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Attribution of profits to permanent establishments under  
UK law – Inbound situations – (UK permanent  
establishment of a non-resident company)

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ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS UNDER UK  
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- INBOUND SITUATIONS -  
(UK PERMANENT ESTABLISHMENT OF A NON-RESIDENT COMPANY)

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## I. Introduction

Economically, it can be very convenient for a company commencing business in another country to establish a permanent establishment (PE) there. A PE (be it a fixed place of business or a dependent agent) is a useful means for canvassing and intensifying customer proximity without the regulatory conditions and costs linked with the implementation and maintenance of subsidiaries. From a tax point of view, it is specifically the fact that the PE is only part of a single legal entity and the consequential direct inclusion of the (initial) losses of the foreign business in the tax base of the company in the resident state (where the credit method is applied)<sup>1</sup> that may render a PE more favourable than a subsidiary. However, the establishment will usually be subject to tax in the source state, which thus has to determine the profits attributable to it. This task has been subject to one of the most controversial discussions in international tax law, which was strongly influenced by the work of the OECD.

The legal position in the UK on taxing the profits of non-UK resident companies trading there through PEs was unclear for a long time. It is submitted that the attribution of profits was basically subject to negotiations with the Revenue, a circumstance that made it extremely difficult for foreign companies to anticipate their tax burden. However, in 2003, explicit legislative rules on profit attribution and the PE concept were introduced in domestic tax law, which were conceived as an adoption of the OECD's thinking and an appeal to the organisation to proceed with the development and implementation of its approach.<sup>2</sup> Indeed, the OECD's concept was refined after 2003 and is now reflected in the Model Tax Convention(s) and the respective Commentaries (OECD MTC). These probably not only mirror the current and prospective international standard as to the application of double tax conventions (DTC) based on the OECD Model but also have a major influence on the shape of many other (not only OECD) countries' domestic rules on profit attribution.<sup>3</sup>

This paper endeavours to analyse whether or not the way and the extent to which those rule have been implemented in the UK have resulted in a consistent concept of profit attribution. The first part of this analysis deals with the application of the domestic provisions on the attribution of profits (specifically in comparison to the OECD Model 2008). It focuses on the general rules rather than on the specific issues arising in respect to the banking industry. The second part endeavours to outline the implications arising if DTCs based on either the 2008 or the new 2010 Model are applicable.

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<sup>1</sup> Under an exemption method neither the losses nor the profits of the PE are included in the tax base of the company. However, to the extent the resident country applies an exemption with (negative) progression, PE losses can still mitigate the tax burden of the company.

<sup>2</sup> See e.g. Anderson, [2003] ET 427 at 428.

<sup>3</sup> See Baker/Collier, [2006] *IFA-GR* 21 at 39.

## **II. The Domestic Rules on Attribution of Profits**

### **1. The Historical Background**

#### **a. Incipient Stages**

The expression “permanent establishment” dates back to the Prussian Trade Regulation Act of 1845.<sup>4</sup> It was implemented in Prussia’s tax law in 1885, under which it evolved to the present sense tax concept in 1891. Subsequently, it appeared in the 1927 League of Nations’ Draft for a Model Tax Convention, which also laid the foundation for the modern methods on attribution of profits to PEs as it pointed out the relevance of accounts showing the PEs income “separately and in proper form”.<sup>5</sup> A separate entity approach was introduced with the 1933 League of Nations’ Draft,<sup>6</sup> which, however, also permitted an attribution based on turnover as well as a total profit apportionment in the absence of accounts.<sup>7</sup> The 1960 OEEC Report and the 1963 OECD Draft took up the PE concept as well as the separate entity thinking and established the modern wording of Article 7, which remained basically unaltered in all OECD Models until the release of the 2010 version (except for minor changes in 1977, the only relevant of which is the inclusion of the words “subject to the provisions of paragraph 3” in paragraph 2).<sup>8</sup>

#### **b. Functionally Separate Entity Approach (FSEA) v Relevant Business Activity Approach (RBAA)**

However, the degree of independence arising from the separate entity fiction underlying the Model(s) was subject to constant disputes that were rather intensified by the above-mentioned 1977 changes and the 1994 OECD’s attempt to clarify the interpretation by amending the Commentary. While some argued for an unlimited independence (FSEA) including the recognition of internal dealings to be valued at arm’s length (i.e. comprising a profit mark-up), others refused such an approach by accentuating the want of legal capacity of the PE. Since it is only part of a single entity and cannot enter into legally binding contracts with the other parts of that entity, the latter voices opined that only (actual) profits of the enterprise arising from transaction with third parties and associated enterprises should be apportioned according to predetermined factors.<sup>9</sup> This was mainly justified by interpreting the phrase “the profits of the enterprise” in Article 7(1) as meaning that the actual profits have to be the starting point (and, consequently, the limitation) of the allocation process.<sup>10</sup>

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<sup>4</sup> Kolck, *Betriebstättenbegriff*, at 9.

<sup>5</sup> See Article 5(4) of the *1927 Draft of a Bilateral Convention for the Prevention of Double Taxation*.

<sup>6</sup> Article 3(1) of the *1933 Draft Convention on the Allocation of Business Income Between States for the Purpose of Taxation*.

<sup>7</sup> Avery Jones et al., [2006] *BIT* 220 (241).

<sup>8</sup> Russo, *Attribution of Profits*, p. 13; Plansky, *Gewinnzurechnung*, p. 45.

<sup>9</sup> Also referred to as the Single Enterprise Approach, see Baker/Collier, [2006] *IFA-GR* 21 at 30.

<sup>10</sup> Vann, *Business Profits*, at 162.

### c. The Approach(es) of the OECD

Several shades of the mentioned approaches developed.<sup>11</sup> The OECD itself did not recommend a pure approach in its Commentaries until the 2008 version but applied a mixture that provided for the recognition of only certain types of dealings.<sup>12</sup> However, it refused the RBAA while promoting the FSEA in the “working hypothesis”, which was developed from 1994 onwards and became the “Authorized OECD Approach” (AOA); this was completed in 2008 with the publication of the “Report on the Attribution of Profits to Permanent Establishments” (including separate parts on global trading, banks and insurance companies). The results of the Report that were held to be consistent with the former Article 7 (such as the guidance on capital attribution) were introduced in the 2008 Commentary, while the AOA as a whole was only implemented by a revised version of Article 7 in 2010.<sup>13</sup>

### d. The Impact on Domestic Law

The degree of independence is equally relevant for the approaches of determining profits attributable to PEs under domestic law. However, only with the enactment of Finance Act 2003 did the UK implement the term “permanent establishment” accompanied by an explicit (general) rule as to the method of attribution.<sup>14</sup> Previously, corporation tax, which was introduced 1965, was levied on non-resident companies subject to the condition that they carried on a trade in the UK through a “branch or agency”,<sup>15</sup> which was defined as meaning “any factorship, agency, receivership, branch or management”.<sup>16</sup> However, UK law did not provide a general rule on how the amount of profit attributable to the “branch or agency” had to be determined but only stated that it included

“any trading income arising directly or indirectly through or from the branch or agency, and any income from property or rights used by, or held by or for, the branch or agency [...]; and such chargeable gains accruing on the disposal of assets situated in the United Kingdom [...].”<sup>17</sup>

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<sup>11</sup> Plansky, *Gewinnzurechnung*, p. 93 et seqq.

<sup>12</sup> See Harris/Oliver, *International Commercial Tax*, at 162 et seqq.

<sup>13</sup> See Arnold, [2011] *BIT* 3.

<sup>14</sup> Already well before, specific rules applied to insurance companies; see Schwarz, *Tax Treaties*, p. 148 with references to the respective case law.

<sup>15</sup> Introduced in section 50(1) Finance Act 1965; see equally section 11(1) ICTA 1988.

<sup>16</sup> See section 834(1) ICTA 1988. It is argued by HMRC that the term “branch or agency” was basically in accordance with the notion of “permanent establishment” as contained in the OECD Model. As the same is opined in respect to the domestic PE concept, the Revenue perceives that its explicit introduction was of no substantive (i.e. altering) effect, see INTM264040.

<sup>17</sup> See e.g. Section 11(1) ICTA 1988.

The problem, however, was identified even well before the enactment of corporation tax in *Pommery and Greno v Aphorpe*, where a French wine merchant sold his products in England through an agent. However, Denman J concluded:

“I do not think it is necessary at all at this stage of the case to decide that. That is a matter of quantum, a matter for the consideration of persons skilled in dealing with such matters as assessing profits of trade.”<sup>18</sup>

Hence, the issue was regularly solved on a case-by-case basis in negotiations with the Revenue, which is why it seldom reached the courts.<sup>19</sup> Therefore, it is impossible to identify clearly a single approach that was consistently applied to the issue in practice. However, in the course of the changes that accompanied the self-assessment system as introduced with the Finance Act 1995, it was established that the branch or agency of the non-resident company is to be treated as being “a separate and distinct person from the non-resident” for determining their liabilities as representatives of the non-resident company,<sup>20</sup> which Schwarz interpreted as support for the separate enterprise hypothesis.<sup>21</sup> The Revenue saw the lack of case law as giving proof of the dispensability of an explicit rule stipulating the approach to profit allocation. It issued a statement in 1995, in which it opined for the arm’s length principle and the application of transfer pricing methods in order to assess the non-resident’s liability to tax under domestic law (irrespective of whether a treaty exists or not).<sup>22</sup> Accordingly, it moved from a position that was perceived as being in practice close to the RBAA<sup>23</sup> to an approach resembling the one taken by the OECD in the Commentary as amended in 1994 (vide supra).<sup>24</sup>

Explicit rules on profit attribution were implemented by the Finance Act 2003 in Section 11AA and Schedule A1 ICTA 1988, which were attended by the introduction of the term “permanent establishment”, the domestic notion of which was provided in sections 148 and 152 and Schedule 26 Finance Act 2003. The implementation had the aim to align domestic law with the OECD’s position and was perceived as support for the development of the working hypothesis.<sup>25</sup> In the course of the Tax Law Rewrite Project, the allocation provisions were moved to Sections 19 – 32 CTA 2009 while the rules on the PE concept were relocated to Sections 1141 – 1153 CTA 2010.

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<sup>18</sup> *Pommery and Greno v Aphorpe* [1886] TC 182 at 189

<sup>19</sup> Casley/Dixon, [2002] *ITPJ* 182 (185).

<sup>20</sup> This rule is now located in section 835E(3) ITA 2007.

<sup>21</sup> Schwarz, *Tax Treaties*, p. 143.

<sup>22</sup> Inland Revenue, [1995] 18 *Tax Bulletin* 234.

