> “29. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm’s length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.”

Paragraph 29 as it read after 17 July 2008 corresponded to the second and subsequent sentences of paragraph 17. On 17 July 2008 paragraph 29 was renumbered as paragraph 56 (see history of paragraph 56), the heading preceding paragraph 29 was moved with it, and the second and subsequent sentences of paragraph 17 were incorporated into paragraph 29 (see history of paragraph 17 in history of paragraph 28) by the report entitled “The 2008 Update to the Model Tax Convention”, adopted by the OECD Council on 17 July 2008.

Paragraph 30: Replaced on 22 July 2010 when paragraph 30 was deleted and a new paragraph 30 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 30 read as follows:

> “30. Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of

expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article)."

Paragraph 30 was previously replaced on 17 July 2008 when it was renumbered as paragraph 57 (see history of paragraph 57) and a new paragraph 30 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 31: Replaced on 22 July 2010 when paragraph 31 was deleted and a new paragraph 31 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 31 read as follows:

"31. In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, *i.e.* by normally including in the sale price an appropriate profit."

Paragraph 31 as it read after 17 July 2008 corresponded to paragraph 17.1. On 17 July 2008 paragraph 31 was renumbered as paragraph 58 (see history of paragraph 58), the heading preceding paragraph 31 was moved with it and paragraph 17.1 was renumbered as paragraph 31 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.1 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 32: Replaced on 22 July 2010 when paragraph 32 was deleted and a new paragraph 32 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 32 read as follows:

"32. On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.[1]

1 Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have been dealt with in Parts II and III of the Report *Attribution of Profits to Permanent Establishments*."

Paragraph 32 as it read after 17 July 2008 corresponded to paragraph 17.2. On 17 July 2008 paragraph 32 was renumbered as paragraph 59 (see history of paragraph 71) and the heading preceding paragraph 32 was moved with it. At the same time, paragraph 17.2 was amended, by revising the footnote, and renumbered as paragraph 32 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, the footnote to paragraph 17.2 read as follows:

"1 Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have already been dealt with in a separate study entitled "The Taxation of Multinational Banking Enterprises" (published under the title Transfer Pricing and Multinational Enterprises — Three Taxation Issues, OECD, Paris, 1984) and which are the subject of paragraphs 19 and 20 below."

Paragraph 17.2 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 33: Replaced on 22 July 2010 when paragraph 33 was deleted and a new paragraph 33 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 33 read as follows:

"33. Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material *e.g.* in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (subparagraph 4 *d)* of Article 5) so that no question of attribution of profit arises in such circumstances."

Paragraph 33 as it read after 17 July 2008 corresponded to paragraph 17.3. On 17 July 2008 paragraph 33 was renumbered as paragraph 60 (see history of paragraph 72) and paragraph 17.3 was renumbered as paragraph 33 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.3 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 34: Replaced on 22 July 2010 when paragraph 34 was deleted and a new paragraph 34 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 34 read as follows:

"34. In the case of intangible rights, the rules concerning the relations between enterprises of the same group (*e.g.* payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights, as well as the costs subsequently incurred with respect to these intangible rights, without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge."

Paragraph 34 as it read after 17 July 2008 corresponded to paragraph 17.4. On 17 July 2008 paragraph 34 was renumbered as paragraph 61 (see history of paragraph 73) and paragraph 17.4 was amended and renumbered as paragraph 34 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 31 March 1994 and until 17 July 2008, paragraph 17.4 read as follows:

"17.4 In the case of intangible rights, the rules concerning the relations between enterprises of the same group (*e.g.* payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge."

Paragraph 17.4 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 35: Amended on 15 July 2014, by replacing the word "income" with "profits" in the last sentence, by the Report entitled "The 2014 Update to the Model Tax Convention", adopted by the Council of the OECD on 15 July 2014. After 22 July 2010 and until 15 July 2014, paragraph 35 read as follows:

"35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7."

Paragraph 35 was replaced on 22 July 2010 when it was deleted and a new paragraph 35 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 35 read as follows:

"35. The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer."

Paragraph 35 as it read after 17 July 2008 corresponded to paragraph 17.5. On 17 July 2008 paragraph 35 was amended and renumbered as paragraph 62 (see history of paragraph 74) and paragraph 17.5 was renumbered as paragraph 35 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.5 was added on 31 March 1994 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993).

Paragraph 36: Amended on 15 July 2014 by the Report entitled "The 2014 Update to the Model Tax Convention", adopted by the Council of the OECD on 15 July 2014. After 22 July 2010 and until 15 July 2014, paragraph 36 read as follows:

"36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment."

Paragraph 36 was replaced on 22 July 2010 when it was deleted and a new paragraph 36 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 36 read as follows:

"36. Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case."

Paragraph 36 as it read after 17 July 2008 corresponded to paragraph 17.6. On 17 July 2008 paragraph 36 was renumbered as paragraph 63 (see history of paragraph 75) and paragraph 17.6 was renumbered as paragraph 36 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 17.6 was added on 31 March 1994 by the report entitled “1994 Update to the Model Tax Convention”, adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled “Attribution of Income to Permanent Establishments” (adopted by the OECD Council on 26 November 1993).

Paragraph 37: Replaced on 22 July 2010 when paragraph 37 was deleted and a new paragraph 37 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 37 read as follows:

> “37. However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.”

Paragraph 37 as it read after 17 July 2008 corresponded to paragraph 17.7. On 17 July 2008 paragraph 37 was renumbered as paragraph 64 (see history of paragraph 76) and paragraph 17.7 was renumbered as paragraph 37 by the report entitled “The 2008 Update to the Model Tax Convention”, adopted by the OECD Council on 17 July 2008.

Paragraph 17.7 was added on 31 March 1994 by the report entitled “1994 Update to the Model Tax Convention”, adopted by the OECD Council on 31 March 1994, on the basis of a previous report entitled “Attribution of Income to Permanent Establishments” (adopted by the OECD Council on 26 November 1993).

Paragraph 38: Replaced on 22 July 2010 when paragraph 38 was deleted and a new paragraph 38 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 38 read as follows:

> “38. The treatment of services performed in the course of the general management of an enterprise raises the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors’ meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skillful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for “profits of management”. In cases identical to the extreme case mentioned above, no account should therefore be

taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management."

Paragraph 38 as it read after 17 July 2008 corresponded to paragraph 21. On 17 July 2008 paragraph 38 was deleted and paragraph 21 was amended and renumbered as paragraph 38 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. At the same time, the heading preceding paragraph 38 was relocated immediately before paragraph 65. After 31 March 1994 and until 17 July 2008, paragraph 21 read as follows:

"21. Another case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skillful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management."

Paragraph 21 was amended on 31 March 1994, by replacing the words "The third" by "Another" at the beginning of the paragraph, by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the OECD Council on 26 November 1993). After 23 July 1992 and until 31 March 1994, paragraph 21 read as follows:

"21. The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skillful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management."

