
US Tax Treaty Newsalert

A Washington National Tax Services (WNTS)
Publication

July 26, 2012

US and Canada Competent Authority Agreement sets standards on attribution of profits to a PE

On June 26, 2012, the United States and Canada concluded a Competent Authority Agreement addressing the interpretation of the provisions in the income tax convention between the United States and Canada, as amended by the 2007 Protocol (and four prior Protocols) ("the Treaty") providing the standards to apply in determining the attribution of profits to a permanent establishment (PE). The 2007 Protocol was signed just as the OECD was finalizing its discussion draft on the attribution of profits to a PE, which was released in May 2008 (the Authorized OECD Approach (AOA)). The AOA was finalized July 17, 2008 and revised in 2010, and is referred to in the Competent Authority Agreement as the "full AOA."

The Competent Authority Agreement marks only the eighth time the United States has adopted the AOA approach in a bilateral income tax treaty. The other treaties adopting this approach are treaties in force with the United Kingdom, Japan, Germany, Belgium, Canada, Bulgaria and Iceland. The AOA has not been adopted in all recently negotiated US bilateral income tax treaties (for example, the protocol with France and the treaty/final protocol with Italy do not adopt the AOA).



The authorized OECD approach/the OECD report on the attribution of profits to PEs

Historically, the basic standard for the attribution of business profits to a PE was the following, taken from Article 7(2) of the OECD Model Tax Convention prior to the 2010 amendment:

[W]here 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.

Countries have taken various, and divergent, interpretations of this language. The United States, in several of the Treasury Technical Explanations to its treaties in effect prior to 2008, interpreted the language as achieving 'substantially' the same effect as the effectively connected rules in section 864 and the regulations thereunder except that the treaty attribution rules did not include what is referred to as the modified force of attraction rule that treats all US source business income as effectively connected income if the taxpayer is engaged in trade or business in the United States regardless of whether there is any actual connection to the US trade or business. The Canadian courts, in *Cudd Pressure Control Inc.*, [1999] 1 C.T.C. (FCA), did not allow a Canadian PE to deduct notional rent paid to a head office for equipment.

The OECD, in its 2008 report entitled "Report on the Attribution of Profits to Permanent Establishments" (the 2008 Report), officially adopted the AOA which, in short, determines the attribution of profits to a PE by treating the PE as a separate enterprise and applying the OECD transfer pricing guidelines for allocating income between the PE and the home office and other parts of the taxpayer. This approach takes into account the functions performed, assets used and risks assumed by the enterprise through the PE and the other parts of the enterprise.

As a result of the AOA, the OECD Commentaries interpreting the Model Treaty were revised consistent with the 2008 Report and Article 7(2) of the OCED Model Tax Convention was revised in 2010 to read as follows:

For purposes of this Article ... the profits that are attributable to the permanent establishment ... are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar circumstances, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The revisions to the Commentaries were done in two parts, the last taking effect after the above change in the language of Article 7(2) because it was not clear that the latter changes in the Commentaries could be made prior to the change in the Model

Treaty language, particularly in those cases where a new Commentary might be viewed as in conflict with an existing Commentary.

In adopting the new standards reflected in the 2008 Report, the OECD noted that, in developing the AOA, it was not constrained by either the original intent or by the historical practice or interpretation of Article 7. Rather, the AOA was intended to reflect the "preferred approach ... given modern-day multinational operations and trade." Consistent with this new approach, the United States takes the position that the AOA applies only to US tax treaties that specifically adopt the AOA in the treaty or accompanying documents, leaving considerable uncertainty regarding the appropriate standards to be applied in US tax treaties that do not adopt the AOA. There are seven US income tax treaties which allow for the AOA and which are actually in the instructions for the 1120F for 2011: the US income tax treaties with the UK (2004), Japan (2005), Germany (2008), Belgium (2008), Canada (2009), Bulgaria (2009), and Iceland (2009).

Observation: The fact that there is considerable uncertainty regarding the appropriate standards to be applied in US tax treaties that do not adopt the AOA should not be read to suggest there is any certainty of result under the AOA. The AOA may change the operative principles and offer more extensive guidelines but the challenge of how to apply transfer pricing principles to intra-corporate transactions and how to take into account functions performed, assets used, and risks assumed is no easy task.

Paragraph 9 of the exchange of notes

Simultaneously with the signing of the 2007 Protocol, the signatories executed two sets of exchanges of notes. The second exchange of notes (Annex B to the Protocol) includes the following paragraph discussing the attribution of profits to a PE:

9. With reference to Article VII (Business Profits)

It is understood that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment. The principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of a single entity. Accordingly, any of the methods described therein as acceptable methods for determining an arm's length result may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines. In particular, in determining the amount of attributable profits, the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. With respect to financial institutions other than insurance companies, a Contracting State may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. In the case of an insurance company, there shall be attributed to a permanent

establishment not only premiums earned through the permanent establishment, but that portion of the insurance company's overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment.

The Competent Authority Agreement

The full import of Paragraph 9, as it relates to the AOA, is far from clear, particularly taking into account that the Exchange of Notes took place before the AOA was finalized, and well before the 2010 changes. The Paragraph 9 language adopts principles consistent with the AOA, including using OECD transfer pricing guidelines and taking into account functions performed, assets used, and risks assumed. However, the text of Article VII(2) remained unchanged, being comparable to the historical language in the OECD Model Treaty.

To clarify the intent, the Competent Authority Agreement states that the competent authorities understand that paragraph 9 of Annex B "indicates that the principles of the full AOA [as most recently revised in 2010] as set out in the Report would apply without waiting for the Report to be finalized." The Agreement goes on to state that the competent authorities "agree that, under Paragraph 9 ... Article VII [Business Profits] ... is to be interpreted in a manner entirely consistent with the full AOA as set out in the Report." The Agreement continues by stating that all other provisions of the Treaty that require a determination of whether an asset or amount is effectively connected or attributable to a PE are also to be interpreted in a manner entirely consistent with the full AOA as set out in the Report.

Apparently in recognition of the uncertainties existing before the Competent Authority Agreement, it is effective prospectively -- for taxable years that begin on or after January 1, 2012. However, taxpayers may choose to apply the entirety of the Agreement for all taxable years beginning after December 31, 2008 (the effective date of the 2007 Protocol).

Observation: The IRS and The Canadian Revenue Agency have been grappling with a number of PE cases in recent years. These cases are often difficult to resolve at the competent authority level. One difficulty arises from the need to apply transfer pricing rules by analogy to determine the profits attributable to a PE, as required by Paragraph 9. As noted above, this determination can raise difficult conceptual issues, such as how to identify the hypothetical transactions or dealings between the PE and its home office, and how to attribute functions, assets and risks between the PE and its home office, that do not arise when applying transfer pricing rules to actual transactions between separate legal entities. The Competent Authority Agreement should help to direct the course of these cases by clarifying that these determinations are to be guided by the full AOA for taxable years beginning after December 31, 2011, and, at the election of the taxpayer, for prior years beginning in 2009.

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