<sup>23</sup> Casley/Dixon, [2002] *ITPJ* 182 (185).

<sup>24</sup> Inland Revenue, [1995] 18 *Tax Bulletin* 234.

<sup>25</sup> See Clavey/Morgan, 14 [2003] *ITR* 33 at 34.

## **2. The Liability to Tax of Non-Resident Companies under UK Law**

### **a. The Charging Provision**

Nowadays, a non-resident company is chargeable to corporation tax only if it carries on a trade in the UK through a PE there (see Section 5(2) CTA 2009). If so, it is taxable on all its profits attributable to that PE (wherever arising), which fall within Section 19 CTA 2009 (see Section 5(3) CTA 2009). To the extent the profits are within the scope of that provision, the non-resident's liability to income tax is precluded by virtue of Section 3(1)(b) CTA 2009. Capital gains accruing to the company are not liable to capital gains tax in the hands of that company but to corporation tax (see Sections 4 and 19(1)(b) CTA 2009).

Notwithstanding the above-mentioned, a liability to income tax exists if a non-resident company draws profits from UK sources without carrying on a trade in the UK or carries on such trade but without having a PE.<sup>26</sup> The same holds true if it is trading through a UK PE but derives profits not attributable to that PE.<sup>27</sup> Generally, the liability to income tax is limited by virtue of Section 815 ITA 2007 for those cases. However, since this paper focuses on the allocation of profits pursuant to Sections 19 et seqq. CTA 2009, the issues arising in regard to income tax are disregarded hereinafter.

### **b. The Relevance of the OECD's Documents for Interpretation of Domestic Law**

The term "permanent establishment" as well as respective attribution methods are well known in international law (vide supra) and reflected in the OECD documents. Therefore, during the consultation process for the UK legislation, the Revenue argued that the domestic rules should be interpreted in accordance with the Commentary but moved away from that position later on.<sup>28</sup> However, by now HMRC again accentuates in its International Manual that for the requirements of a PE as defined in Section 1141 et seqq. CTA 2010 and the separate enterprise principle under domestic legislation the OECD Commentary is a useful means of interpretation.<sup>29</sup> This is made subject to the condition that the Commentary does not "materially vary through periodic updates or amendments" from the version being relevant at the time when the domestic provisions were enacted.<sup>30</sup> However, unlike for transfer pricing (see Section 164 TIOPA 2010), direct reference to the OECD documents is not made in the legislation. Therefore, at first glance, it seems not necessary to take any account of them.

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<sup>26</sup> INTM262020.

<sup>27</sup> Bramwell, *Taxation of Companies*, para. P1.1.1.

<sup>28</sup> See Bramwell, *Taxation of Companies*, para P3.1.9.

<sup>29</sup> See INTM264050 and INTM267040.

<sup>30</sup> INTM264050.

However, to the extent the wording of the national rules resembles the wording of the OECD Model Tax Convention, nothing prevents OECD documents from being consulted just like any other legal opinion published in literature. Furthermore, the Commentary receives additional authority from the fact that it served as an important basis for drafting the domestic legislation that was issued in order to align national taxation with the international standard as reflected by the work of the OECD.<sup>31</sup> Hence, it is persuasive to argue that the opinion expressed in the Commentary has to be taken into account in the context of an historical approach to interpretation. Although the status conveyed by such indirect reference is much weaker compared to the direct approach as applied to the TPGL (as it is likelier to be overruled by systematic or teleological aspects of domestic law), a complete disregard of the Commentary would be imprudent (which does not imply at all that one must follow it but only that it should be considered). However, this approach carries the discussion on static or ambulatory usage known from the treaty context to the level of statutory construction of domestic law. With that regard, it should make no difference whether or not the recent Commentary “materially varies” from the version that existed when domestic law was enacted. Only the one that existed when the Finance Act 2003 was issued can be relevant in the context of historical interpretation (this historical aspect did not change (i.e. was not updated) in the course of the Rewrite Project since the relocation of the rules to CTA 2009 were not accompanied by any material changes). However, subsequent documents can still be of persuasive value like any other legal opinions (vide supra). This resembles the approach in a treaty context pursuant to the *Commerzbank* principles (vide infra).<sup>32</sup>

Although HMRC’s approach does not seem to be exactly the same (from an intellectual point of view), since it does not distinguish between the relevance of the Commentary as a means of historical interpretation on the one hand and its impact as a legal opinion of only persuasive value on the other, it is rather unlikely that material differences will arise in practice. In respect to both opinions the position under the 2008 Commentary (which is, for the most part, identical to the 1994 Commentary) will have a particular impact. Contrarily, taking into account the 2010 Commentary on Article 7 OECD MTC is excluded as the latter refers to the new version of Article 7, on which the domestic law is not based.

The following paragraphs endeavour to provide an overview of UK law and its application by HMRC. Where appropriate, reference is made (in accordance with the above-mentioned principles) to the 2008 Commentary in order to explain the domestic concepts.

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<sup>31</sup> See the Government’s Explanatory Notes to Chapter 4 of Part 2 CTA 2009 para. 117.

<sup>32</sup> *Commerzbank v IRC*, [1990] STC 285 at 297 et seq.



### **c. The Preconditions of Section 19(1) CTA 2009**

Chapter 4 of Part 2 CTA 2009 on the attribution of profits is only applicable if a non-resident company trades in the UK through a PE within the meaning of Section 19(1) CTA 2009.

#### **aa. Non-Resident Company**

“Company” includes bodies corporate but not partnerships.<sup>33</sup> A company is non-UK resident when neither the place of incorporation (see section 14 CTA 2009) nor the central management and control of its business is in the UK (case law rule).<sup>34</sup> The issues that can arise with that respect are beyond the scope of this paper.

#### **bb. Trading**

As to the requirement of a “trade”, Section 1119 CTA 2010 provides that this includes “any venture in the nature of trade”. Similarly, the former Section 832 ICTA 1988 (now repealed) stated that “trade includes every trade, manufacture, adventure or concern in the nature of trade”. Both definitions are quite broad but supplemented with extensive case law.<sup>35</sup> Basically, it is a matter of fact whether a transaction amounts to a trade within that perception (or e.g. to an investment). The courts have developed non-exhaustive “badges of trade”, summarized, for example, in *Marson v Morton and Others*, the specifics of which are (again) not within the scope of this study.<sup>36</sup> Extensive guidance can be found in HMRC’s Business Income Manual.<sup>37</sup>

#### **cc. Trading “in” the UK**

The non-resident company must be trading “in” the UK in contrast to trading “with” the UK. The traditional criterion for the determination of where a trade is carried on, which was already considered as early as 1881 in *Erichsen v Last*,<sup>38</sup> is the place where the contract is concluded. This principal evolved in the Champagne Cases. In *Grainger & Son v Gough* – where UK agents of a French wine merchants received orders from customers in the UK, which were transmitted to the French principal who decided at his own discretion whether or not he would execute the orders – the court found that no part of the trade was carried on in the UK.<sup>39</sup> Contrarily, in *Werle v Colquhoun* the Court of Appeal considered the trade to be carried on here on the grounds that the

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<sup>33</sup> See Bramwell, *Taxation of Companies*, para P1.1.3.

<sup>34</sup> See *Simon’s Taxes*, para. D4.103; for central management and control see especially *De Beers Consolidated Mines Ltd v Howe*, [1906] AC 455.

<sup>35</sup> See BIM20065.

<sup>36</sup> *Marson v Morton and Others* [1986] 1 WLR 1343 at 1348.

<sup>37</sup> BIM20201 et seqq.

<sup>38</sup> *Erichsen v Last* [1881] LR 8 QBD 414.

<sup>39</sup> *Grainger & Son v Gough* [1986] 3 TC 462.

UK agents of a foreign wine merchant accepted orders for the latter on their own account.<sup>40</sup> However, in *Greenwood v FL Smidth*, Atkin LJ observed that the place of contracting is (although important) not the only decisive factor and that it has to be determined where “the operations take place from which the profits in substance arise”.<sup>41</sup> This was approved by Lord Radcliffe in *Firestone Tyre and Rubber Co. Ltd. v Lewellin*.<sup>42</sup>

In respect to the chargeability of non-resident companies to corporation tax, the main criterion for trading “in” the UK is the existence of a UK PE (see Section 19(1) CTA 2009). Both domestic PE tests require a “business” carried on in the country (vide infra). However, since the expression “business” is wider than the concept of “trade”,<sup>43</sup> conducting a “business in” the UK does not necessarily imply that someone is also “trading in” the UK. Therefore, the above-mentioned criteria (e.g. the place where the contracts are concluded) are still relevant.

#### **dd. The Notion of Permanent Establishment**

Section 1141(1) CTA 2010 provides that a non-resident company has a PE in the UK either if

- “(a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or
- (b) an agent acting on behalf of the company has and habitually exercises there authority to do business on behalf of the company.”

The wording of Section 1141(1) CTA 2010 resembles Article 5(1) OECD MTC. A service PE provision as contained in the UN Model (see Article 5(3)(b) UN Model Tax Convention) or in the alternative rule provided in Paragraph 42.23 of the OECD Commentary is not enshrined in domestic law.

#### **(1) The Fixed Place of Business**

As to the notion of the expressions “company” and “business” vide supra. The expressions “place of business”, “fixed” and “through which” are persuasively interpreted in accordance with the OECD Commentary and are, therefore, not set out in detail in this paper.<sup>44</sup> However, it is to be noted that (in accordance with the UK’s observation in the Commentary to Article 5)<sup>45</sup> HMRC

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<sup>40</sup> *Werle & Co v Colquhoun* [1888] LR 20 QBD 753 at 760.

<sup>41</sup> *Greenwood v FL Smidth & Co*, 3 [1921] KB 583 at 593.

<sup>42</sup> See *Firestone Tyre and Rubber Co. Ltd. v Lewellin*, [1957] 1 WLR 464 at 471.

<sup>43</sup> See *American Leaf Blending Co. Sdn. Bhd. v Director-General of Inland Revenue*, [1979] A.C. 676 at 684.

<sup>44</sup> INTM266060 et seqq.