Paragraph 21 as it read after 23 July 1992 corresponded to paragraph 20 of the 1977 Model Convention. On 23 July 1992 paragraph 21 of the 1977 Model Convention was renumbered as paragraph 22 (see history of paragraph 39) and paragraph 20 of the 1977 Model Convention was renumbered as paragraph 21 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 20 of the 1977 Model Convention corresponded to paragraph 18 of the 1963 Draft Convention. Paragraph 20 of the 1963 Draft Convention was renumbered as paragraph 22 (see history of paragraph 40) and paragraph 18 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) was renumbered as paragraph 20 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 38 as it read after 21 September 1995 was deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 21 September 1995 and until 17 July 2008, paragraph 38 read as follows:

"38. *Greece* will take into consideration the comments in paragraph 18 above where payments under the name of royalties are made to a head office by its permanent establishment."

Paragraph 38 was added on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995.

Paragraph 38 as it read before 31 March 1994 was amended and renumbered as paragraph 52 (see history of paragraph 92) by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994.

Paragraph 39: Replaced on 22 July 2010 when paragraph 39 was deleted and a new paragraph 39 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 39 read as follows:

"39. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 38 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office."

Paragraph 39 as it read after 17 July 2008 corresponded to paragraph 22. On 17 July 2008 paragraph 39 was amended and renumbered as paragraph 65 (see history of paragraph 78). At the same time, paragraph 22 was amended, by replacing the reference therein to "paragraph 21" with a reference to "paragraph 38", and renumbered as paragraph 39 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 22 read as follows:

"22. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 21 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office."

Paragraph 22 as it read after 23 July 1992 corresponded to paragraph 21 of the 1977 Model Convention. On 23 July 1992 paragraph 22 of the 1977 Model Convention was renumbered as paragraph 23 (see history of paragraph 40) and paragraph 21 of the 1977 Model Convention was renumbered as paragraph 22, and amended by replacing the reference therein to paragraph 20 by a reference to paragraph 21 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 21 of the 1977 Model Convention corresponded to paragraph 19 of the 1963 Draft Convention. Paragraph 21 of the 1963 Draft Convention was amended and renumbered as paragraph 23 (see history of paragraph 51) of the 1977 Model Convention. At the same time, paragraph 19 of the 1963 Draft Convention was amended and renumbered as paragraph 21 of the 1977 Model Convention when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 19 read as follows:

"19. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the recommendation made is designed to prevent this. Nevertheless it follows from what is said in paragraph 18 that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office."

Paragraph 40: Replaced on 22 July 2010 when paragraph 40 was deleted and a new paragraph 40 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 40 read as follows:

"40. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated."

Paragraph 40 as it read after 17 July 2008 corresponded to paragraph 23. On 17 July 2008 paragraph 40 was deleted and paragraph 23 was renumbered as paragraph 40 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 23 as it read after 23 July 1992 and until 17 July 2008 corresponded to paragraph 22 of the 1977 Model Convention. Paragraph 23 of the 1977 Model

Convention was renumbered as paragraph 24 (see history of paragraph 51) and paragraph 22 of the 1977 Model Convention was renumbered as paragraph 23 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 22 of the 1977 Model Convention corresponded to paragraph 20 of the 1963 Draft Convention. Paragraph 22 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963), was amended and renumbered as paragraph 24 (see history of paragraph 52) and the preceding heading was moved with it when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 20 of the 1963 Draft Convention was renumbered as paragraph 22 of the 1977 Model Convention.

Paragraph 40 as it read after 31 March 1994 was deleted on 15 July 2005 by the report entitled "The 2005 Update to the Model Tax Convention", adopted by the OECD Council on 15 July 2005. After 31 March 1994 and until 15 July 2005, paragraph 40 read as follows:

> "40. *Australia* does not recognise intra-entity transfers for tax purposes. Accordingly, Australia does not allow a mark-up for profit on dealings between permanent establishments or between a permanent establishment and its head office."

Paragraph 40 was replaced on 31 March 1994 when it was deleted and a new paragraph 40 was added was replaced by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994. After 23 July 1992 and until 31 March 1994, paragraph 40 read as follows:

> "40. While *New Zealand*, for the purpose of negotiating conventions with other member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations."

Paragraph 40 as it read after 23 July 1992 corresponded to paragraph 38 of the 1977 Model Convention. On 23 July 1992 paragraph 40 of the 1977 Model Convention was deleted and paragraph 38 was renumbered as paragraph 40 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 38 was added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 40 of the 1977 Model Convention was deleted on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992. In the 1977 Model Convention and until 23 July 1992, paragraph 40 read as follows:

> "40. The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase "separate enterprise" to "independent enterprise" and by deleting the last fourteen words."

Paragraph 40 was added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 40.1: Amended and renumbered as paragraph 66 (see history of paragraph 79) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 40.2: Amended and renumbered as paragraph 67 (see history of paragraph 80) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 40.3: Amended and renumbered as paragraph 68 (see history of paragraph 81) on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 41: Replaced on 22 July 2010 when paragraph 41 was deleted and a new paragraph 41 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 41 read as follows:

> "41. The treatment of interest charges raises particular issues. First, there might be amounts which, under the name of interest, are charged by a head office to its permanent establishment with respect to internal "loans" by the former to the latter. Except for financial enterprises such as banks, it is generally agreed that such internal "interest" need not be recognised. This is because:
>
> — From the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment.
>
> — From the economic standpoint, internal debts and receivables may prove to be non existent, since if an enterprise is solely or predominantly equity funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. Whilst, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed."

Paragraph 41 was previously replaced on 17 July 2008 when it was renumbered as paragraph 75 (see history of paragraph 85), the heading preceding paragraph 41 was moved with it and a new paragraph 42 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 42: Replaced on 22 July 2010 when paragraph 42 was deleted and a new paragraph 42 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 42 read as follows:

> "42. For these reasons, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special situation of banks, as mentioned below."

Paragraph 42 was previously replaced on 17 July 2008 when it was renumbered as paragraph 76 (see history of paragraph 86) and a new paragraph 42 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 43: Replaced on 22 July 2010 when paragraph 43 was deleted and a new paragraph 43 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 43 read as follows:

> "43. A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment."

Paragraph 43 was previously replaced on 17 July 2008 when it was renumbered as paragraph 77 (see history of paragraph 87) and a new paragraph 43 was added by the report entitled “The 2008 Update to the Model Tax Convention”, adopted by the OECD Council on 17 July 2008.

Paragraph 44: Replaced on 22 July 2010 when paragraph 44 was deleted and a new paragraph 44 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 27 was moved immediately before paragraph 44. After 17 July 2008 and until 22 July 2010, paragraph 44 read as follows:

> “44. The approach suggested in this Commentary before 1994, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality, in particular the fact that an independent enterprise would normally be expected to have a certain level of “free” capital.”

Paragraph 44 was previously replaced on 17 July 2008 when it was renumbered as paragraph 78 (see history of paragraph 88) and a new paragraph 44 was added by the report entitled “The 2008 Update to the Model Tax Convention”, adopted by the OECD Council on 17 July 2008.

Paragraph 45: Replaced on 22 July 2010 when paragraph 45 was deleted and a new paragraph 45 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 45 read as follows:

> “45. Consequently, the majority of member countries consider that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. This appropriate capital structure will take account of the fact that in order to carry out its activities, the permanent establishment requires a certain amount of funding made up of “free” capital and interest bearing debt. The objective is therefore to attribute an arm’s length amount of interest to the permanent establishment after attributing an appropriate amount of “free” capital in order to support the functions, assets and risks of the permanent establishment. Under the arm’s length principle a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors.”

