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The Relationship of Head Office and Its Foreign Permanent Establishments: The Current State of the Authorised OECD Approach – Part One

Part One of this two-part article reviews permanent establishment (PE) taxation by examining the development, purpose and mixed reception of the Authorised OECD Approach (AOA) across major jurisdictions, highlighting the limited consensus achieved and how the AOA has impeded further work on the attribution of profits to PEs.

1. The Authorised OECD Approach at a High Level

1.1. Introduction

The taxation of permanent establishments (PEs) and the interpretation of article 7 of the Organisation for Economic Cooperation and Development (OECD) Model[1] had been subject to significant variations in OECD member states in the 20th century. Indeed, many states had adopted different approaches in their domestic laws, resulting in the use of several methods of profit attribution.[2] This lack of uniformity in the application and interpretation of article 7 could lead to situations of double taxation or non-taxation.

In order to try to achieve a consensus in this area, the OECD decided in the late 1990s to examine how the principles developed in the 1995 OECD Transfer Pricing Guidelines (TPG)[3] should apply in the context of the relationship between a PE and the rest of the enterprise to which it belongs and ultimately produced the Authorised OECD Approach (AOA) for the attribution of profits to PEs as the solution.

This article will review the AOA, which is now around 20 years old. In this section, the authors will describe the AOA at a high level, review its purpose and history including the alternative approaches (which it rejects) and the results under the different approaches. In the following section, the authors will look at the reception of the AOA in the states represented here (Australia, Canada, France, Germany, India, Italy, Japan, the Netherlands, South Africa, Sweden, Switzerland, the United Kingdom and the United States) and how it has impeded further work on the attribution of profits to PEs. In Part Two of the article, the authors will begin the third section by considering what the AOA changed on the ground in more detail with a focus on the free capital of banks, and the fourth section will look at concerns around the lack of symmetry it produces compared to the tax treaty treatment of separate associated enterprises covered by the TPG, with the conclusion and future possibilities for change in the fifth section.

The authors emphasize that the states of the authors are by no means generally representative of the world at large, all being OECD members except for India and South Africa. Our main goals in the article are to demonstrate that –

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1. OECD, *Model Tax Convention on Income and on Capital*, 2017 Condensed Version [hereinafter *OECD Model* (2017)].

2. Evidence of this variety is found in the branch reports for IFA Cahiers de Droit Fiscal International, *The attribution of profits to permanent establishments* (vol. 91B, SDU 2006).

3. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), Primary Sources IBFD [hereinafter TPG]. The TPG have been updated 16 times up to 2022, *see* TPG (2022), pp. 3-5 and a further update was approved in 2024, OECD, *Pillar One - Amount B: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project* (2024), pp. 10-49, which adds an Annex to ch. IV of the TPG entitled "Special considerations for baseline distribution activities". The authors refer to the 2022 version unless indicated otherwise.

even among this less-than-representative group of states – the OECD has not achieved its desired consensus and that there are structural problems in the rules adopted by the OECD, not to mention political problems, which have been highlighted by the subsequent OECD Base Erosion and Profit Shifting (BEPS) Project.[4]

1.2. Outline of the AOA

The AOA is based on the aspiration that the profits to be attributed to a PE are those that the PE would have earned at arm's length – in particular in its dealings with other parts of the enterprise – if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and the other parts of the enterprise.[5]

The AOA has two main elements:
(1) the functionally separate entity (FSE) approach treats the PE, for the purposes of attribution of profits, as a functionally separate entity from the rest of the enterprise; and
(2) a two-step analysis is used for the attribution process.

The 2010 OECD Report summarizes these two steps as follows:[6]

> Step One
>
> A functional and factual analysis, leading to:
>
> – The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;
>
> – The identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the PE;
>
> – The identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the PE;
>
> – The identification of other functions of the PE;
>
> – The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognized, having passed the threshold test; and
>
> – The attribution of capital based on the assets and risks attributed to the PE.
>
> Step Two
>
> The pricing on an arm's length basis of recognized dealings through:
>
> – The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and
>
> – Selecting and applying by analogy to the guidance in the Guidelines the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

Under the first step, a functional and factual analysis is undertaken to assess the income creation capacity of a PE as a separate and independent enterprise engaged in the same or similar activities, by considering the functions performed, the assets used and the risks assumed by that PE. On the last point in Step One, it is worth noting that it is necessary to determine how much of the enterprise's equity capital is needed to cover those assets and to support the risks assumed. This process implies, first, to measure the risks and value the assets attributed to the PE and then to determine the equity capital needed to support the risks and assets attributed to the PE.[7] Then, under the second step, the profit attributable to the PE is determined by the arm's length principle.[8] Thus, when the AOA is fully applied, assets are attributed to the PE as if it is the owner of these assets separately from the rest of the enterprise, and a similar approach is taken for risks.