<sup>45</sup> OECD-Comm. 2008, Article 5 para. 45.5.

specifically excludes the mere operation of a server from being treated as a PE (whether or not it is geographically fixed and distinctly attributable to the non-resident).<sup>46</sup>

Section 1141(2) CTA 2010 provides a non-exhaustive list of “fixed place of business” PEs similar to that of Article 5(2) OECD MTC. As in the OECD Model until 1977, the “building site and construction or installation project” provision is embedded in that list instead of being contained in its own paragraph (see Section CTA 2010). Furthermore, it is not made subject to the twelve-month duration requirement of Article 5(3) OECD MTC. However, this does not solve the issue of whether or not it constitutes its own category of PE or must fulfil the general requirements of a “fixed place of business”.<sup>47</sup> As (specifically small or medium-sized) building sites and construction or installation projects are usually lasting only for a short-term period (not even meeting the six months presumption applied to the “fixed place of business” test)<sup>48</sup> and are in most cases established for carrying out just a single transaction,<sup>49</sup> the deletion of the twelve-month condition could be interpreted as an extension of the general rule of Section 1141(1) CTA 2010. From that point of view, the inclusion of the provision in Section 1141(2) CTA 2010 could “infect” the construction of the list as such and provide an argument for not examining the requirements of a “fixed place of business” to the extent that one of the subparagraphs of that rule is applicable. However, it is more likely that the opposite was intended. Since Section 1141(2) CTA 2010 is based on Article 5(2) OECD MTC, for the latter of which it is made clear in the Commentary that the requirements of Article 5(1) OECD MTC must be met,<sup>50</sup> the same should hold true for domestic law. Therefore, a project in the aforementioned sense will only constitute a PE to the extent it is “a fixed place of business”, for the interpretation of which the list is only of limited relevance since it is “without prejudice to the generality” of that test.

Furthermore, Section 1141(2) CTA 2010 does not only cover extraction (like Article 5(2) OECD MTC) but also exploration for natural resources. In accordance with the interpretation above, this extension has no material effect.

## **(2) The Dependent Agent**

The dependent agent provision (Section 1141(1)(b) CTA 2010) is also based on the OECD Model. Since, from a common law perspective, an agent can bind his principal whether or not he is concluding contracts “in the name of” the latter, the respective phrase of Article 5(5) OECD MTC

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<sup>46</sup> INTM266100.

<sup>47</sup> See in respect to Article 5(3) OECD MTC Bendlinger/Görl/Schon, [2006] *Intertax* 180.

<sup>48</sup> See INTM266070.

<sup>49</sup> See Görl, in: Vogel/Lehner, *DTC*, Article 5 para. 56.

<sup>50</sup> *OECD-Comm. 2008*, Article 5 para. 12.

was not adopted. However, whilst, under the OECD Model, the person acting on behalf of the enterprise must have and habitually exercise “authority to conclude contracts”, the domestic provision requires an agent having and habitually exercising “authority to do business on behalf of the company”. The latter term seems to cover a much wider range of activities that may suffice for constituting a PE than the conclusion of contracts as required by the OECD. Nonetheless, this does not at all entail that contracting is not of relevance from the domestic law perspective. On the contrary, the authority to create legal obligations binding upon the principal is already a criterion within the perception of “trading in” a country as shaped by UK case law (vide supra).<sup>51</sup> However, this also brings along the “profits in substance” test as set out in *Smidth v Greenwood*<sup>52</sup> and *Firestone Tyre & Rubber Co Ltd v Lewellin*.<sup>53</sup> In total, it leads to a concept, which is not only in support of the OECD’s tendency to water down the requirement of “authority to contract” by accepting economic considerations (the OECD argues that a person must not necessarily bind the principal legally if it negotiated all relevant elements and details of the contract – a thinking that was recently rejected in *Dell Norway and Zimmer*)<sup>54</sup> but to an approach that is even wider than this.

Section 1142 CTA 2010 (based on Article 5(6) OECD MTC) provides that independent agents acting in the ordinary course of their business are not regarded to constitute a PE. HMRC states that the agent is independent if the relationship between him and the principal is “the same as a relationship between independent businesses dealing with each other at arms length”.<sup>55</sup> The use of transfer pricing terminology is rather unhelpful in the present context, specifically as it seems to indicate that associated enterprises always come within the scope of the provision. However, HMRC makes it clear that the phrase is to be interpreted in accordance with the guidance of the OECD Commentary (i.e. by assessing the legal and economic self-reliance of the agent).<sup>56</sup> This guidance is also declared to be applicable in respect to the issue of whether or not and under which conditions subsidiaries can be dependent agents (meaning that the mere dependency under company law is to be disregarded).<sup>57</sup> In respect to the “ordinary course of business” requirement, broad reference is made to the Commentary as well.<sup>58</sup>

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<sup>51</sup> Equally Casley/Dixon, [2002] *ITPJ* 182, at 185.

<sup>52</sup> *Smidth v Greenwood* [1921] 3 KB 583 at 593.

<sup>53</sup> *Firestone Tyre and Rubber Co. Ltd. v Lewellin*, [1957] 1 WLR 464 at 471.

<sup>54</sup> *Dell Product v Tax East*, 14 [2011] 371; *Société Zimmer Ltd v Ministre de l'Économie, des Finances et de l'Industrie*, 12 [2010] *ITLR* 739.

<sup>55</sup> INTM264080.

<sup>56</sup> See *OECD-Comm. 2008*, Article 5 para. 36 et seqq.

<sup>57</sup> INTM264080.

<sup>58</sup> INTM264070.

### **(3) Preparatory or Auxiliary Activities**

For both alternatives (dependent agent and fixed place of business) a PE is not deemed to exist if the activities performed are of a mere preparatory or auxiliary character (see section 1143 CTA 2010). Section 1143(3) CTA 2010 provides a non-exhaustive list of such activities that basically corresponds to the one contained in the OECD Model. However, the domestic rule does not provide for an equivalent to Article 5(4)(f) OECD MTC, which states that a combination of exempted activities is also to be treated as being exempt to the extent that the overall activity is still of preparatory or auxiliary character.<sup>59</sup> Because of the latter condition in the MTC and the statement in Section 1143(2) CTA 2010 that the list is “without prejudice to the generality of the preparatory or auxiliary expression” (in conjunction with the lack of an explicit exclusion of the combination clause in CTA 2010), domestic law and the OECD Model should nonetheless lead to the same result. Thus, the missing reference to combined activities has no material effect.

### **(4) Associated Companies**

It has already been mentioned above that HMRC submits that subsidiaries do not automatically constitute PEs of their parents (although an equivalent to Article 5(7) OECD MTC was not implemented in domestic law).<sup>60</sup> This accords with Görl’s opinion in Vogel, who persuasively argued that Article 5(7) OECD MTC is a redundant provision, considering that subsidiary and parent are legally separate companies.<sup>61</sup> However, in accordance with the Model, a PE is assumed if the subsidiary meets the “fixed place of business” test or acts as a dependent agent (leaving the shareholdings out of account).<sup>62</sup>

### **(5) Conclusion**

The wording of the UK’s domestic PE concept is largely in accordance with the OECD’s (not least because of the principles of interpretation set out above). However, it also carries over the inconsistencies of the OECD’s concept to domestic law. Specifically, the meaning of the illustrative lists in Sections 1141(2) and 1143(3) CTA 2010 is ambiguous. This is particularly problematic due to the fact that (for the purpose of domestic law) the UK made amendments compared to the provisions contained in Article 5 OECD MTC. It would have been preferable from the perspective of legal certainty to explicitly state the purpose and impact of those rules. If the UK intended to extend the notion of “fixed place of business” by including the “exploration for national resources” provision, or wanted to exclude a “combination of exempted activities” to be treated as auxiliary or

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<sup>59</sup> *OECD-Comm. 2008*, Article 5 para. 27.

<sup>60</sup> INTM264080.

<sup>61</sup> Görl, in: Vogel/Lehner, *DTC*, Article 5 para. 174 and 165.

<sup>62</sup> INTM264080.

preparatory, it seems (from the author's point of view) that it failed to achieve those aims. On the other hand, the uncertainties and disputes that arose under Article 5(5) OECD MTC in respect to the permissibility of economic considerations in interpreting the phrase "authority to conclude contracts" were solved unambiguously in favour of the OECD's opinion by substituting the term "contracts" with "business" and connecting the phrase with the "trade in" requirement. It cannot be ignored that in individual cases this may lead to results that go even beyond the OECD's position in the Commentary. However, it is a clear statement that basically resolves the controversy currently going on internationally, which is why the amendment is to be generally welcomed.

#### **d. Chargeable Income**

To the extent the requirements of Section 19(1) CTA 2009 are met, Section 19(2) CTA 2009 determines that the non-resident company is chargeable on any of the following profits attributable to the PE:

- “(a) trading income arising directly or indirectly through or from the establishment
- (b) income from property or rights used by, or held by or for, the establishment, and
- (c) chargeable gains falling within section 10B of TCGA 1992
  - (i) as a result of assets being used in or for the purpose of the trade carried on by the company through the establishment, or
  - (ii) as a result of assets being used or held for the purposes of the establishment or being acquired for use by or for the purpose of the establishment”

As to the notion of "trade" in Section 19(2)(a) CTA 2009 see the explanations above. Section 19(2)(b) CTA 2009 also brings non-trading income within the charge to corporation tax. The rule generally covers royalties, interest and dividends as well as income from property (e.g. rent from letting PE premises; see the examples in *Bramwell*).<sup>63</sup> However, the non-resident is only liable to tax in that respect as well if it is trading in the UK (vide supra). This is also a precondition for the chargeability of capital gains stipulated in Section 19(3)(c) CTA 2009 in conjunction with Section 10B TCGA.

The further requirements of the above-mentioned provisions are closely linked to the general approach to attributing profits and are, therefore, discussed in more detail below.

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<sup>63</sup> See Bramwell, *Taxation of Companies*, para. 1.1.5. However, dividends are largely exempted by Part 9A CTA 2009, see INTM651010. As regards property, it should be noted that usually the non-resident landlord scheme will apply, see INTM262040.

### e. The Separate Enterprise Approach

Central to the attribution of profits is the “separate enterprise principle” enshrined in Section 21 CTA 2009, which provides in Paragraph 1 that

“The profits of the non-UK resident company that are attributable to the permanent establishment are those that the establishment would have made if it were a distinct and separate enterprise which

- (a) engaged in the same or similar activities under the same or similar conditions and
- (b) dealt wholly independently with the non-UK resident company.”

Apparently, the wording of the provision is based on Article 7(2) OECD MTC.<sup>64</sup> However, if the legislator had left it at that, the position under domestic law would have been equally ambiguous as the one under the OECD Model has been (vide supra for the differing interpretations that have arisen in respect to Article 7(2) OECD MTC). Therefore, Section 22 CTA 2009 supplements the general rule by stating that

“In accordance with the separate enterprise principle, transactions between the permanent establishment and any other part of the non-UK resident company are treated as taking place on such terms as would have been agreed between parties dealing at arm’s length.”