Paragraph 45 was previously replaced on 17 July 2008 when it was renumbered as paragraph 79 (see history of paragraph 89) and a new paragraph 45 was added by the report entitled “The 2008 Update to the Model Tax Convention”, adopted by the OECD Council on 17 July 2008.

Paragraph 46: Replaced on 22 July 2010 when paragraph 46 was deleted and a new paragraph 46 was added by the report entitled “The 2010 Update to the Model Tax Convention”, adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 46 read as follows:

"46. As explained in section D-2 (*v)b)* of Part I of the Report *Attribution of Profits to Permanent Establishments*, there are different acceptable approaches for attributing "free" capital that are capable of giving an arm's length result. Each approach has its own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of "free" capital attributable to a permanent establishment, which either put more emphasis on the actual structure of the enterprise of which the permanent establishment is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing "free" capital is to recognise:

— the existence of strengths and weaknesses in any approach and when these are likely to be present;

— that there is no single arm's length amount of "free" capital, but a range of potential capital attributions within which it is possible to find an amount of "free" capital that can meet the basic principle set out above."

Paragraph 46 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 46 as it read before 21 September 1995 was amended and renumbered as paragraph 42 of the Commentary on Article 12 (see history of paragraph 42 of the Commentary on Article 12) by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

Paragraph 47: Replaced on 22 July 2010 when paragraph 47 was deleted and a new paragraph 47 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 47 read as follows:

"47. It is recognised, however, that the existence of different acceptable approaches for attributing "free" capital to a permanent establishment which are capable of giving an arm's length result can give rise to problems of double taxation. The main concern, which is especially acute for financial institutions, is that if the domestic law rules of the State where the permanent establishment is located and of the State of the enterprise require different acceptable approaches for attributing an arm's length amount of free capital to the permanent establishment, the amount of profits calculated by the State of the permanent establishment may be higher than the amount of profits calculated by the State of the enterprise for purposes of relief of double taxation."

Paragraph 47 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 47 was deleted on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995. After 23 July 1992 and until 21 September 1995, paragraph 47 read as follows:

"47. *Portugal* reserves the right to tax at source as royalties income from the leasing of industrial, commercial or scientific equipment and of containers, as well as income arising from technical assistance in connection with the use of, or the right to use, such equipment and containers."

Paragraph 47 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, partly on the basis of paragraph 31 of a previous report entitled *The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment* (adopted by the OECD Council on 13 September 1983) and of paragraph 49 of another report entitled *The Taxation of*

Income Derived from the Leasing of Containers (also adopted by the OECD Council on 13 September 1983).

Paragraph 48: Replaced on 22 July 2010 when paragraph 48 was deleted and a new paragraph 48 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 48 read as follows:

> "48. Given the importance of that issue, the Committee has looked for a practical solution. OECD member countries have therefore agreed to accept, for the purposes of determining the amount of interest deduction that will be used in computing double taxation relief, the attribution of capital derived from the application of the approach used by the State in which the permanent establishment is located if the following two conditions are met: first, if the difference in capital attribution between that State and the State of the enterprise results from conflicting domestic law choices of capital attribution methods, and second, if there is agreement that the State in which the permanent establishment is located has used an authorised approach to the attribution of capital and there is also agreement that that approach produces a result consistent with the arm's length principle in the particular case. OECD member countries consider that they are able to achieve that result either under their domestic law, through the interpretation of Articles 7 and 23 or under the mutual agreement procedure of Article 25 and, in particular, the possibility offered by that Article to resolve any issues concerning the application or interpretation of their tax treaties."

Paragraph 48 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 48 was deleted on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995. After 23 July 1992 and until 21 September 1995, paragraph 48 read as follows:

> "48. *Spain* reserves the right to tax at source as royalties payments from the leasing of industrial, commercial or scientific equipment and of containers."

Paragraph 48 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, on the basis of paragraph 31 of a previous report entitled *The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment* (adopted by the OECD Council on 13 September 1983) and of paragraph 49 of another report entitled *The Taxation of Income Derived from the Leasing of Containers* (also adopted by the OECD Council on 13 September 1983).

Paragraph 49: Replaced on 22 July 2010 when paragraph 49 was deleted and a new paragraph 49 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 49 read as follows:

> "49. As already mentioned, special considerations apply to internal interest charges on advances between different parts of a financial enterprise (*e.g.* a bank), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the application of Article 7 to the permanent establishments of banks and enterprises carrying on global trading, is discussed in Parts II and III of the *Report Attribution of Profits to Permanent Establishments*."

Paragraph 49 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 49 as it read before 21 September 1995 was renumbered as paragraph 46 of the Commentary on Article 12 (see history of paragraph 46 of the Commentary on Article 12) by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

Paragraph 50: Replaced on 22 July 2010 when paragraph 50 was deleted and a new paragraph 50 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 50 read as follows:

> "50. The determination of the investment assets attributable to a permanent establishment through which insurance activities are carried on also raises particular issues, which are discussed in Part IV of the Report."

Paragraph 50 was previously replaced on 17 July 2008 when it was renumbered as paragraph 80 (see history of paragraph 90) and a new paragraph 50 was added by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 51: Replaced on 22 July 2010 when paragraph 51 was deleted and a new paragraph 51 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 51 read as follows:

> "51. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, *e.g.* by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits based on other methods."

Paragraph 51 as it read after 17 July 2008 corresponded to paragraph 24. On 17 July 2008 paragraph 51 was renumbered as paragraph 81 (see history of paragraph 91) and paragraph 24 was renumbered as paragraph 51 and amended, by inserting the words, "based on other methods", at the end of the paragraph, by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 24 read as follows:

> "24. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise

with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, *e.g.* by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."

Paragraph 24 as it read after 23 July 1992 corresponded to paragraph 23 of the 1977 Model Convention. On 23 July 1992 paragraph 24 of the 1977 Model Convention was renumbered as paragraph 25 (see history of paragraph 52), the heading preceding paragraph 24 was moved with it and paragraph 23 of the 1977 Model Convention was renumbered as paragraph 24 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 23 of the 1977 Model Convention corresponded to paragraph 21 of the 1963 Draft Convention. Paragraph 23 of the 1963 Draft Convention was renumbered as paragraph 25 (see history of paragraph 53) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 21 of the 1963 Draft Convention was amended and renumbered as paragraph 23 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 21 read as follows:

"21. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case, and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, *e.g.* by applying appropriate coefficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively undeveloped enterprise operating on both sides of a land frontier, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."

Paragraph 52: Replaced on 22 July 2010 when paragraph 52 and the preceding heading were deleted and a new paragraph 52 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 52 and the preceding heading read as follows:

"*Paragraph 4*

52. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear."