The AOA permits the characterization of the head office (or rest of the enterprise) and the PE as two separate enterprises, but only for the purposes of the source state's right to tax and the residence state granting double taxation relief on the income of the PE, and not for the purposes of acknowledging the head office's own profit as distinct from the PE's profit.[9] This is made clear in the text of the current article 7(1)-(2), set out as in Table 1, compared with the previous version.[10]

1.3. Purpose and history of the AOA

The arm's length principle underlying both article 7 and article 9 is based on the same policy. Related enterprises are treated like unrelated enterprises to prevent biasing choices between insourcing and outsourcing, etc., by applying the arm's length (market terms) principle to related enterprises.[11] PEs are treated like separate enter-

4. The authors do not consider in this article Pillar One and Pillar Two of the second part of the BEPS Project, which produces further issues in relation to attribution of profits to PEs. The OECD Transfer Pricing Profiles available at https://www.oecd.org/en/topics/sub-issues/transfer-pricing/transfer-pricing-country-profiles.html, which were originally published in 2021-2022 and are being updated progressively from mid-2025, give a high-level view of 78 states' approaches to the AOA, including the states represented here (*see* questions 30 and 31 in the 2021-2022 versions and questions 43-45 in the 2025 versions). The Profiles express the view of the various states' governments, which may not fully accord with case law and non-government views.
5. OECD, *Report on the Attribution of Profits to Permanent Establishments* para. 8, p. 12 (OECD 2010), Primary Sources IBFD [hereinafter 2010 Report], paraphrasing the language of art. 7(2) of the *OECD Model* (2010). The 2010 Report related to the art. 7 of the Model as altered in 2010. Its substantive content was substantially the same as OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2008), Primary Sources IBFD [hereinafter 2008 Report], which related to art. 7 as it stood prior to the 2010 changes and explained as well the provisions of art. 7 that were omitted in the 2010 version of art. 7.
6. 2010 Report, Pt. I, para. 44, p. 21.
7. 2010 Report, Pt. I, para. 107, p. 35.
8. 2010 Report, Pt. I, paras. 57-59, pp. 24-25.
9. P. 181 *OECD Model: Commentary on Article 7(28)* (2017).
10. *OECD Model* (2017), p. 199 (art. 7 version in 2008 Model), pp. 33-34 (art. 7 as modified in 2010). The main differences are in italics. The point made here applies to both versions of art. 7(2) but is explicit in the text of the 2010 version in the introductory words whereas, for the pre-2010 version, it is implied by the words "in each Contracting State".
11. TPG, para. 1.8, p. 32.

Table 1. Comparison of previous and current article 7(1)-(2)

Article 7 pre-2010	Article 7 since 2010
1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, *the profits of the enterprise* may be taxed in the other State *but only so much of them as is attributable to that permanent establishment*.	1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, *the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2* may be taxed in that other State.
2. *Subject to the provisions of paragraph 3*, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were *a distinct and separate enterprise* engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.	2. *For the purposes of this Article and Article [23 A] [23B]*, the profits that are attributable in each Contracting State to the permanent establishment *referred to in paragraph 1* are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were *a separate and independent enterprise* engaged in the same or similar activities under the same or similar conditions, *taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment* and through the other parts of the enterprise.

prises to prevent biasing choices between using PEs and separate (related) enterprises by treating the PE as, in effect, an enterprise separate from the rest of the enterprise and applying the arm's length principle between the PE and the rest of the enterprise or other related enterprises.[12]

Nevertheless, some authors believe that the arm's length principle is an inappropriate tool for allocating profits to a PE that is part of a highly integrated enterprise with a common profit-maximizing purpose.[13] This criticism may be seen as part of a more general criticism of the application of the arm's length principle to the allocation of profits between states, which is based on the premise of related parties dealing with each other as if they were unrelated.[14] For the purposes of this article, the authors do not pursue the deeper debate about the suitability of transfer pricing and the AOA for profit allocation and attribution in international taxation.