The term “transaction” is usually used in a legal meaning. As a company cannot “transact” with itself in that sense,<sup>65</sup> the OECD substituted the term as regards intra-entity relations with the expression “dealing”.<sup>66</sup> Despite the different wording, the concept is the same: Notional internal “transactions” are to be generally recognized for the purpose of profit attribution.

In respect to actual transactions with third parties (i.e. legal entities), the separate enterprise hypothesis requires a treatment that feigns that the respective part of the enterprise itself entered into the transaction and not the enterprise as such.<sup>67</sup> Accordingly, the PE’s profits generally consist of the trading income, non-trading income and chargeable gains as defined in Section 19(3) CTA 2009, which accrue from its internal (notional) transactions with other parts of the company and from the company’s (actual) transactions with other (related or unrelated) parties, which can be allocated to the PE.

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<sup>64</sup> See Attard/Cussons, in: Reimer, *PE*, UK, para. 89.

<sup>65</sup> Birla, [2005] *BTR* 207, 215; Schwarz, *Tax Treaties*, p. 145; Hume/Beeton, [2004] 3942 *Taxation* 401.

<sup>66</sup> OECD, *2008 PE-Report*, para. 13.

<sup>67</sup> Niehaves, in: Haase, *AStG/DBA*, Article 7 para. 161.

The following paragraphs illustrate the concept of hypothesizing the separate enterprise and calculating its profits under domestic law. They specifically endeavour to evaluate the extent to which UK law provides for a consistent and workable application of the separate enterprise principle. As the concept is largely based on OECD principles, particular emphasis is given to compliance with the OECD Commentary.

#### **aa. Simulating the Separate Enterprise**

The PE must be assumed as a separate enterprise “engaged in the same or similar activities under the same and similar conditions” (Section 21(1) CTA 2009).

#### **(1) Functional and Factual Analysis and Identification of Risks**

For the allocation of (actual) transactions to the PE as well as for the recognition and classification of internal transactions it is necessary to identify which functions the PE performs, which risks it assumes and which assets it (economically) owns.<sup>68</sup> Therefore, HMRC refers to its guidance on performing a functional and factual analysis in the context of transfer pricing, which complies with the OECD’s approach.<sup>69</sup>

As to the identification of risks, HMRC looks at the functions that give rise to the risk and the place from where it is controlled, which is “where the people with the authority to decide to take on the risk and with the capability of managing that risk are located”.<sup>70</sup> This is essentially in accordance with the OECD’s concept of key entrepreneurial risk taking or significant people function although this idea was not separately (i.e. statutory) implemented for the PE concept.

While the existing transfer pricing techniques can be applied to the identification of functions and risks, some issues that are specific to the PE context cannot be solved by reference to those principles, which is why they are covered by the legislation. This particularly concerns the attribution of assets, the PE’s credit rating and the allocation of (notional) equity and loan capital.

#### **(2) Attribution of Assets**

There is no common concept of attributing assets to PEs but the allocation depends on the particular context in which the issue becomes relevant. The legislation provides some guidance specifically where non-trading income and capital gains are concerned (Sections 19(3)(b) and (c) CTA 2009). Although these provisions technically relate to the general chargeability of the mentioned categories

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<sup>68</sup> See Senior, [2006] *IFA-UK* 665 at 673.

<sup>69</sup> INTM267050.

<sup>70</sup> INTM441030



of profits, they also stipulate requirements that can essentially be considered as (asset) allocation methods.

### **(a) Non-Trading Income**

As regards non-trading income, the underlying assets (property or rights) are allocated to the PE pursuant to Section 19(3)(b) CTA 2009 when they are “used by, or held by or for, the establishment”. Under the OECD Model, the respective income is covered by Articles 6, 10, 11, 12 or 21 OECD MTC, of which the latter provisions refer to Article 7 OECD MTC when the assets are “effectively connected” with a PE. Article 6 OECD MTC, on the other hand, uses the *situs* principle, which is, however, not applied in Section 19(3)(b) CTA 2009. As for intangibles, HMRC seems to allocate the whole asset to the PE for the purpose of non-trading income if the above-mentioned criteria are met (with the result that the full amount of the consequential payments, and not only a share of them, is allotted to the PE).<sup>71</sup> This is contradictory to the OECD’s assumption that it is basically impossible to allocate intangibles to only one part of the company in the context of internal royalties, which the UK endorses by an explicit prohibition of deductions for such notional payments; *vide infra*.<sup>72</sup> Admittedly, the issue of whether intangibles should be attributed partly or completely to specific parts of the enterprise equally arises under the MTC.<sup>73</sup> However, a more consistent domestic approach would have been welcomed.<sup>74</sup>

### **(b) Capital Gains**

With respect to capital gains, the assets must be (physically) situated in the UK (see in this respect Sections 275 TCGA 1992 et seqq.) and used “in or for the purpose of the trade carried on by the company through the establishment” at or before the time the gain accrued (see Section 10B TCGA 1992 in conjunction with Section 19(3)(c) CTA 2009). Alternatively, the mentioned provisions attribute the asset to the PE if it is situated in the UK and “used or held for the purposes of the establishment at or before the time the gain accrued or acquired for use by or for the purposes of the permanent establishment”. The relevant article of the OECD MTC (Article 13(2)) only states that the property must form “part of the business property”. Domestic and treaty provisions seem to be largely in accordance.

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<sup>71</sup> See INTM262040.

<sup>72</sup> OECD-Comm. 2008, Article 7, para. 34. The 2010 Commentary now explicitly states that the “effectively connected” test has to be construed in accordance with the PE Report 2010, see (inter alia) OECD-Comm. 2010, Article 12 para. 21.1.

<sup>73</sup> See as to the allocation for the mentioned treaty articles Nowotny, *Betriebstättengewinnermittlung*, p. 162 et seqq.

<sup>74</sup> The domestic rule is even more problematic as it is assumed to be a broad extension of the “effectively connected” test (see Bramwell, *Taxation of Companies*, para. P3.3.11).

Intangibles (if created after 2002) do not fall within Section 19(3)(c) CTA 2009 as their disposal does not usually give rise to a chargeable gain but rather to business income.<sup>75</sup> To this extent, HMRC argues that an asset is (completely) attributable to a PE if it is “used” in the trade carried on through the latter.<sup>76</sup> This is quite broad and inconsistent with the legislation’s position as to royalties (see the explanations as to non-trading income above).

### **(c) Trading Stock**

As to the attribution of trading stock, no explicit reference is made in the legislation (Section 19(3)(a) CTA 2009 is of no help in that respect). Section 23 CTA 2009 simply presupposes that an allocation is to be conducted. In accordance with the OECD Report, it should be inferred from the location of the asset and the structure of the business (specifically taking into account the allocation of inventory risks) as revealed by the functional and factual analysis.<sup>77</sup>

### **(d) Capital Attribution**

A (rather general) reference to the allocation of assets to the PE is provided in the context of drafting the (notional) balance sheet that is required for attributing capital (vide infra). In that context, HMRC states that assets are to be allocated to the PE if it derives income through them.<sup>78</sup> Further guidance is not provided. However, as a matter of coherence, the above-mentioned principles regarding trading stock and assets used for non-trading income should apply.

### **(e) Conclusion**

Considered as a whole, the task of attributing assets to the PE under UK domestic law is rather complex and not entirely consistent. Senior, too, specifically criticised the fact that the situation regarding intangibles appears to be incoherent.<sup>79</sup> On the one hand, the UK adopts the opinion that internal royalties should not be charged because an allocation of intangibles is considered to be practically impossible. On the other hand, HMRC applies an (exclusive) allocation in order to directly attribute actual royalties (i.e. royalties charged to third parties) to the PE as well as for attributing profits arising from disposals of intangibles (including intra-entity transfers; vide infra) and calculating the amount of free capital. Admittedly, this issue is also controversial under OECD Model and Commentary (until 2008).

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<sup>75</sup> CIRD10101 et seqq.

<sup>76</sup> See CIRD10200 on Sections 859(2)(b) and 863 CTA 2009.

<sup>77</sup> See OECD, *PE Report 2008*, Part I, para. 279.

<sup>78</sup> INTM267130.

<sup>79</sup> See Senior, [2006] *IFA-UK* 665 at 674.

Furthermore, domestic law applies different rules with varying formulations for all above-mentioned purposes (for tangibles as well as for intangibles). However, despite this inconsistent wording, it seems possible to deduce a common directive for allocating assets to the PE. Section 19(3)(b) CTA 2009 concisely stipulates that assets have to be allotted to the PE when they are “used by, or held by or for, the establishment”. Since the wording of Section 19(3)(a) CTA 2009 (“directly or indirectly through or from the establishment”) is of no particular help (as it basically only repeats the directive of Section 21 CTA 2009) and no rules exist *in the legislation* as regards the attribution for the purpose of calculating free capital, it appears persuasive to apply the same thinking (“used by, or held by or for”) for all purposes. Furthermore, in the author’s view, the wording of Section 19(3)(b) CTA 2009 essentially implies the requirements contained in the legislation for capital gains in Section 19(3)(c) CTA 2009, with the exception of the condition that the assets must be “situated” in the UK.<sup>80</sup> Accordingly, it would have been preferable for the sake of clarity to implement the mentioned wording as the general concept for attributing assets under UK law in the form of a subparagraph to Section 21(2) CTA 2009 instead of using the current concept contained in Section 19(3) CTA 2009). For the purpose of capital gains, the requirement of a UK *situs* could have been retained in Section 10B TCGA 1992.

### **(3) Credit Rating**

Pursuant to Section 21(2)(a) CTA 2009 the PE has the same credit rating as the non-UK resident company of which it is part has as a whole. This assumption is a concession to the legal character of the PE not being a legal entity and stands in tension with the separate enterprise hypothesis. However, the PE factually raises its credits at the interest rate applicable to the company, which is generally below the costs an independent enterprise of the size of the PE would have to bear.<sup>81</sup> In accordance with this attribute explicitly stipulated by domestic law, intra-entity guarantees in respect to borrowings and payments on such guarantees are disregarded.<sup>82</sup> Although this may not be a very consistent concept, it complies with the OECD’s approach that was already mentioned in the 2001 Discussion Draft.<sup>83</sup>

### **(4) Equity and Loan Capital**

Furthermore, Section 21(2)(b) CTA 2009 requires the PE to have (for tax purposes) “such equity and loan capital as it could reasonably be expected to have” if it were a separate and distinct enterprise.

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<sup>80</sup> Senior’s reasoning in the branch report seems to support this argument; see Senior, [2006] *IFA-UK* 665 at 670.

<sup>81</sup> INTM267130.

<sup>82</sup> INTM267130.

<sup>83</sup> OECD, *2001 Discussion Draft*, para. 164.