Paragraph 52 as it read after 17 July 2008 corresponded to paragraph 25. On 17 July 2008 paragraph 52 was renumbered as paragraph 82 (see history of paragraph 92), paragraph 25 was renumbered as paragraph 52 and the heading preceding paragraph 25 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 25 as it read after 23 July 1992 corresponded to paragraph 24 of the 1977 Model Convention. On 23 July 1992 paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 (see history of paragraph 53), paragraph 24 of the 1977 Model Convention was renumbered as paragraph 25 and the preceding heading was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 24 of the 1977 Model Convention corresponded to paragraph 22 of the 1963 Draft Convention. Paragraph 24 of the 1963 Draft Convention was amended and renumbered as paragraph 26 (see history of paragraph 54) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 22 of the 1963 Draft Convention was amended and renumbered as paragraph 24 and the preceding heading was moved with it. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 22 read as follows:

"22. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2 of the Article, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits: and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles embodied in the Article. It is considered, however, that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment, and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory."

Paragraph 53: Replaced on 22 July 2010 when paragraph 53 was deleted and a new paragraph 53 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 53 read as follows:

"53. It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use."

Paragraph 53 as it read after 17 July 2008 corresponded to paragraph 26. On 17 July 2008 paragraph 26 was renumbered as paragraph 53 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 26 as it read after 23 July 1992 corresponded to paragraph 25 of the 1977 Model Convention. On 23 July 1992 paragraph 26 of the 1977 Model Convention was renumbered as paragraph 27 (see history of paragraph 54) and paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 25 of the 1977 Model Convention corresponded to paragraph 23 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963). Paragraph 25 of the 1963 Draft Convention was amended and renumbered as paragraph 27 (see history of paragraph 55) and paragraph 23 was renumbered as paragraph 25 when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 53 was deleted on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. After 31 March 1994 and until 29 April 2000 paragraph 53 read as follows:

"53. *Australia* reserves the right to include a provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise."

Paragraph 53, as it read after 31 March 1994 corresponded to paragraph 39. On 31 March 1994 paragraph 39 was amended and renumbered as paragraph 53 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994. After 23 July 1992 and until 31 March 1994 paragraph 39 read as follows:

"39. *Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise."

Paragraph 39 as it read after 23 July 1992 corresponded to paragraph 37 of the 1977 Model Convention. On 23 July 1992 paragraph 39 of the 1977 Model Convention was renumbered as paragraph 41 (see history of paragraph 85), the heading preceding paragraph 39 was moved with it. At the same time, paragraph 37 of the 1977 Model Convention was renumbered as paragraph 39 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 37 was added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 54: Replaced on 22 July 2010 when paragraph 54 was deleted and a new paragraph 54 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2010 and until 22 July 2010, paragraph 54 read as follows:

"54. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in vacuo* that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result."

Paragraph 54 as it read after 17 July 2008 corresponded to paragraph 27. On 17 July 2008 paragraph 54 was renumbered as paragraph 83 (see history of paragraph 93) and paragraph 27 was renumbered as paragraph 54 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 27 as it read after 23 July 1992 corresponded to paragraph 26 of the 1977 Model Convention. On 23 July 1992 paragraph 27 of the 1977 Model Convention was renumbered as paragraph 28 (see history of paragraph 55) and paragraph 26 of the 1977 Model Convention was renumbered as paragraph 27 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 26 of the 1977 Model Convention corresponded to paragraph 24 of the 1963 Draft Convention. Paragraph 26 of the 1963 Draft Convention was amended and renumbered as paragraph 28 (see history of paragraph 56) and the preceding heading was moved with it when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 24 of the 1963 Draft Convention was amended and renumbered as paragraph 26 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 24 read as follows:

> "24. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total income by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result."

Paragraph 55: Replaced on 22 July 2010 when paragraph 55 was deleted and a new paragraph 55 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 55 read as follows:

> "55. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any

rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws."

Paragraph 55 as it read after 17 July 2008 corresponded to paragraph 28. On 17 July 2008 paragraph 28 was renumbered as paragraph 55 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 28 as it read after 23 July 1992 corresponded to paragraph 27 of the 1977 Model Convention. On 23 July 1992 paragraph 28 of the 1977 Model Convention was renumbered as paragraph 29 (see history of paragraph 56), the heading preceding paragraph 28 was moved with it and paragraph 27 of the 1977 Model Convention was renumbered as paragraph 28 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 27 of the 1977 Model Convention corresponded to paragraph 25 of the 1963 Draft Convention. Paragraph 27 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963), was amended and renumbered as paragraph 29 (see history of paragraph 55) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 25 of the 1963 Draft Convention was amended and renumbered as paragraph 27 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 25 read as follows:

"25. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own law."

Paragraph 56: Replaced on 22 July 2010 when paragraph 56 and the preceding heading were deleted and a new paragraph 56 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 56 and the preceding heading read as follows:

"*Paragraph 5*

56. In paragraph 4 of Article 5 there are listed a number of examples of activities which, even though carried on at a fixed place of business, are deemed not to be included in the term "permanent establishment". In considering rules for the allocation of profits to a permanent establishment the most important of these examples is the activity mentioned in paragraph 5 of this Article, *i.e.* the purchasing office."

Paragraph 56 as it read after 17 July 2008 corresponded to paragraph 29. On 17 July 2008 paragraph 29 was renumbered as paragraph 56 and the heading preceding paragraph 29 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 29 as it read after 23 July 1992 corresponded to paragraph 28 of the 1977 Model Convention. On 23 July 1992 paragraph 29 of the 1977 Model Convention was renumbered as paragraph 30 (see history of paragraph 57), paragraph 28 of the 1977 Model Convention was renumbered as paragraph 29 and the heading preceding paragraph 28 was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 28 of the 1977 Model Convention corresponded to paragraph 26 of the 1963 Draft Convention. Paragraph 28 of the 1963 Draft Convention, was renumbered as paragraph 30 (see history of paragraph 58) and the preceding heading was moved with it when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 26 of the 1963 Draft Convention was amended and renumbered as paragraph 28 and the preceding heading was moved with it. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 26 read as follows:

> "26. In paragraph 3 of Article 5 defining the concept of permanent establishment there are listed a number of examples of activities which, even though carried on at a fixed place of business, are not to be deemed to be included in the term "permanent establishment". In considering rules for the allocation of profits to a permanent establishment the most important of these examples is the activity mentioned in paragraph 5 of the present Article, *i.e.* the purchasing office."

Paragraph 57: Replaced on 22 July 2010 when paragraph 57 was deleted and a new paragraph 57 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 57 read as follows:

> "57. Paragraph 5 is not, of course, concerned with the organisation established solely for purchasing; such an organisation is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which, although carrying on other business, also carries on purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities will also be excluded in calculating the taxable profits of the permanent establishment."

Paragraph 57 as it read after 17 July 2008 corresponded to paragraph 30. On 17 July 2008 paragraph 30 was renumbered as paragraph 57 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 30 as it read after 23 July 1992 corresponded to paragraph 29 of the 1977 Model Convention. On 23 July 1992 paragraph 30 of the 1977 Model Convention was renumbered as paragraph 31 (see history of paragraph 58), the heading preceding paragraph 30 was moved with it and paragraph 29 of the 1977 Model Convention was renumbered as paragraph 30 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 29 of the 1977 Model Convention corresponded to paragraph 27 of the 1963 Draft Convention. Paragraph 29 of the 1963 Draft Convention, was amended and renumbered as paragraph 31 (see history of paragraph 71) and the preceding heading was moved with it when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 27 of the 1963 Draft Convention was amended and renumbered as paragraph 29 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 27 read as follows:

> "27. This present paragraph is not, of course, concerned with the organisation established solely for purchasing; such an organisation is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which although carrying on other business also carries on

purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities will also be excluded in calculating the taxable profits of the permanent establishment."