For much of the history of the provisions,[15] however, there were different bodies involved in developing the detailed rules, which meant that there was less-than-seamless implementation of the policy. The PE concept was adopted out of German law and developed by the League of Nations in the 1920s by the technical experts drafting the principles and first model treaties and by the smaller Fiscal Committee of technical experts in the early 1930s.[16] The arm's length principle and its application to related enterprises and PEs was developed by Mitchell Carroll and the International Chamber of Commerce for the League of Nations and finalized in the mid-1930s as the method of allocation of profits under the League models, though the principle was already being applied by some states.[17] The League's subsequent work in the 1940s left the outcomes of the 1920s and 1930s still in place. At that time, the main area of interest was the attribution of profits to PEs as the modern multinational enterprise (MNE) group structure was then in its infancy.

Articles 7 and 9 of the OECD Model and their Commentaries were developed originally by the OECD's predecessor, the Organisation for European Economic Cooperation (OEEC), published in 1960 and incorporated in the 1963 Draft OECD Model.[18] At this stage, the only international tax work done by the OEEC/OECD was through its Fiscal Committee on tax treaties by senior tax officials who were also treaty negotiators, and there was no separate work done on transfer pricing (and no transfer pricing profession as such). For this relatively brief period, there was unification of the work on the articles by delegates who took different views from the work on transfer pricing in the 1930s. The main structure of the Commentary on Article 7 and particularly on Article 7(2) published then continued in place up until 2008. While the OEEC/OECD work on the PE definition had very much a small and medium enterprise (SME) focus, as evidenced by many of the examples in the Commentary on Article 5 of the OECD Model, the attribution work not surprisingly

12. 2010 Report, Pt. I, para. 55, p. 23 stating the aim "to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises", though it is recognized that complete parity is not possible.
13. For example, M. Kobetsky, *Article 7 of the OECD Model: Defining the Personality of Permanent Establishments*, 60 Bull. Intl. Taxn. 10, p. 425 (2006), Journal Articles & Opinion Pieces IBFD.
14. B.E. Lebowitz, *Transfer Pricing and the End of International Taxation*, Tax Notes Intl. (27 Sept. 1999); and J. Sasseville & R. Vann, *Article 7: Business Profits - Global Tax Treaty Commentaries*, IBFD (2019).
15. For a detailed historical analysis and comparison with a particular focus on banking and based on published documents of international organizations up to 1984, *see* I.J.J. Burgers, *Taxation and Supervision of Branches of International Banks* chs. 16-20 (IBFD 1991), Books IBFD.
16. S. Jogarajan, *Double Taxation in the League of Nations* pp. 37-41, 134-44, 203-215 (Cambridge 2018); S. Jogarajan, *League of Nations and International Tax in the 1930s*, in *Studies in the History of Tax Law*, vol. 11, pp. 424-426 (P. Harris & D. De Cogan eds., Hart 2023).
17. Jogarajan, id., at pp. 422-423, 427-428; Sasseville & Vann, *supra* n. 14, at sec. 1.2.1.; J. Hattingh, *On the Origins of Model Tax Conventions: Nineteenth-Century German Tax Treaties and Laws Concerned with the Avoidance of Double Tax*, in *Studies in the History of Tax Law*, vol. 6, p. 55 (J. Tiley ed., Hart 2013). There were a number of states applying variations of the arm's length principle in domestic law and treaty contexts well before this time.
18. OEEC, *The elimination of double taxation, Third report of the Fiscal Committee* pp. 23, 33-34 (OEEC 1960); *OECD Draft Double Taxation Convention on Income and Capital* pp. 45, 79-89 (1963). In 1977, art. 7 was modified slightly and the Commentary slightly revised and expanded, *OECD Model* (1977), pp. 28-29, 72-82. The Commentary was more significantly modified and expanded in 1994, *OECD Model: Commentary on Article 7* (1996), pp. 82-100. The further developments in 2008 and 2010 are discussed later, *infra* nos. 27-28 and text.

seemed mainly focussed on larger enterprises (e.g. references to banks and insurance enterprises in the pre-2010 Commentary on Article 7).