### **(a) The Case Law**

The landmark cases in respect to capital allocation are the decisions in the US *NatWest* cases (specifically the first two), in which NatWest (a UK bank) operated through branches in the States. In *NatWest I*, the US Court of Federal Claims found the formulary apportionment of interest expenses provided in US domestic law to be contrary to the equivalent of Article 7 OECD MTC in the UK-US treaty whereas it held that the deductible interest might be adjusted by allocating an “adequate capital to the branch”.<sup>84</sup> In *NatWest II* the US Court stated that the separate enterprise principle does not imply that the US branch has to fulfil the capital requirements imposed on actual legal entities incorporated under US law.<sup>85</sup> As a result, the *NatWest* cases basically reject both approaches to allocation of capital the OECD now recommends. However, *NatWest II* approved the former UK approach (as applied after 1978)<sup>86</sup> to the allocation of free working capital to branches of banks,<sup>87</sup> pursuant to which the Revenue regarded that amount as interest-free capital that followed from the branch’s books subject to (rather limited) adjustments that reflected the amount needed to fund identifiable capital expenses.<sup>88</sup>

### **(b) The Preferred Approach: The Thin Capitalisation Method**

While the former concept was only relevant for the banking industry, Section 21(2)(b) CTA 2009 also covers non-financial businesses of non-resident companies operating in the UK through PEs. As the amount of capital has to equate to the amount a separate enterprise would have, the legislation is evidently in favour of what the OECD calls the “thin capitalisation method”.<sup>89</sup> Pursuant to the OECD Report(s), this approach requires the PE’s capital to be calculated on an arm’s length basis taking into account the assets used and risks assumed.<sup>90</sup> In a non-banking environment, the OECD foregoes the inclusion of risks since there are usually only insufficient instruments to identify and measure them.<sup>91</sup> Accordingly, HMRC bases its interpretation of the “thin capitalisation method” under domestic law (as to PEs in general) only on the attributable assets.

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<sup>84</sup> *National Westminster Bank PLC v United States (NatWest I)*, [1999] 1 ITLR 725 at 743.

<sup>85</sup> *National Westminster Bank PLC v United States (NatWest II)*, [2003] 6 ITLR 292; both decisions were confirmed in *NatWest IV*, see *National Westminster Bank PLC v United States*, [2008] 10 ITLR 423.

<sup>86</sup> Before 1978 the UK applied the PW Formula (“Price Waterhouse formula”), which allocated a portion of the bank’s total free capital to the PE based on the ratio of the PEs liabilities to the bank’s worldwide liabilities. However, the approach was abandoned after it was opined that it was contrary to the separate enterprise hypothesis as it did not take account of the actual conditions under which branches operated, see Birla, [2005] *BTR* 207 at 214.

<sup>87</sup> *NatWest II* (loc. cit.) at 317.

<sup>88</sup> INTM267702.

<sup>89</sup> See INTM267120.

<sup>90</sup> OECD, *PE Report 2008*, Part I, para. 163.

<sup>91</sup> OECD, *PE Report 2008*, Part I, para. 143.

It sets out a four-step procedure that basically implies the drawing of a (notional) balance sheet (which must not necessarily equal the PE's existing accounts since it serves the mere purpose of calculating the free capital).<sup>92</sup> Tangible and intangible assets (disregarding any revaluations above or below cost) are to be included in these sheets (i.e. attributed to the PE) if it "derives profits" from them (vide supra). In a second step, it is determined how much equity and how much interest-bearing debt has to be assumed in respect to those assets.<sup>93</sup> This step is based on "thin capitalisation principles using an independent banker approach". Furthermore, the capital structure of the non-resident company as a whole and of other UK companies that are comparable is considered. Under the third step, the funding costs (i.e. interest and borrowing costs) payable on the amount qualifying as debt capital in accordance with Step 2 are determined. In a fourth step, the PE's claimed funding costs are adjusted (if differing from the costs calculated under Step 3).

As pointed out above, the legislation expresses a strong preference for the thin capitalisation method. Thus, HMRC opines that it may only be possible to use the capital allocation method (which applies the capital ratio of the company to the PE) in cases where the activities of the PE and the company are sufficiently equal.<sup>94</sup> For the most part, this concept is in accordance with the OECD's opinion, which (particularly under pressure from the UK) neither recommends a single approach to the allotment of capital nor states that all approaches being authorised in the PE Report must be accepted domestically.<sup>95</sup> However, this domestic concept carries some practical difficulties (vide infra).

### **(c) The Practical Implications**

The capital attribution rules are specifically (but not explicitly) relevant for the banking sector. In this respect, the assets of the bank must be risk-weighted in accordance with the FSA regulatory regime.<sup>96</sup> However, under the thin capitalisation approach (vide supra), the capital of the PE does not equal the amount a separate and distinct enterprise would be required to have under the regulations since it is assumed that UK companies would usually have some capital in excess of that amount.<sup>97</sup> Furthermore, whereas the OECD suggests applying the regulatory approach as safe harbour, the UK explicitly refused such a concept,<sup>98</sup> which is why it is necessary to actually find

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<sup>92</sup> INTM267130.

<sup>93</sup> In respect to the allocation of the interest expenses this basically implements the tracing approach, see OECD, *PE Report 2008*, Part I, para. 186.

<sup>94</sup> INTM267140.

<sup>95</sup> OECD, *PE Report 2008*, Part I, para. 124.

<sup>96</sup> INTM 277712.

<sup>97</sup> INTM267701.

<sup>98</sup> See INTM267783.

comparables. However, it is submitted that this task is extremely difficult since basically only the large UK incorporated banks publish their regulatory ratios, which are (in essence) not comparable to the operations of PEs, which will usually be much smaller.<sup>99</sup> Furthermore, it is observed that HRMC tends to simply apply the average ratio of 12% (9% Tier 1 and 3% Tier 2).<sup>100</sup> Therefore, it seems that the thin capitalisation approach is not workable in practice. Moreover, the method can lead to a result where the summed up amount of free capital (considering all parts of the company) is higher than the equity the company (as such) actually has. Therefore, the new legislation on attributing profits to PEs with respect to relief by credit or exemption provides that account has to be taken of the rest of the company (see Section 43(4) TIOPA 2010).<sup>101</sup> This effectively leads to an implementation of the capital allocation (rather than the thin capitalisation) method. It is incoherent that the domestic legislation as to the attribution of capital for PEs situated in the UK does not equally support such an approach (but only under the restrictions set out above).

#### **bb. Calculating the Profit of the Simulated Enterprise**

Hypothesising the PE as a separate and distinct enterprise with its own functions, assets and risks is the basis for the allocation of actual transactions and the recognition of intra-entity dealings (internal transactions; vide supra).

The attributable profit made from actual transactions can usually be directly inferred from the agreements between the parties. This is only with the exception of transaction between related persons, which are subject to adjustments under the transfer pricing legislation.<sup>102</sup> In the context of the OECD MTC, this gave rise to the question of whether the former Article 7 allowed adjustments to the profits of the PE that were made from transactions with related parties (this is to be distinguished from the adjustments under Article 9 in respect to the enterprise as such), which is why the US used to include a specific provision to ensure this possibility.<sup>103</sup> The issue seems to be the same under domestic law since Section 22 CTA 2009 only stipulates that “transactions between the permanent establishment and any other part of the non-UK resident company” are to be treated as taking place at arm’s length. However, as *Hemmelrath* persuasively argued in respect to Article 7, the possibility of adjustments was always inherent in the separate enterprise hypothesis,<sup>104</sup> which is an argument that can be similarly used for the UK’s domestic legislation. Therefore, the amounts attributable to the PE from transactions with related entities must also be at arm’s length. As

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<sup>99</sup> See Long/Hails, [2005] 787 *Tax Journal* 9.

<sup>100</sup> See Long/Hails, [2005] 787 *Tax Journal* 9.

<sup>101</sup> Bell, [2011] *BTR* 425 at 427.

<sup>102</sup> Sections 146 TIOPA 2010 et seqq.

<sup>103</sup> See Hemmelrath, in: Vogel/Lehner, *DTC*, Article 7 para. 7.

<sup>104</sup> See Hemmelrath, in: Vogel/Lehner, *DTC*, Article 7 para. 94.

mentioned above, the same applies to intra-entity dealings, which must be generally recognized (Section 22 CTA 2009).

The demanded application of the arm's length standard requires the use of transfer pricing techniques. However, the domestic legislation on transfer pricing is only legally applicable to transactions between related parties. Hence, transfer pricing principles only come within the scope of Sections 21 and 22 CTA 2009 by way of interpretation.<sup>105</sup> This could lead to the question of whether only the domestic provisions or also the TPGL should be used for interpretation and which one should prevail. However, because of the explicit reference to the latter made by the domestic rules, differences are unlikely to arise.<sup>106</sup> Accordingly, transfer prices (including a profit mark-up) are to be determined in accordance with the general methodology, which includes the application of the traditional methods as well as the profit methods.<sup>107</sup>

As to intra-entity dealings, CTA 2009 provides some exceptions to the general directive of recognizing and valuing them at arm's length. These are set out in the following paragraphs that endeavour to give an overview on the treatment of selected internal transactions.

### **(1) Provision of Goods and Services**

Section 23 CTA 2009 provides that the supply of goods and services to the PE shall only be treated as an intra-entity dealing "if the goods and services are of a kind that the company supplies, in the ordinary course of its business, to third parties dealing with it at arm's length." If this is not the case, the issue is dealt with as an expense, which means that the costs of the goods and services are attributable to the PE if they were incurred for its purposes (vide infra). This is largely consistent with the 2008 OECD Commentary.<sup>108</sup>

Although the wording of Section 23 CTA 2009 does only refer to situations where services and goods are transferred *to* the UK PE, it was persuasively argued that the same principles are applicable (as a matter of interpreting the general rule in Section 22 CTA 2009 in a consistent way) in respect to situations where the UK PE transfers goods and services to other parts of the company (with the consequence that the UK can only include a mark-up in the tax base when the goods and services are of the kind mentioned above).<sup>109</sup> This also implies, that the UK cannot impose any

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<sup>105</sup> INTM267040.

<sup>106</sup> See section 164 TIOPA 2010.

<sup>107</sup> See the examples in INTM267050 et seqq.

<sup>108</sup> See *OECD-Comm. 2008*, Article 7 para. 31 and 35. A slight difference can arise concerning goods, for which the Commentary (also) refers to the purpose of the particular supply, see *OECD-Comm. 2008*, Article 7 para. 33.