Paragraph 58: Replaced on 22 July 2010 when paragraph 58 and the preceding heading were deleted and a new paragraph 58 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until they were deleted on 22 July 2010, paragraph 58 and the preceding heading read as follows:

"*Paragraph 6*

58. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment."

Paragraph 58 as it read after 17 July 2008 corresponded to paragraph 31. On 17 July 2008 paragraph 31 was renumbered as paragraph 58 and the heading preceding paragraph 31 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 31 as it read after 23 July 1992 corresponded to paragraph 30 of the 1977 Model Convention. On 23 July 1992 paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 (see history of paragraph 71), the heading preceding paragraph 31 was moved with it. At the same time, paragraph 30 of the 1977 Model Convention was renumbered as paragraph 31 and the heading preceding paragraph 30 was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 30 of the 1977 Model Convention corresponded to paragraph 28 of the 1963 Draft Convention. Paragraph 30 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) was amended and renumbered as paragraph 32 (see history of paragraph 72) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 28 of the 1963 Draft Convention was renumbered as paragraph 30 and the preceding heading was moved with it.

Paragraph 59: Replaced on 22 July 2010 when paragraph 59 was renumbered as paragraph 71 (see history of paragraph 71), the heading preceding paragraph 59 was amended and moved with it and a new paragraph 59 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 60: Replaced on 22 July 2010 when paragraph 60 was amended and renumbered as paragraph 72 (see history of paragraph 72) and a new paragraph 60 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 61: Replaced 22 July 2010 when paragraph 61 was renumbered as paragraph 73 (see history of paragraph 73) and a new paragraph 61 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 62: Replaced on 22 July 2010 when paragraph 62 was amended and renumbered as paragraph 74 (see history of paragraph 74) and a new paragraph 62 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 63: Replaced on 22 July 2010 when paragraph 63 was amended and renumbered as paragraph 75 (see history of paragraph 75) and a new paragraph 63 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 64: Replaced on 22 July 2010 when paragraph 64 was amended and renumbered as paragraph 76 (see history of paragraph 76) and a new paragraph 64 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 65: Replaced on 22 July 2010 when paragraph 65 was amended and renumbered as paragraph 78 (see history of paragraph 78), the preceding heading was moved with it and a new paragraph 65 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 66: Replaced on 22 July 2010 when paragraph 66 was amended and renumbered as paragraph 79 (see history of paragraph 79) and a new paragraph 66 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 67: Replaced on 22 July 2010 when paragraph 67 was amended and renumbered as paragraph 80 (see history of paragraph 80) and a new paragraph 67 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 68: Amended on 15 July 2014, by adding the words "on these profits" in the suggested provision, by the Report entitled "The 2014 Update to the Model Tax Convention", adopted by the Council of the OECD on 15 July 2014. After 22 July 2010 and until 15 July 2014, paragraph 68 read as follows:

> "68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State's preferred position as to the arm's length price or method. These States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm's length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:
>
>> Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement."

Paragraph 68 was replaced on 22 July 2010 when it was amended and renumbered as paragraph 81 (see history of paragraph 81) and a new paragraph 68 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 69: Replaced on 22 July 2010 when paragraph 69 was deleted and a new paragraph 69 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 69 read as follows:

"69. With regard to paragraph 45, *Greece* notes that the Greek internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. Concerning loans contracted by an enterprise that relate in whole or in part to the activities of the permanent establishment, Greece allows as deduction the part of the interest which corresponds to the amount of a loan contracted by the head office and actually remitted to the permanent establishment."

Paragraph 69 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 70: Replaced on 22 July 2010 when paragraph 70 was deleted and a new paragraph 70 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 70 read as follows:

"70. *Portugal* wishes to reserve its right not to follow the position expressed in paragraph 45 of the Commentary on Article 7 except whenever there are specific domestic provisions foreseeing certain levels of "free" capital for permanent establishments."

Paragraph 70 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 71: Corresponds to paragraph 59 as it read before 22 July 2010. On that date paragraph 71 was deleted and paragraph 59 was renumbered as paragraph 71 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 59 was renumbered "Paragraph 4" and moved with it.

Paragraph 59 as it read after 17 July 2008 corresponded to paragraph 32. On 17 July 2008 paragraph 32 was renumbered as paragraph 59 and the heading preceding paragraph 32 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 32 as it read after 23 July 1992 corresponded to paragraph 31 of the 1977 Model Convention. On 23 July 1992 paragraph 32 of the 1977 Model Convention was renumbered as paragraph 33 (see history of paragraph 72), paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 and the heading preceding paragraph 31 was moved with it, by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 31 of the 1977 Model Convention corresponded to paragraph 29 of the 1963 Draft Convention. Paragraph 31 of the 1963 Draft Convention was amended and renumbered as paragraph 33 (see history of paragraph 73) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 29 of the 1963 Draft Convention was amended and renumbered as paragraph 31 and the preceding heading was moved with it. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 29 read as follows:

"29. Although it has not been found necessary in this Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most Member States."

Paragraph 71 as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

"71. With regard to paragraph 46, *Sweden* wishes to clarify that it does not consider that the different approaches for attributing "free" capital that the paragraph refers to as being "acceptable" will necessarily lead to a result in accordance with the arm's length principle. Consequently, when looking at the facts and circumstances of each case in order to determine whether the amount of interest deduction resulting from the application of these approaches conforms to the arm's length principle, Sweden in many cases would not consider that the other States' approach conforms to the arm's length principle. Sweden is of the opinion that double taxation will therefore often occur, requiring the use of the mutual agreement procedure."

Paragraph 71 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 72: Corresponds to paragraph 60 as it read before 22 July 2010. On that date paragraph 72 was deleted and paragraph 60 was amended and renumbered as paragraph 72 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 60 read as follows:

"60. This interpretation of the term "profits", however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, *e.g.* dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article."

Paragraph 60 as it read after 17 July 2008 corresponded to paragraph 33. On 17 July 2008 paragraph 33 was renumbered as paragraph 60 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 33 as it read after 23 July 1992 corresponded to paragraph 32 of the 1977 Model Convention. On 23 July 1992 paragraph 33 of the 1977 Model Convention was amended and renumbered as paragraph 34 (see history of paragraph 73) and paragraph 32 of the 1977 Model Convention was renumbered as paragraph 33 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 32 of the 1977 Model Convention corresponded to paragraph 30 of the 1963 Draft Convention. Paragraph 32 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963), was amended and renumbered as paragraph 34 (see history of paragraph 74) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 30 of the 1963 Draft Convention was amended and renumbered as paragraph 32 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 30 read as follows:

"30. This interpretation of the term "profits", however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, *e.g.* dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc. or by the provisions of the present Article."

Paragraph 72 as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

"72. *Portugal* wishes to reserve its right not to follow the "symmetry" approach described in paragraph 48 of the Commentary on Article 7, insofar as the Portuguese internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. In eliminating double taxation according to

> Article 23, Portugal, as the home country, determines the amount of profits attributable to a permanent establishment according to the domestic law."