The Commentary on Article 7 was significantly concerned with practical issues and, while giving primary emphasis to PE accounts, came up with a number of indirect methods (putting aside the formulary apportionment allowed under pre-2010 article 7(4) where it was customary under the law of the PE state and approximated the separate enterprise arm's length outcome) and allocation of cost rules for expenses not related to the main business of the enterprise, particularly interest, royalty and management fee deductions, where generally no deductions or profits on dealings with the rest of the enterprise were allowed. Again, the focus was mainly on PE attribution rather than associated enterprises – the 1963 Commentary on Article 7 had 11 pages on article 7 and one mid-size paragraph on article 9 (a substantial disparity, which is still the case in the OECD Model (2017) with 26 pages to 5 pages).[19]

As the modern MNE group was starting to emerge in the mid-20th century, part of the explanation for the continuation of the League of Nations pattern may be the largely European origins of the Commentary with PEs very common, especially in the SME area, and the growth of European MNE groups lagging behind the Anglo-American world.[20] The OECD broadened the tax mandate of the Fiscal Committee, which did the tax treaty work and some other narrow technical issues, to include tax policy and other tax issues in 1971 and renamed it the Committee on Fiscal Affairs (CFA). The treaty work undertaken by the Fiscal Committee was continued as Working Party 1 (WP1) on double taxation and related matters henceforth with its immediate concern the revision of the 1963 Draft, producing a draft Model in 1974 and the final Model in 1977.[21]

The separation of the OECD transfer pricing work from its tax treaty work has an unexpected history.[22] Most are now aware that transfer pricing work is undertaken by the CFA's Working Party 6 (WP6) on Multinational Enterprises. WP6 was set up by the CFA shortly after its creation in response to OECD-wide work on developing guidelines for MNEs on responsible business conduct, the first version of which was published in 1976.[23] Coincidentally around the same time that this issue came up in the CFA, Working Group 7 (WG7) of WP1 –dealing with the revision of articles 7 and 9 and their Commentaries for the 1977 Model – decided not to do detailed work on transfer pricing, partly because of the time pressure to complete the Model. The United States in particular, which had been trying to get WG7 to look at the issue, was disappointed by this decision. The CFA identified three priority tax areas for the OECD-wide MNE project – namely financial strategy, investment incentives and transfer pricing – and directed WP6 to deal with them in the manner and order of its choosing. WP6 began work on all three topics together through a questionnaire to member states but quickly established a sub-group on transfer pricing and, from the mid-1970s, transfer pricing became predominant in WP6 work, resulting in the first version of what is now the TPG.[24]

Two studies were undertaken by the OECD through WP6 on the PE profit attribution issue before the work on the AOA. The first in 1984 concerned the taxation of multinational banks and was a continuation of the 1979 work by WP6 though mainly focussed on PEs, as banks have largely operated cross-border in the form of branches.[25] This work had a largely transfer pricing mindset and had no impact on the terms of either the OECD Model or its Commentaries. The second 1994 study on Attribution of Income to Permanent Establishments was more general in scope.[26] When WP6 was set up, it was required to work together with other relevant CFA committees and, for the 1983 and 1994 reports, WP6 completed its draft work and then consulted with WP1 on the results – particularly for the 1994 report – which led to some significant changes to the Commentary on Article 7.

After the completion of the 1995 TPG, WP6 returned to PE attribution in the latter part of the 1990s. A working hypothesis was developed as to the preferred approach for attributing profits to a PE under article 7 and first published in 2001. The objective was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise should be taken and how the TPG could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle. Specifically, the project was not "constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention is to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade".[27]

The project was completed in two steps.[28] In 2008, the OECD made no changes to the text of article 7 and preserved what clearly were non-AOA parts of the previous Commentary even though they were flatly contradictory to the 2008 Report, especially the treatment of intra-entity

19. *OECD Model* (2017), pp. 173-198, 226-230.
20. G. Jones, *Multinationals and Global Capitalism: From the Nineteenth to the Twenty First Century* p. 290 (Oxford 2004).
21. Sasseville & Vann, *supra* n. 14, at sec. 1.2.2.; R. Vann, *Do We Need Article 7(3)? History and Purposes of the Business Profits Deduction Rule in Tax Treaties*, in *Studies in the History of Tax Law*, vol. 5, p. 393 (J. Tiley ed., Hart 2012).
22. This history will be published separately, so the material here is a brief summary without references.
23. OECD, *International Investment and Multinational Enterprises* (OECD 1976).
24. OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (OECD 1979), *see* Burgers, *supra* n. 15, at ch. 18.
25. OECD, *The Taxation of Multinational Banking Enterprises*, in *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* pp. 55-70 (OECD 1984), *see* Burgers, id., at ch. 19.
26. OECD, *Model Tax Convention: Attribution of Income to Permanent Establishments* (OECD 1994). The work on the 1994 report largely predated the work that led to the TPG (1995), which started in 1992 and did not deal with PE attribution but listed it as a future topic, TPG (1995), para. 11, p. P-9.
27. OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (OECD 2001), preface para. 3, p. 4.
28. 2010 Report, preface, paras. 4-8, pp. 8-9.