<sup>109</sup> See Senior, [2006] *IFA-UK* 665 at 674; similarly Petriccione, in: *Attribution of Profits*, at 368.

mark-ups merely because the main activity of the PE is the provision of services to the enterprise to which it belongs, providing a real benefit to the latter. The Commentary, however, opines for an arm's length remuneration for these so-called "specific services".<sup>110</sup>

## **(2) Internal Transfer of Capital Assets and Intangibles**

As regards the transfer of capital assets from UK PEs to overseas head offices, Section 25(1) TCGA 1992 explicitly states that there is a deemed market value disposal and reacquisition when the respective asset ceases to be a chargeable asset.<sup>111</sup> This is the case when the asset is no longer attributable to the PE in accordance with the principles stipulated in Section 19(3)(c) CTA 2009 (vide supra). Furthermore, for the purpose of capital allowances, equipment is treated as being disposed of either at market value or at the original cost (if the latter is lower), which effectuates a recapture of the difference between the respective value and the written-down value (see sections 61 and 62 CAA 2001 in conjunction with the separate enterprise hypothesis).<sup>112</sup> Accordingly, a transfer from an overseas head office to a UK PE is to be treated as an acquisition at the lower of the market value or the original costs pursuant to Section 13 CAA 2001.<sup>113</sup>

The 2008 OECD Commentary basically does not deal with the category of capital assets as such.<sup>114</sup> It only indicates that a mere temporary transfer of machinery is not assumed to constitute a dealing (i.e. only an allocation of costs is permissible).<sup>115</sup> However, from this statement it can be inferred that the general position is that all permanent transfers should be remunerated at arm's length (*argumentum e contrario*).<sup>116</sup> The UK's domestic provisions are in accordance with the Commentary interpreted that way.

As regards intangibles, Section 859(2)(b) CTA 2009 stipulates that the internal transfer from the UK PE to the overseas head office is to be treated as a deemed market value disposal and reacquisition for the purposes of corporation tax.<sup>117</sup> On the other hand, if an asset begins "to be held for the purposes of a trade carried on by the company in the United Kingdom through a permanent establishment" the asset is treated as acquired at its net book value (see Section 863 CTA 2009).<sup>118</sup>

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<sup>110</sup> *OECD-Comm. 2008*, Article 7 para. 36.

<sup>111</sup> Bramwell, *Taxation of Companies*, para. P1.1.9.

<sup>112</sup> Petriccione, in: *Attribution of Profits*, at 368.

<sup>113</sup> Petriccione, in: *Attribution of Profits*, at 369.

<sup>114</sup> See Russo, [2004] *BIFD* 472 at 478; Plansky, *Gewinnzurechnung*, at 164.

<sup>115</sup> *OECD-Comm. 2008*, Article 7 para. 33;

<sup>116</sup> Plansky, *Gewinnzurechnung*, at 164

<sup>117</sup> CIRD10200.

<sup>118</sup> CIRD10200; Petriccione, in: *Attribution of Profits*, at 369.



The 2008 OECD Commentary rather seems to reject such taxation since it assumes an (exclusive) allocation of intangibles to be practically impossible.<sup>119</sup>

### **(3) Interest and Royalties**

Sections 31(1) CTA 2009 denies the recognition of internal royalties or similar payments made for the use of intangible assets by the PE. However, Section 32(2) explicitly states that this “does not prevent a deduction for any contribution by the permanent establishment to the costs of creation of an intangible asset”. Although the legislation only covers the case of payments made by the PE to the overseas head office, the same should apply as a matter of consistency to payments made by the head office to the UK PE,<sup>120</sup> which can be effectuated by an according interpretation of Section 22 CTA 2009. This is largely consistent with the 2008 OECD Commentary.<sup>121</sup>

Section 32(2) CTA 2009 states that internal interest payments and other financing costs made by the PE are not deductible (i.e. are not recognized as an internal transaction) unless they are paid “in the ordinary course of a financial business carried on” by the PE. As in the context of royalties, this prohibition should also apply the other way around by construing Section 22 CTA 2009 accordingly. Section 32 CTA 2009 also complies with the 2008 Commentary.

### **(4) Other Dealings**

Furthermore, internal dealings on loans in order to guarantee the creditworthiness of another part of the company are not accepted due to the assumption of Section 21(1)(a) CTA 2009 that both have the same credit rating (vide supra).<sup>122</sup> Besides, no explicit prohibition of intra-entity dealings is prescribed in the legislation. Therefore, the separate enterprise principle will apply to those dealings, which means that a transfer price (including a profit mark-up) has to be determined.

### **(5) Deductible Expenses**

Although some internal transactions are disregarded, the *actual* costs the enterprise suffered are generally deductible for the PE to the extent they were incurred for its purposes and a deduction would be permissible if the PE was a company (see Section 29 CTA 2009). In that regard it does not matter where the expenses arose or whether or not they were reimbursed by the PE. The section makes it clear that this approach also applies to executive and management expenses. However, with regard to the deductibility of interest expenses, the limit imposed by the attribution of interest-

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<sup>119</sup> See *OECD-Comm. 2008*, Article 7 para. 34.

<sup>120</sup> See Petriccione, in: *Attribution of Profits*, at 370.

<sup>121</sup> See *OECD-Comm. 2008*, Article 7 para. 34.

<sup>122</sup> *OECD-Comm. 2008*, Article 7 para. 41 et seqq.

free capital has to be taken into account (see Section 30 CTA 2009), which means that the deduction, even of actual interest, is denied to the extent to which the underlying loan is treated as part of the PE's equity (see the explanations above for the calculation). The rules largely reflect the opinion of the OECD in the 2008 Commentary, in which (in the course of the 2008 update) also explicit recommendations on capital attribution were included.<sup>123</sup>

## **(6) Conclusion**

The recognition of internal dealings under UK law and the regime as regards expenses is for the most part in compliance with the OECD Model 2008. The difficulties as to the (internal) transfer of intangibles are illustrated above. The UK did not implement the “specific services” concept, the OECD uses in its Commentary. However, practically, the latter point will not be of huge significance. Unfortunately, the UK rules are drafted in a very one-sided manner since they (according to their wording) only prohibit deductions to be made at arm's length but do not explicitly deal with the taxation of, for example, internal services provided by the PE to other parts of the company. Although a consistent result can be deduced on the basis of a restrictive interpretation of the separate enterprise principle in Section 22, this way of drafting is not very persuasive.<sup>124</sup>

## **f. The Current State of Play**

The UK's domestic rules on attribution of profits to PEs of non-UK resident companies (including the concept of PE as such) seem to be “somehow in between”. On the one hand, they are largely based on the OECD's concept prior to 2010. However, this also implies that some of the inconsistencies that were already included in the OECD Model are transferred to the level of domestic law. This specifically concerns the lists in Section 1141(2) and 1143(3) CTA 2010 and the restrictions that apply on the separate enterprise thinking. Similar to the OECD's approach, UK domestic law supports neither a full FSEA nor a full RBAA but applies a mixture of both. In particular, it is conceptually questionable to allow the exclusive allocation of intangibles for the purpose of taxing their cross-border transfer within the single entity but deny the deduction of royalties at arm's length. On the other hand, the OECD's concept is not implemented word for word, which is largely to the advantage, but to some extent also to the disadvantage, of comprehensibility and consistency. The rule in Section 22 CTA 2009, which explicitly states that internal transactions shall be recognized, renders the situation as to the degree of independence that the PE is assumed to have under domestic law much clearer than does the old version of Article 7

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<sup>123</sup> *OECD-Comm. 2008*, Article 7 para. 45 et seqq.

<sup>124</sup> Similarly Petriccione, in: *Attribution of Profits*, at 369.

OECD MTC does for the purpose of treaties, which is why it substantially increases legal certainty. However, the concept of attributing assets is drafted in a far more complex way than necessary. Additionally, the wording of the restrictions as to the recognition of dealings does rather compromise the comprehensibility of the UK's concept.

Moreover, the inner consistency of UK law is also affected by the implementation of the new concept as regards the allocation of profits to PEs of UK resident companies for the purpose of relief under TIOPA 2010. While the former approach for calculating the credit referred to the rules discussed in this paper, new Section 43 TIOPA 2010 incorporates a system that is basically separate from Chapter 4 of Part 2 CTA 2009. The new regime is essentially based on the OECD Model 2010 and does not contain the restrictions on dealings that are applicable in respect to the inbound situation (non-UK resident company trading in the UK).<sup>125</sup> It also provides support for the capital allocation method for computing the amount of equity the PE is deemed to have for tax purposes, which is (from a practical point of view) easier and in many cases more reliable than the thin capitalisation method, which largely depends on the accessibility of comparables.

Further complications arise when treaties are applicable (especially when they are based on the OECD Model 2010). The following paragraphs endeavour to illustrate the respective issues.

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<sup>125</sup> Additionally, Section 18A(6)(b) and (7)(b) CTA 2009 determine that (in a first step), for the purpose of attributing profits/losses for calculating the amount under the exemption regime, the 2010 Model is assumed to be applicable for non-full treaty territories.

### III. The Impact of Double Tax Conventions

#### 1. The Status of Tax Treaties under UK Domestic Law

##### a. Incorporation

The outcome reached by applying domestic rules and principles is generally subject to the provisions of double tax conventions. Since the UK considers national and international law as being separate from each other (dualist theory), DTCs only influence the legal position of taxpayers to the extent an incorporation or transformation into domestic law has occurred (although the agreement is binding on the state *as subject of international law* from the moment of ratification).<sup>126</sup> As a matter of simplification, tax treaties are usually implemented by means of delegated legislation.<sup>127</sup> Section 2 TIOPA 2010 states that a DTC on income, corporation and capital gains tax (inter alia) has effect pursuant to Section 6 TIPOA 2010 if Her Majesty issues an Order in Council (after a draft of the Order has been approved by the House of Commons in accordance with Section 5 TIOPA 2010) declaring that a DTC has been made “with a view to affording relief from double taxation” and “that it is expedient that those arrangements should have effect.”<sup>128</sup> Section 6(2) TIOPA 2010 provides an exhaustive list that determines in which regard(s) effect is given to DTCs to which such an Order in Council refers. This is (inter alia) the case

“(e) for determining the income or chargeable gains to be attributed to agencies, branches or establishments in the United Kingdom of non-UK resident persons [...].”

Section 6(1) TIOPA 2010 stipulates that the effect conceded by these provisions is given “despite anything in any enactment”. Hence, to the extent the PE definitions and rules on profit attribution embedded in UK DTCs are narrower than the domestic provisions set out above, they restrict the taxing rights that would arise in accordance with the latter.<sup>129</sup> Although in dualist systems the (incorporated) treaty rules are subject to potential treaty overrides by domestic law, this is of no particular relevance in the current context since it would require (at least from the UK perspective) a clear intention of the legislator to render the respective treaty provisions inapplicable, which was obviously not the purpose of the implementation of the domestic PE definition and the attribution system in 2003.<sup>130</sup>

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<sup>126</sup> See Harris/Oliver, *International Commercial Tax*, p. 21.