Paragraph 72 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 73: Corresponds to paragraph 61 as it read before 22 July 2010. On that date paragraph 73 was deleted and paragraph 61 was amended and renumbered as paragraph 73 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 61 read as follows:

> "61. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (see paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21)."

Paragraph 61 as it read after 17 July 2008 corresponded to paragraph 34. On 17 July 2008 paragraph 34 was renumbered as paragraph 61 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 34 as it read after 23 July 1992 corresponded to paragraph 33 of the 1977 Model Convention. On 23 July 1992 paragraph 34 of the 1977 Model Convention was amended and renumbered as paragraph 35 (see history of paragraph 74) and paragraph 33 of the 1977 Model Convention was amended, by substituting the word "noted" for "noticed" in the second sentence, and renumbered as paragraph 34, by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 33 of the 1977 Model Convention corresponded to paragraph 31 of the 1963 Draft Convention. Paragraph 33 of the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963), was amended and renumbered as paragraph 35 (see history of paragraph 75) when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. At the same time, paragraph 31 of the 1963 Draft Convention was amended and renumbered as paragraph 33 of the 1977 Model Convention. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 31 read as follows:

> "31. To the extent that an application of the present Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraphs 3 and 4 of Article 7, paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12)."

Paragraph 73, as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

> "73. *Germany*, *Japan* and the *United States*, whilst agreeing to the practical solution described in paragraph 48, wish to clarify how this agreement will be implemented. Neither Germany, nor Japan, nor the United States can automatically accept for all purposes all calculations by the State in which the permanent establishment is located. In cases involving Germany or Japan, the second condition described in paragraph 48 has to be satisfied through a mutual agreement procedure under Article 25. In the case of Japan and the United States, a taxpayer who seeks to obtain additional foreign tax credit limitation must do so through a mutual agreement procedure in which the taxpayer would have to prove to the Japanese or the United States competent authority, as the case may be, that

double taxation of the permanent establishment profits which resulted from the conflicting domestic law choices of capital attribution methods has been left unrelieved after applying mechanisms under their respective domestic tax law such as utilisation of foreign tax credit limitation created by other transactions."

Paragraph 73 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 74: Corresponds to paragraph 62 as it read before 22 July 2010. On that date paragraph 74 was deleted and paragraph 62 was amended and renumbered as paragraph 74 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 62 read as follows:

"62. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discuss the principles governing whether, in the particular case of computer software, payments should be classified as business profits within Article 7 or as a capital gain within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States."

Paragraph 62 as it read after 17 July 2008 corresponded to paragraph 35. On 17 July 2008 paragraph 35 was amended and renumbered as paragraph 62 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 29 April 2000 and until 17 July 2008, paragraph 35 read as follows:

"35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as income within Articles 7 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States."

Paragraph 35 was amended on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on

Fiscal Affairs on 27 January 2000). After 23 July 1992 and until 29 April 2000, paragraph 35 read as follows:

> "35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as commercial income within Articles 7 or 14 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States."

Paragraph 35 as it read after 23 July 1992 corresponded to paragraph 34 of the 1977 Model Convention. On 23 July 1992 paragraph 35 of the 1977 Model Convention was renumbered as paragraph 36 (see history of paragraph 75) and paragraph 34 of the 1977 Model Convention was amended and renumbered as paragraph 35 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, on the basis of Appendix 3 of the Report entitled "The Tax Treatment of Software", adopted by the OECD Council on 23 July 1992. In the 1977 Model Convention and until 23 July 1992, paragraph 34 read as follows:

> "34. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States."

Paragraph 34 of the 1977 Model Convention corresponded to paragraph 32 of the 1963 Draft Convention. Paragraph 32 of the 1963 Draft Convention, was amended and renumbered when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 32 read as follows:

> "32. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral Conventions paragraph 7 of the present Article gives first preference to the special Articles on dividends, interest etc. It follows from the rule that the present Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles and, in addition, to dividends, interest and royalties which under

paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12 fall within the present Article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States."

Paragraph 74 as it read after 17 July 2008 and until it was deleted on 22 July 2010, read as follows:

"74. With reference to paragraphs 6 and 7, *New Zealand* notes that it does not agree with the approach put forward on the attribution of profits to permanent establishments in general, as reflected in Part I of the Report *Attribution of Profits to Permanent Establishments*."

Paragraph 74 was added on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 75: Corresponds to paragraph 63 as it read before 22 July 2010. On that date paragraph 75 was amended and renumbered as paragraph 85 (see history of paragraph 85) and the preceding heading was moved with it. At the same time, paragraph 63 was amended and renumbered as paragraph 75 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 63 read as follows:

"63. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term "profits" includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits."

Paragraph 63 as it read after 17 July 2008 corresponded to paragraph 36. On 17 July 2008 paragraph 36 was renumbered as paragraph 63 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 36 as it read after 23 July 1992 corresponded to paragraph 35 of the 1977 Model Convention. On 23 July 1992 paragraph 36 of the 1977 Model Convention was renumbered as paragraph 38 (see history of paragraph 92), the heading preceding paragraph 36 was moved with it and paragraph 35 of the 1977 Model Convention was renumbered as paragraph 36 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 35 of the 1977 Model Convention corresponded to paragraph 33 of the 1963 Draft Convention. Paragraph 33 of the 1963 Draft Convention, was amended and renumbered when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 33 read as follows:

"33. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a Convention under negotiation a deviation has been made from the recommended definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice that, in agreement with the national tax laws of one or both of the States, the term "profits" includes special classes of receipt, such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits."

Paragraph 75.1: Added on 15 July 2014 by the report entitled "The 2014 Update to the Model Tax Convention" adopted by the Council on 15 July 2014, on the basis of another report entitled "Tax treaty issues related to emissions permits/credits" (adopted by the OECD Committee on Fiscal Affairs on 26 June 2014).

Paragraph 76: Corresponds to paragraph 64 as it read before 22 July 2010. On that date paragraph 76 was amended and renumbered as paragraph 86 (see history of paragraph 86) and paragraph 64 was amended and renumbered as paragraph 76 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 64 read as follows:

"64. It should also be noted that, whilst the definition of "royalties" in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial, or scientific equipment", the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers to be appropriate given the nature of such income."

Paragraph 64 as it read after 17 July 2008 corresponded to paragraph 37. On 17 July 2008 paragraph 37 was renumbered as paragraph 64 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 37 as it read after 23 July 1992 replaced paragraph 37 of the 1977 Model Convention. On 23 July 1992 paragraph 37 of the 1977 Model Convention was renumbered as paragraph 39 (see history of paragraph 53) and a new paragraph 37 was added by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, on the basis of two previous reports entitled "The Taxation of Income from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the OECD Council on 13 September 1983) and "The Taxation of Income from the Leasing of Containers" (adopted by the OECD Council on 13 September 1983).

Paragraph 77: Corresponds to paragraph 8 as it read before 22 July 2010. On that date paragraph 77 was renumbered as paragraph 87 (see history of paragraph 87) and paragraph 8 was amended and renumbered as paragraph 77 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 8 read as follows:

"8. Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character."

Paragraph 8 as it read after 17 July 2008 corresponded to paragraph 2.1. On 18 July 2008 paragraph 8 was deleted and paragraph 2.1 was amended, by inserting the word "with" in the first sentence, and renumbered as paragraph 8 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 29 April 2000 and until 17 July 2008, paragraph 2.1 read as follows:

"2.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character."