notional interest except for banks, royalties and service/management fees. In 2010, after multiple revisions and extensive consultation, the OECD incorporated the development of the working hypothesis, now known as the AOA outlined previously, for the profit allocation to a PE into the text of article 7 of the OECD Model and rewrote the Commentary. As with the 1983 and 1994 reports, WP6 consulted with WP1 but on this occasion was determined to avoid the constraints of history, which WP1 was apparently not happy with, resulting in the two-stage adoption of the AOA in 2008 and 2010. Even so, in rewriting the Commentary in 2010, parts of the pre-2008 Commentary were retained so that, for both the 2008 and 2010 versions, there is the possibility of contradiction within the Commentary, as noted in section 4.3.

1.4. Different approaches to PE attribution

Lack of agreement among states and uncertainty in relation to PE attribution were significant drivers for the WP6 work, leading to the 1983, 1994, 2008 and 2010 reports on the topic.

So far as differences in approach among states are concerned, the 2008 Report discusses a number of other approaches in contradistinction to the FSE approach, which were grouped under the aegis of the "relevant business activity" approach and rejected by the AOA.[29] The discussion considers a wide variety of permutations in relation to this rejected category but, for ease of exposition, the authors look at four approaches based on the OECD discussion and the pre-2010 OECD Commentary:

- the limited independence approach of the 1963-2008 Commentary (made most explicit in the Commentary from 1994 on based on the 1994 report):[30] uses the FSE approach but only applies it for dealings related to the external business of the PE, e.g. transfer of inventory to a PE if it was in business of selling the inventory but not for other dealings such as notional loans (unless the enterprise was a bank), licences of intellectual property, back office, etc., services provided to or by the PE;
- the single entity approach, which only recognizes actual revenue and expense of the enterprise as a whole and divides income between a PE and the rest of an enterprise on a source of income and allocation of deductions basis (which can often, but not always, get the same result as FSE where the PE or the rest of the enterprise has significant losses on a stand-alone basis);
- overall profits of the enterprise are required in the line of business of the PE before profits could be attributed to that PE, e.g. if an enterprise has a media business and a building supplies business and the PE is only in the building supplies business losses incurred in head office or other PEs in the building supplies business could reduce the enterprise profit available to attribute to a PE, even though the PE was profitable on stand-alone basis, but losses in the media business could not reduce available profits; and
- overall profits of the enterprise are required in the channel of the business line conducted by the particular PE before profit could be attributed to that PE (e.g. continuing the example in the previous point, losses incurred by the rest of the enterprise in that channel of the line of business, such as the head office or another PE providing building supplies to the PE in question for sale by it could limit the amount of profits to attribute to the PE but not losses made in the channel of that line of business of a third PE).

Depending on the approach, the head office and the PE can be looked at as wholly two distinct entities (functionally separate entities) or at least in part (limited independence and business line approaches), or as a global entity within which one identifies what actual revenue and expenses belong to the PE (single entity).

Note that the business line approaches result from a reading that the word "profits" in pre-2010 article 7(1) is independent of the calculation of the PE's attributable profits under article 7(2) and puts a cap on those profits. The change in language in 2010 article 7(1) and (2) cross referring to each other is intended to eliminate this reading of the two provisions.

By way of example, assume that a head office (HO) of a company, which has only one line of business and one PE, manufactures goods sold by the PE (with the physical transfer of the goods to the PE treated under the AOA as a notional sale) and the PE incurs notional interest on a "loan" from the HO, even though the enterprise as a whole has no external interest expense. The HO own costs of manufacture are 60, the transfer price of the goods to the PE are 100 (assumed to be correct under transfer pricing principles as cost of goods sold (COGS) for the PE), the PE's own costs of sale are 20, the notional interest paid by the PE to HO is 10 and the PE third party sale price of the inventory is 150. The results under the different approaches are set out in Table 2.