<sup>127</sup> Baker, *DTC*, Introductory Topics, para. F.03.

<sup>128</sup> Technically, Section 2 et seqq. TIOPA 2010 do not confer the power on Her Majesty to issue an “Order in Council”, which can rather be made in exercise of the royal prerogative, but impose certain conditions and procedures that must be adhered to in order to trigger the effect specified in Section 6 TIPOA 2010 (i.e. an Order would be valid even without the approval prescribed in Article 5 TIOPA 2010 but not effective pursuant to Section 6 TIOPA 2010), see Roxan, in: Maisto, *Tax Treaties and Domestic Law*, p. 318 et seq.

<sup>129</sup> See Schwarz, *Tax Treaties*, p. 19.

<sup>130</sup> See for the requirement of a “clear intention of the legislator to override the treaty” Miller/Oats, *International Taxation*, para. 7.4. with further references.

## **b. Can Double Tax Conventions Impose or Increase Taxation?**

The question that arises in respect to the attribution of profits to PEs is rather whether or not treaties can impose taxes by virtue of a treaty notion of PE that is wider than the one in Section 1141 et seqq. CTA 2010 (i.e. impose taxes where domestic law does not provide for taxation) or whether or not they can increase an existing domestic tax liability on the grounds of treaty principles on profit allocation that differ from those in Section 19 et seqq. CTA 2009.

On an international level, the matter is controversial. While the *Hoge Raad* in the Netherlands tended to assume that treaties might also work to the disadvantage of the taxpayer, the prevailing opinion in most countries seems to be that they cannot impose taxes or increase an existing tax liability.<sup>131</sup> However, the question cannot be answered universally but depends first and foremost on the domestic law of the state at issue. DTCs have the purpose of avoiding double taxation that could arise when states would exercise their jurisdiction to tax that they have by virtue of their sovereignty.<sup>132</sup> They do not confer taxing rights upon the Contracting States but seek to impose limits on the possibility of exercising the national tax jurisdiction.<sup>133</sup> Accordingly, they are (as such) not designed to provide a legislative basis for imposing or increasing taxation, which is why (separate) domestic rules are required that clearly specify whether and to which extent taxes are levied. However, this does not prevent the national legislator from including provisions that automatically extend taxation to the limits defined in a country's DTCs.<sup>134</sup>

At first glance, it appears arguable that Section 6(2)(e) TIOPA 2010 replaces the domestic rules on attribution of profits to permanent establishments with the respective treaty rules for the purpose of determining the basis for corporation tax.<sup>135</sup> Indeed, the Revenue tried to apply a similar reasoning to transfer pricing, for which it referred to what is now Section 6(2)(f) TIOPA 2010, so as to render the equivalents of Article 9 OECD MTC of the UK's DTCs directly applicable for adjusting the taxable income of associated enterprises since the treaty rules appeared to go further than the domestic provisions.<sup>136</sup> Although the approach found some approval in literature due to the wording "double tax agreements have effect [...] for determining the income" (see Section 6(2)(f) TIOPA

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<sup>131</sup> See Baker, *DTC, Introductory Topics*, para. B.02 et seqq. with references to the decisions of the Hoge Raad.

<sup>132</sup> See Vogel, in: Vogel/Lehner, *DTC*, Introduction, para. 71. This does not preclude that DTCs also aim at preventing fiscal evasion, see *OECD-Comm. 2008*, para. 16; Schwarz, *Tax Treaties*, p. 4.

<sup>133</sup> Vogel, in: Vogel/Lehner, *DTC*, Introduction, para. 71.

<sup>134</sup> See Baker, *DTC*, Introductory Topics, para. B.05.

<sup>135</sup> A similar effect could be assumed in respect to Section 6(2)(b), see Schwarz, *Tax Treaties*, p. 15.

<sup>136</sup> See Hohlfeld, *DBA*, p. 66.

2010),<sup>137</sup> the Revenue eventually dropped this reasoning when cases concerning the issue were likely to reach the courts.<sup>138</sup> This is persuasive taking into account the words “with a view to affording relief from double taxation” in Section 2(1) TIOPA 2010, which clearly expresses the (limited) impact and relevance of treaties for the purposes of UK law. Accordingly, the legislation does not confer the power to impose or increase taxes by implementing DTCs.<sup>139</sup> Contrarily, taxes may only be imposed by the issuance of an explicit domestic provision by Parliament.<sup>140</sup> This result does not conflict with the decision in *Union Texas Petroleum Corporation v Critchley*, where the court found a treaty rule that provided for a 5% deduction on a tax credit on dividends to be permissible. Economically, the charge represented (a part of) the domestic income tax, which is why the treaty as such did not impose a tax.<sup>141</sup>

### c. Conclusion

Tax treaties (or, more precisely, implemented or transformed tax treaties) impose limits to domestic taxation, which the taxpayer can invoke to mitigate his tax burden and which (generally) prevail over domestic provisions. On the other hand, DTCs do not (at least in the UK) provide a basis for imposing or increasing taxes. However, this leads to an asymmetric effect, which specifically becomes apparent in case of treaties based on Article 7 of the OECD Model 2010 (vide infra).

## 2. The Interpretation of Tax Treaties

Before turning to these aspects, it shall be briefly illustrated which status the OECD Commentary has for interpreting treaties that are based on the Model, since most parts of the OECD’s concepts are explained in this document rather than being explicitly formulated in the Model. Referring to *IRC v Commerzbank*<sup>142</sup> and *Memec*,<sup>143</sup> the Commentary is often assessed as supplementary material within Article 32 of the Vienna Convention.<sup>144</sup> However, in the *Smallwood* case, the Special Commissioners conceded a more elevated status to it by considering the document as establishing the special meaning within Article 31(4) of the Vienna Convention.<sup>145</sup> This is persuasive since treaty negotiations that are based on the wording of the OECD Model usually

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<sup>137</sup> Oliver, [1970] *BTR* 345 at 398.

<sup>138</sup> Oliver, [1998] *BTR* 1 et seqq.

<sup>139</sup> Equally Oliver, [1998] *BTR* 1 at 2.

<sup>140</sup> See Baker, *DTC*, para. B.05.

<sup>141</sup> Similarly Schwarz, *Tax Treaties*, p. 16.

<sup>142</sup> See *IRC v Commerzbank*, [1996] *STC* 285 at 298.

<sup>143</sup> *Memec plc v Commissioners of Inland Revenues*, [1996] *TC* 77 at 93.

<sup>144</sup> See Schwarz, *Tax Treaties*, p. 74.

<sup>145</sup> *Smallwood v Revenue and Customs Commissioners*, [2008] *STC* (SCD) 629 at 651.

take account of the interpretation of that wording given to it by the OECD.<sup>146</sup> However, in *Commerzbank* it has also been made clear that subsequent Commentaries (i.e. versions of the Commentary the OECD published after the treaty at issue was concluded) only have persuasive value.<sup>147</sup> Obviously, new explanations cannot form part of a historical approach to interpretation (and, therefore, cannot be regarded as being part of the “special meaning” the negotiators wanted to give to the wording of the Model). Furthermore, such amendments of the Commentary do not fall within Article 31(3)(a) Vienna Convention, which requires a contractual agreement.<sup>148</sup> Article 31(3)(b) of the Convention demands (at least) a considerable time of subsequent practice, which must suffice to constitute an *opinio juris* (i.e. a settled opinion of courts and administration).<sup>149</sup> Hence, the Commentary that was in force when the treaty was concluded has to be taken into account as being the “special meaning” of the words used in the treaty while subsequent Commentaries only have persuasive value.

### 3. Treaties Based on the Old OECD Approach

Since the 2008 Commentary and domestic law are largely consistent, treaties concluded after 2008 on the old version of the Model will usually not give rise to any particular deviations of treaty law from UK domestic law (vide supra). However, some more issues may arise where treaties were negotiated on the basis of older Commentaries. Although the OECD regards the amendments made to the document in 2008 as being of purely clarifying nature that does not entail any “true” differences to the prior version, the 2008 Commentary obviously contains concepts that were not applicable before.<sup>150</sup> This specifically becomes apparent as to the attribution of capital, for which now the application of the capital allocation or thin capitalisation method is prescribed, which was not the case before. Indeed, both methods were rejected on the grounds of the separate enterprise principle in *NatWest*. To the extent, that courts construe older treaties to be based on such a rather narrow conception of independence, those treaties will override the domestic provisions (e.g. disregard the domestic concept of capital attribution).

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<sup>146</sup> See Schwarz, *Tax Treaties*, p. 74.

<sup>147</sup> See *IRC v Commerzbank*, [1996] STC 285 at 298.

<sup>148</sup> See in detail Lang, [2011] *IWB* 281 at 282.

<sup>149</sup> Lang, [2011] *IWB* 281 at 284.

<sup>150</sup> See for a comprehensive comparison Plansky, *Gewinnzurechnung*, p. 245 et seqq.

#### **4. The 2010 Model**

With the 2010 Model, the OECD took the next step in implementing the AOA and amended Article 7 OECD MTC as well as the Commentary and the Report on Attribution of Profits to Permanent Establishments, to which the Commentary extensively refers for the purpose of interpreting the new business profits article. While the OECD considered the wording of Article 7 OECD MTC 2008 to be wedded to its opinion expressed in the Commentary prior to 2010 and, thus, held the Article to be unsuitable for applying the FSEA to its full extent, the new version provides the required basis for the new thinking. Therefore, the limitations in respect to the degree of hypothesised independence of the PE that were acknowledged under the 2008 cluster (due to the fact that the PE is only part of a single enterprise and not a legal entity itself) are repudiated under the 2010 approach.

##### **a. The PE Concept**

The wording of Article 5 OECD MTC did not change with the 2010 update. Furthermore, the OECD made it clear that the AOA does not entail any changes to the PE concept as such.<sup>151</sup> Therefore, the conclusions in respect to the compliance of the UK's domestic rules on the notion of PE with the OECD's 2008 cluster are equally valid in respect to the 2010 Model (vide supra).