Paragraph 2.1 was added on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 8 was deleted on 17 July 2008 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 23 July 1992 and until 17 July 2008, paragraph 8 read as follows:

"8. Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In OECD member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course, reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention."

Paragraph 8 as it read after 23 July 1992 corresponded to paragraph 7 of the 1977 Model Convention. On 23 July 1992 paragraph 8 of the 1977 Model Convention was renumbered as paragraph 9 (see history of paragraph 11) and paragraph 7 of the 1977 Model Convention was renumbered as paragraph 8 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 7 was amended when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977. In the 1963 Draft Convention (adopted by the OECD Council on 30 July 1963) and until the adoption of the 1977 Model Convention, paragraph 7 read as follows:

> "7. Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of this solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In O.E.C.D. countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. Current trends of political thought in Europe seem likely to make such companies even more common in future than they are at present. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course -- reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities of the country should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention."

Paragraph 78: Corresponds to paragraph 65 as it read before 22 July 2010. On that date paragraph 78 was renumbered as paragraph 88 (see history of paragraph 88). At the same time, paragraph 65 was amended, by replacing the cross reference to "paragraph 8" with "paragraph 77", renumbered as paragraph 78 and the preceding heading was moved with it by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 65 read as follows:

> "65. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 8 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, *i.e.* by the elimination of Article 14."

Paragraph 65 as it read after 17 July 2008 corresponded to paragraph 39. On 18 July 2008 paragraph 39 was amended, by replacing the cross-reference to "paragraph 2.1" with "paragraph 8" and renumbered as paragraph 65 and the heading preceding paragraph 38 was relocated immediately before paragraph 65 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 29 April 2000 and until 17 July 2008, paragraph 39 read as follows:

> "39. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 2.1 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, *i.e.* by the elimination of Article 14."

Paragraph 39 was added on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 39 as it read after 23 July 1992 and until 31 March 1994 was amended and renumbered as paragraph 53 (see history of paragraph 53) by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994.

Paragraph 79: Corresponds to paragraph 66 as it read before 22 July 2010. On that date paragraph 79 was renumbered as paragraph 89 (see history of paragraph 89) and paragraph 66 was amended, by replacing the cross-reference to "paragraph 13" with "paragraph 14", and renumbered as paragraph 79 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 66 read as follows:

> "66. *Belgium* cannot share the views expressed in paragraph 13 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 1 of Article 7. This is especially the case where a contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with paragraph 1 of Article 7. That contracting State thus disregards the legal personality of the foreign entity and acts contrary to paragraph 1 of Article 7."

Paragraph 66 as it read after 17 July 2008 corresponded to paragraph 40.1. On 17 July 2008 paragraph 40.1 was amended, by replacing the cross-reference to "paragraph 10.1" with "paragraph 13", and renumbered as paragraph 66 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 28 January 2003 and until 17 July 2008, paragraph 40.1 read as follows:

> "40.1 *Belgium* cannot share the views expressed in paragraph 10.1 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 1 of Article 7. This is especially the case where a contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with paragraph 1 of Article 7. That contracting State thus disregards the legal personality of the foreign entity and acts contrary to paragraph 1 of Article 7."

Paragraph 40.1 was added on 28 January 2003 by the report entitled "The 2002 Update to the Model Tax Convention", adopted by the OECD Council on 28 January 2003.

Paragraph 80: Corresponds to paragraph 67 as it read before 22 July 2010. On that date paragraph 80 was renumbered as paragraph 90 (see history of paragraph 90). At the same time, paragraph 67 was amended, by replacing the cross reference to "paragraph 13" with "paragraph 14" and renumbered as paragraph 80 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 67 read as follows:

> "67. *Luxembourg* does not share the interpretation in paragraphs 13 which provides that paragraph 1 of Article 7 does not restrict a Contracting State's right to tax its own residents under controlled foreign companies provisions found in its

domestic law as this interpretation challenges the fundamental principle contained in paragraph 1 of Article 7."

Paragraph 67 as it read after 17 July 2008 corresponded to paragraph 40.2. On 17 July 2008 paragraph 40.2 was amended, by replacing the cross-reference to "paragraph 10.1" with "paragraph 13", and renumbered as paragraph 67 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 28 January 2003 and until 17 July 2008, paragraph 40.2 read as follows:

"40.2 *Luxembourg* does not share the interpretation in paragraphs 10.1 which provides that paragraph 1 of Article 7 does not restrict a Contracting State's right to tax its own residents under controlled foreign companies provisions found in its domestic law as this interpretation challenges the fundamental principle contained in paragraph 1 of Article 7."

Paragraph 40.2 was added on 28 January 2003 by the report entitled "The 2002 Update to the Model Tax Convention", adopted by the OECD Council on 28 January 2003.

Paragraph 81: Corresponds to paragraph 68 as it read before 22 July 2010. On that date paragraph 81 was renumbered as paragraph 91 (see history of paragraph 91) and paragraph 68 was amended, by replacing the cross reference to "paragraph 13" with "paragraph 14", and renumbered as paragraph 81 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 68 read as follows:

"68. With reference to paragraph 13, *Ireland* notes its general observation in paragraph 27.5 of the Commentary on Article 1"

Paragraph 68 as it read after 17 July 2008 corresponded to paragraph 40.3. On 17 July 2008 paragraph 40.3 was amended, by replacing the cross-reference to "paragraph 10.1" with "paragraph 13", and renumbered as paragraph 68 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 28 January 2003 and until 17 July 2008, paragraph 40.3 read as follows:

"40.3 With reference to paragraph 10.1, *Ireland* notes its general observation in paragraph 27.5 of the Commentary on Article 1."

Paragraph 40.3 was added on 28 January 2003 by the report entitled "The 2002 Update to the Model Tax Convention", adopted by the OECD Council on 28 January 2003.

Paragraph 82: Replaced on 22 July 2010 when paragraph 82 was renumbered as paragraph 92 (see history of paragraph 92) and a new paragraph 82 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 83: Replaced on 22 July 2010 when paragraph 83 was renumbered as paragraph 93 (see history of paragraph 93) and a new paragraph 83 was added by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 84: Added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

Paragraph 85: Corresponds to paragraph 75 as it read before 22 July 2010. On that date paragraph 75 was amended, by deleting New Zealand from the list of countries making the reservation, and renumbered as paragraph 85 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. At the same time, the heading preceding paragraph 75 was moved with it. After 17 July 2008 and until 22 July 2010, paragraph 75 read as follows:

"75. *Australia* and *New Zealand* reserve the right to include a provision that will permit their domestic law to apply in relation to the taxation of profits from any form of insurance."

Paragraph 75 as it read after 17 July 2008 corresponded to paragraph 41. On 17 July 2008 paragraph 41 was renumbered as paragraph 75 and the heading preceding paragraph 41 was moved with it by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 41 was amended on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. After 23 July 1992 and until 29 April 2000, paragraph 41 read as follows:

"41. *New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of insurance."