Note that in this stylized example, the FSE approach produces a lower PE profit than the other three approaches (assuming that the business line approach follows the pre-2010 OECD Commentary on notional interest outside the banking sector). A greater variety of results may follow if there were significant head office losses (for the business line approach, assuming the losses are in manufacturing the goods) or the transfer price from HO to the PE was greater than the PE sale price (for the single entity approach).

The critical difference in the three relevant business activity examples compared to the FSE approach is the rejection of a deduction for the notional interest unmatched by any external interest expense, in each case based on the pre-2010 Commentary, though not necessarily with the same reasoning. Whether even the FSE approach would require deduction for the notional interest is discussed in section 3.2., but it is assumed that the conditions in the

29. 2008 Report, Pt. I, paras. 59-79, pp. 23-27; although the OECD attaches this discussion to art. 7(1), at least one of the approaches is better seen as an interpretation of art. 7(2).
30. P. 208, paras. 32-33 *OECD Model: Commentary on Article 7* (2008).

Table 2. Different approaches to PE attribution				
PE	**Functionally separate entity**	**Relevant business activity**		
		Limited independence	Single entity	Business line
	2010	Pre-2010 OECD	Other approaches	
Revenue/sales	150	150	50[1]	150
PE actual expenses	20	20	20	20
"COGS" expense (notional)	100	100	-	100
"Interest" expense (notional)	10	-	-	-
Profit	20	30	30	30

1. Of the 150 sale price, 50 is sourced in the PE state and 100 in the residence state.

2010 Report for such a deduction are satisfied. In the case of limited independence and business line (the two overall profit limitation approaches are grouped as there are no other business lines or channels in the line of business), borrowing and lending is not the line of business of the PE of selling goods and, so, no deduction for notional interest is allowed. In the single entity approach, the PE state only recognizes actual revenue and expense of the enterprise – not notional expenses whether in the PE's main business line or not. Thus, the deduction of the notional COGS expense does not appear in the single entity calculation, but the same result is produced through the sourcing of the income of the enterprise. The 100 transfer price sources 100 of the 150 sale price in the HO, so it is not taxable in the PE state as it is foreign source income of a non-resident. Only 50 of the 150 is sourced in the PE state, which produces the equivalent economic effect of a COGS deduction for 100 but achieved by a reduction at the revenue line, not a deduction of a notional expense at the expense line.

Whichever of the approaches applies, under the treaty, they are restricted to the PE and cover taxation of the PE in the PE state, giving double tax relief to the enterprise in the residence state for tax paid in the PE state on the PE's profits (*see* section 1.2.).

There is nothing, however, to prevent the domestic law of individual states treating also the HO as a separate entity in calculating the profit of the enterprise taxable in the residence state. A state that employs a territorial system – such as France – with respect to corporate income taxation may view the HO taxwise as an independent entity and determine its income on that basis by including the transfer price for the goods and the notional interest as income of the HO in the previous example. This may differ from the position in states that tax companies on their worldwide income in their domestic law. In this latter situation, many residence states would compute two amounts: first, the profits of the general enterprise, which would not include the internal dealings but would include the sale price of the goods as revenue and the actual expenses of the enterprise including the actual HO and PE expenses as deductions, and secondly, the profits to be attributed to the PE (which may or may not include notional expenses and for which double taxation relief will be provided in the residence state). On this view, "internal dealings" of a PE could be viewed as dealings with the "remainder" of the enterprise, or with the general enterprise.[31]

Similarly, there is nothing in the AOA which requires states' domestic tax law to adopt the AOA for the purpose of taxing PEs under that law – the treaty simply acts as a limit on the amount that can be taxed: "The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host state of the PE."[32]

In theory, the AOA is a general approach which applies to all sectors and all transactions or recognized dealings under treaties that adopt the AOA, as is evident from the 2010 Report. Some states apply the AOA to all sectors, at least under AOA treaties, but some states not adopting the AOA treaty provision (that is, the 2010 Model version) in their treaties still apply it in practice to banks for the purpose of determining the profit attributable to a bank PE consistently with the arm's length standard on the basis of the pre-2010 Commentary, being the exception to non-recognition of notional interest deductions referred to previously.[33] In fact, the development and structure of the 2010 Report clearly shows that the AOA was largely drafted with financial institutions in mind. Again, there can also be divergences between how domestic law and treaties operate in such cases, with some states having special domestic law provisions for taxing PEs of banks or financial institutions – as opposed to other enterprises – but many states not having such special domestic law rules.