##### **b. Hypothesising the Separate Enterprise**

The starting point for attributing profits to PEs is the same as under the 2008 cluster – the PE must be simulated as a separate and independent enterprise (formerly “distinct and separate”) which performs its own functions, bears its own risks, (economically) possesses its own assets and has its own capital (i.e. “equity”).<sup>152</sup> Since this idea was already (partly) embedded in the “old” OECD thinking that was adopted by the UK, the dogmatic and theoretical framework of the domestic rules is (to basically the same extent to which the 2008 Commentary complies with the 2010 Model) in accordance with the 2010 cluster. The 2010 concept also brings along a consistent concept on the allocation of intangibles. In general terms, the attribution is made subject to the significant people functions (the SPF concept is basically already applied in UK law; vide supra) that assume the underlying risks of the intangible assets. For tangibles on the other hand, the “place of use” is usually the decisive criterion. As regards free capital, the OECD recommends (as it did in the 2008 Commentary) the application of a thin capitalisation or a capital allocation approach (further methods are discussed for banking businesses).<sup>153</sup>

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<sup>151</sup> See e.g. OECD, *PE Report 2010*, Preface, para. 9.

<sup>152</sup> The change in the wording from “distinct and separate” under the 2008 Model to “separate and independent” appears to be an attempt to highlight that the FSEA should be applicable.

<sup>153</sup> OECD, *PE Report 2010*, Part II, para. 85 et seqq.



### **c. Calculating the Profit of the Hypothesised Enterprise**

As under the 2008 Model, the profits of the permanent establishment consist of its transactions with related and unrelated companies and its dealings with other parts of the company. Under the OECD MTC 2010, generally all internal dealings must be recognized and valued at arm's length to the extent they are based on an identifiable economical event.

Accordingly, the restrictions as to the provision of service and goods that were contained in the 2008 Model (vide supra) are no longer applicable (i.e. it has no longer to be determined whether or not the goods or services relate to the ordinary course of the company's business).<sup>154</sup> The arm's length principle also applies to the provision of executive and general administrative services (e.g. accounting), transfers of assets (whether tangible or intangible) and internal royalties.<sup>155</sup> With regard to intra-entity interest payments, the OECD is still reluctant (basically because of the possibilities of abuse).<sup>156</sup> However, even these payments are acknowledged when the "loans" are provided by a part of the company that performs a real treasury function (i.e. it must not only occasionally equip the other parts of the company with money but must be generally responsible for raising and providing credit).<sup>157</sup>

Since the UK's domestic position complies for the most part with the 2008 Commentary, these amendments at the OECD level have created a situation where UK domestic law is in conflict with the OECD's approach. Specifically, the restrictions contained in Sections 23, 29, 31 and 32 CTA 2009 (vide supra) are not in accordance with the recent concept. As to the transfer of tangible assets, no significant differences arise while the domestic position in respect to intangibles appears to be broader than the OECD's (specifically because of the application of the "place of use" test under UK law; vide supra).

### **d. The Implications of Treaties Based on the OECD MTC 2010**

On the one hand, the current provisions contained in Chapter 4 of Part 2 CTA 2009 extend the scope of taxation that would arise on the basis of an unlimited application of the separate enterprise principle by stipulating that certain categories of internal transactions are to be disregarded and do not give rise to a deduction. Instead, only a share of the actual costs the enterprise has incurred as a whole is allocated to the PE (vide supra). This specifically relates to royalties, interest and the provision of goods and services (including administrative and management services). Since the

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<sup>154</sup> See Bobbet/Avery Jones, [2010] *BIT* 20 et seqq.

<sup>155</sup> See Reimer, in: Reimer, *PE*, OECD MTC, para. 131 et seqq.

<sup>156</sup> Plansky, *Gewinnzurechnung*, p. 209.

<sup>157</sup> Plansky, *Gewinnzurechnung*, p. 209.

OECD Model 2010 determines that even these dealings must be generally recognized, this extension of the domestic tax base would not be in accordance with the business profits articles in actual treaties based on the new MTC.<sup>158</sup> Pursuant to Section 6(1) TIOPA 2010, DTCs have effect “despite anything in any enactment”, which is why implemented treaties generally impose limits to the taxing rights exercised by domestic law. Consequently, the DTC would override the domestic provisions and the UK would need to grant deductions for the above-mentioned dealings at arm’s length.

On the other hand, domestic law also ignores dealings for the purpose of taxing profits that would potentially arise from such intra-entity transactions under the separate enterprise principle of the 2010 Model. Accordingly, (inter alia) internal royalty payments or service fees received by the PE are not taxable domestically. Furthermore, as set out above, treaties can neither impose nor increase taxation. Section 6(2)(e) TIOPA 2010 (in conjunction with the respective DTC) does not provide a basis for exercising taxing rights, which can only be done through explicit domestic rules. In other words, the additional taxing rights that the OECD MTC 2010 leaves to the UK (compared to the 2008 Model) are currently not effectuated.

Without an according amendment of domestic law, this asymmetric result (deduction for dealings in respect to which the PE is (economically) the payer but no taxation on amounts received by the PE as supplier) has the potential to result in a substantial decrease in Revenue. Other countries have similar issues in respect to the new OECD Model and have started revising their domestic provision in order to give effect to the additional rights before enacting treaties on the basis of the 2010 Model.<sup>159</sup>

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<sup>158</sup> The Commentary makes it clear that the general recognition of dealings (including the refusal to grant a deduction because of their nature as intra-entity transactions) is (also) a matter of Article 7 rather than (only) of Article 24(3) OECD MTC 2010 (see *OECD-Comm.* 2010, Article 7, para. 31). Therefore, the (contentious) extent to which the non-discrimination article is incorporated in UK law is of no particular relevance in the present context. See generally, in respect to the incorporation of Article 24(3) OECD MTC 2010, Avery Jones, in: Maisto, *Tax Treaties and Domestic Law*, Ch. 6, p. 135 and Baker, *DTC*, Article 24, para. 24B.26 with further references to the relevant case law.

<sup>159</sup> See e.g. Section 1 AStG as proposed by the German government in its draft for the Annual Tax Act 2013 ([http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetzentwuerfe\\_Arbeitsfassungen/2012-05-23-jahressteuergesetz-2013.html](http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetzentwuerfe_Arbeitsfassungen/2012-05-23-jahressteuergesetz-2013.html)).

## 5. Proposed Amendment

However, it should be noted that all UK treaties currently in force are based on the 2008 Model.<sup>160</sup> Only the new DTCs with Barbados (signed on 26 April 2012) and Liechtenstein (signed on 11 June 2012) are based on the new version of Article 7 OECD MTC. However, neither treaty has so far been incorporated. Therefore, a revision of the domestic rules seems not to be too urgent at the moment. Furthermore, the clash of domestic provisions based on the assumptions in the 2010 Model and a treaty based on the 2008 version could also result in contradictions. The taxing rights as to intra-entity royalties, interest and services (inter alia) that domestic law would endeavour to exercise would be restricted by the only limited independence of the PE assumed in the 2008 MTC. On the other hand, the domestic provisions would also give deductions for the mentioned dealings at arm's length, which would not be required under a treaty based on the old Model. Furthermore, domestic law could not restrict this grant by referring to the treaty since this would also result in the DTC increasing the tax burden.<sup>161</sup> Again, the result would be an asymmetric effect that could compromise the amount of revenue.

Accordingly, a domestic provision that endeavours to bring about a consistent outcome under the 2010 as well as under the 2008 Model has to be drafted two-pronged. While maintaining the general rules currently contained in Chapter 4 of Part 2 CTA 2009, this could be effectuated through the implementation of a provision like the following:

- (1) To the extent a double tax agreement based on the OECD Model Tax Convention as amended in 2010 is applicable,
  - (a) the limitations on the recognition and valuation of transaction between the permanent establishment and any other part of the non-UK resident company stipulated in Section 23, 31 and 32 do not apply and
  - (b) this part is to be read in such a manner as best secures consistency to the OECD Commentary as amended in 2010 and the Report on the Attribution of Profits to Permanent Establishments as amended in 2010.

Such a rule would allow exercising the full taxing rights under the 2008 and 2010 Models and could also ensure a consistent interpretation of treaty and domestic law to the extent a DTC based on the 2010 MTC is in force.

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<sup>160</sup> See Baker, [2011] *BTR* 626 at 626.

<sup>161</sup> The rejection of a deduction equates to the imposition of an additional charge. This is the reason why Vogel even considers that the refusal to deduct losses in the context of the exemption method (justified with the principle of symmetry) is inadmissible on the grounds that a treaty may not increase taxation, see Vogel, in: Vogel/Lehner, *DTC*, Article 23A/B, para. 48.

#### **IV. Conclusion**

The UK's domestic provisions on the attribution of profits in inbound situations (foreign company trading in the UK through a PE) are for the most part in accordance with the former Article 7 OECD MTC and the Commentary as amended in 2008. At first glance, this is quite surprising, taking into account that the UK had already issued its domestic provisions in 2003 while the work of the OECD was only finalized with the PE Report in 2008. Specifically the implementation of the capital attribution concept and the assumption that all parts of the enterprise have the same credit rating are significant anticipations of central aspects of the AOA. On the other hand, it illustrates how large the influence was that the UK presumably had on the development of the OECD's concept.

Unfortunately, the implementation of that concept also transferred some of the flaws of the OECD approach under the 2008 Model on the level of domestic law. This regards the PE concept as well as the attribution rules as such. Although the separate enterprise principle and the general recognition of dealings are explicitly prescribed in Chapter 4 of Part 2 CTA 2009, a consistent application is (in the same manner as under the OECD Commentary) prevented by the stipulation of certain restrictions. However, notwithstanding that this leads to a result that is not conceptually consistent, it has the advantage of approximating the outcomes of treaty law and domestic law. This basically ensures that the UK can currently exercise all taxing rights it is allowed to exercise under its treaties, all of which are based on the old OECD Model. Only two of the DTCs recently concluded apply the new version of Article 7 OECD MTC. However, those treaties have not yet come into force. Presumably, it will take time for the 2010 concept to become significant in the quite large treaty network since it cannot be effectuated without (time-consuming) renegotiations. Furthermore, many states are still reluctant to use the new Article (many developing countries because they fear an erosion of their source taxing rights, and some developed countries because their domestic law is not yet adjusted to the new concept). Therefore, it seems not yet to be necessary or advisable to adopt the domestic rules as the principal (and sole) domestic concept.

Nonetheless, if treaties enter into force, which are based on the new thinking, it would be expedient to implement an alternative provision that provides for the required taxing rights. Such a rule would have to render the restrictions on the separate enterprise thinking under the current provisions inapplicable and must provide for an interpretation consistent with the OECD Commentary 2010. A respective proposal was made above. This would also have the advantage of increasing the consistency with Section 43 TIOPA 2010 (attribution of profits in the outbound situation) that has already relinquished the mentioned restrictions.

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