Paragraph 41 as it read after 23 July 1992 corresponded to paragraph 39 of the 1977 Model Convention. On 23 July 1992 paragraph 39 was renumbered as paragraph 41 and the heading preceding paragraph 39 of the 1977 Model Convention was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 39 and the heading preceding it were added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 86: Corresponds to paragraph 76 as it read before 22 July 2010. On that date paragraph 76 was amended, by deleting New Zealand from the list of countries making the reservation, and renumbered as paragraph 86 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010. After 17 July 2008 and until 22 July 2010, paragraph 76 read as follows:

"76. *Australia* and *New Zealand* reserve the right to include a provision clarifying their right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian and New Zealand tax purposes) from the carrying on of a business in Australia or New Zealand, as the case may be, through a permanent establishment."

Paragraph 76 as it read after 17 July 2008 corresponded to paragraph 42. On 17 July 2008 paragraph 42 was renumbered as paragraph 76 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 42 was amended on 29 April 2000, by adding New Zealand as a country making the reservation, by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. After 23 July 1992 and until 29 April 2000, paragraph 42 read as follows:

"42. *Australia* reserves the right to include a provision clarifying its right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian tax purposes) from the carrying on of a business in Australia through a permanent establishment."

Paragraph 42 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 87: Corresponds to paragraph 77, which was renumbered as paragraph 87 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 77 as it read after 17 July 2008 corresponded to paragraph 43. On 17 July 2008 paragraph 43 was amended, by deleting Spain from the list of countries making the reservation, and renumbered as paragraph 77 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008. After 29 April 2000 and until 17 July 2008, paragraph 43 read as follows:

> "43. *Korea*, *Portugal* and *Spain* reserve the right to tax persons performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a permanent establishment (or a fixed base) available to them for the purpose of performing such services or activities."

Paragraph 43 was added on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 43 as it read after 23 July 1992 and until 21 September 1995 was renumbered as paragraph 39 of the Commentary on Article 12 (see history of paragraph 39 of the Commentary on Article 12) by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

Paragraph 88: Amended on 15 July 2014, by adding Turkey to the list of countries making the reservation, by the Report entitled "The 2014 Update to the Model Tax Convention", adopted by the Council of the OECD on 15 July 2014. After 22 July 2010 and until 15 July 2014, paragraph 88 read as follows:

> "88. *Italy* and *Portugal* reserve the right to tax persons performing independent personal services under a separate article which corresponds to Article 14 as it stood before its elimination in 2000."

Paragraph 88 as it read after 22 July 2010 corresponded to paragraph 78. On 22 July 2010 paragraph 78 was renumbered as paragraph 88 by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 78 as it read after 17 July 2008 corresponded to paragraph 44. On 17 July 2008 paragraph 44 was renumbered as paragraph 78 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 44 was added on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 44 was deleted on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995. After 23 July 1992 and until 21 September 1995, paragraph 44 read as follows:

> "44. *Canada* and *Japan* reserve the right to subject income derived from the leasing of industrial, commercial or scientific equipment and of containers to a withholding tax at source at a rate equal to that on royalties. However, they would be prepared to agree to apply, on a reciprocal basis, the rules of Article 8 to income derived from the leasing of containers used in international traffic."

Paragraph 44 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, on the basis of paragraph 29 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the OECD Council on 13 September 1983) and of paragraph 47 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the OECD Council on 13 September 1983.

Paragraph 89: Corresponds to paragraph 79, which was renumbered as paragraph 89 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 79 as it read after 17 July 2008 corresponded to paragraph 45. Paragraph 45 was renumbered as paragraph 79 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 45 was added on 29 April 2000 by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 45 as it read after 23 July 1992 and until 21 September 1995 was amended and renumbered as paragraph 41 of the Commentary on Article 12 (see history of paragraph 41 of the Commentary on Article 12) by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

Paragraph 90: Corresponds to paragraph 80, which was renumbered as paragraph 90 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 80 as it read after 17 July 2008 corresponded to paragraph 50. On 17 July 2008 paragraph 50 was renumbered as paragraph 80 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 50 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992, on the basis of paragraph 50 of a previous report entitled "The Taxation of Income Derived from the Leasing of Containers" (adopted by the OECD Council on 13 September 1983).

Paragraph 91: Corresponds to paragraph 81, which was renumbered as paragraph 91 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 81 as it read after 17 July 2008 corresponded to paragraph 51. On 17 July 2008 paragraph 51 was renumbered as paragraph 81 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 51 was added on 23 July 1992 by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 92: Corresponds to paragraph 82, which was renumbered as paragraph 92 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 82 as it read after 17 July 2008 corresponded to paragraph 52. On 17 July 2008 paragraph 52 was renumbered as paragraph 82 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 52 was amended on 29 April 2000, by changing the list of countries making the reservation to delete New Zealand and add Portugal, by the report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. After 31 March 1994 and until 29 April 2000, paragraph 52 read as follows:

> "52. *Australia* and *New Zealand* reserve the right to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied,

so far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 52 as it read after 31 March 1994 corresponded to paragraph 38. On 31 March 1994 paragraph 38 was amended and renumbered as paragraph 52 by the report entitled "1994 Update to the Model Tax Convention", adopted by the OECD Council on 31 March 1994. After 23 July 1992 and until 31 March 1994, paragraph 38 read as follows:

"38. *Australia* and *New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 38, as it read after 23 July 1992, corresponded to paragraph 36 of the 1977 Model Convention. On 23 July 1992 paragraph 38 of the 1977 Model Convention was renumbered as paragraph 40 (see history of paragraph 40), paragraph 36 of the 1977 Model Convention was renumbered as paragraph 38 and the heading preceding paragraph 36 was moved with it by the report entitled "The Revision of the Model Convention", adopted by the OECD Council on 23 July 1992.

Paragraph 36 and the heading preceding it were added when the 1977 Model Convention was adopted by the OECD Council on 11 April 1977.

Paragraph 93: Corresponds to paragraph 83, which was renumbered as paragraph 93 on 22 July 2010, by the report entitled "The 2010 Update to the Model Tax Convention", adopted by the OECD Council on 22 July 2010.

Paragraph 83 as it read after 17 July 2008 corresponded to paragraph 54. On 17 July 2008 paragraph 54 was renumbered as paragraph 83 by the report entitled "The 2008 Update to the Model Tax Convention", adopted by the OECD Council on 17 July 2008.

Paragraph 54 was added on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

Paragraph 94: Added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

Paragraph 95: Added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

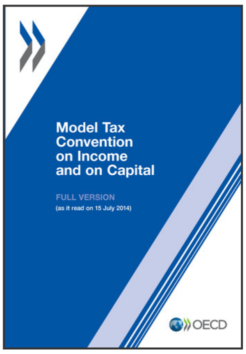
Paragraph 96: Amended on 15 July 2014 by the Report entitled "The 2014 Update to the Model Tax Convention", adopted by the Council of the OECD on 15 July 2014. After 22 July 2010 and until 15 July 2014, paragraph 96 read as follows:

"96. *Chile*, *Greece*, *Mexico* and *Turkey* reserve the right to use the previous version of Article 7, *i.e.* the version that was included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention. They do not, therefore, endorse the changes to the Commentary on the Article made through that update."

Paragraph 96 was added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

Paragraph 97: Added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.

Paragraph 98: Added on 22 July 2010 by the report entitled the "2010 Update to the Model Tax Convention" adopted by the OECD Council on 22 July 2010.



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