31. *See* Van Raad's "egg and yolk" view of the PE ("internal dealings" are between the PE [yolk] and the general enterprise of which the PE is a part [egg], in the same fashion as heirs of an estate may be able buy something from that estate while they themselves are co-owners of it, or an individual partner may transact with the partnership of which he is partner), referred to in R. Russo, *Tax Treatment of 'Dealings' Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty*, 58 Bull. Intl. Taxn. 10, p. 481 (2004), Journal Articles & Opinion Pieces IBFD.
32. 2010 Report, Pt. I, para. 9, p. 13.
33. Pp. 210, 212, paras. 41-42, 49 *OECD Model: Commentary on Article 7* (2008).

2. Mixed Reception of AOA

2.1. Introductory remarks

In this section, the authors look at the reception of the AOA by the states represented here and subsequent attempts to develop it further. The AOA under the OECD Model is solely concerned with the operation of tax treaties for calculating the limit on the profits that can be taxed to the PE by the PE state and for giving relief in the residence state against double taxation for tax levied by the PE state in accordance with the treaty. For states considering how to tax international business income, the AOA poses a number of choices: to ignore it entirely and continue with its pre-AOA domestic law and tax treaty policy; to adopt it in domestic law for outbound and/or inbound investment; and/or to adopt it only in tax treaties which will automatically apply to outbound and inbound cases as noted previously. For a state to adopt the AOA fully, and not just for tax treaty purposes by incorporating it in domestic law, the regime may require two groups of changes to domestic law as it is not unusual for states to have separate domestic law tax rules for outbound and inbound business investment. Although the main point of the AOA is the tax limit in the PE state, its operation in the residence state is often more complex because most states do not follow the OECD Model in the tax treaty double tax relief article. Hence, the authors consider the residence state first.

2.2. The AOA cannot be easily implemented by residence states

The AOA constitutes an extensive tax fiction, which is generally confined to the measurement of income and might require specific legislative rules in the domestic law of the tax system.

PEs are generally not legal entities[34] and do not qualify as "resident" for tax treaty purposes.[35] In some cases, domestic law may – for specific purposes – treat a PE as if it is a resident. In Australia (*see* section 2.3.2.), for the purpose of attribution of profits, PEs of foreign banks are treated as separate resident entities under domestic tax law if the bank does not elect out of this tax treatment. In some states like Canada, for withholding tax purposes, a non-resident enterprise that has a branch in that state (e.g. Canada) is treated as a resident so that interest and dividends received as part of that branch are not subject to withholding tax, though payments by it may be.[36] In the Netherlands (as well as other states), a PE can be a withholding agent for certain taxes; this is the case for wage withholding tax[37] but also for the conditional withholding tax[38] to be levied on interest and royalties payable by a Dutch resident withholding agent[39] to an affiliated recipient entity established in a low-tax jurisdiction, as well as in a situation involving abuse.[40]

Furthermore, some states, such as Australia, India, Italy, South Africa and Sweden, apply specific rules to PEs for tax accounting purposes, regarding them as autonomous taxpayers.[41] In none of these cases does this specific treatment make them residents of the state generally.

34. Although there could be a hybrid entity or a partnership with a PE that is taxed in the name of the member(s).
35. *See* for instance in FR: *Conseil d'Etat*, 20 Sep. 2017, n° 392231, *Sté Mecatronic*; or in CA: Supreme Court, *Crown Forest Industries Ltd v Canada* [1995] 2 SCR 802.
36. Income Tax Act sec. 212(13.3).
37. Art. 6(2)(a) *Wet op de Loonbelasting 1964* (Wage Withholding Tax Act 1964).
38. Withholding Tax Act 2021/*Wet bronbelasting 2021* (WTA 2021).
39. Conditional withholding tax is also due if the affiliated withholding agent is not established in the Netherlands, but the interest or royalties due are attributable to a PE in the Netherlands (art. 3.3(1)(b) WTA 2021 for interest and art. 3.4(1)(b) WTA 2021 for royalties).
40. The conditional withholding tax may also be levied on dividends paid to an affiliated recipient entity resident in a low-tax jurisdiction or in cases of abuse (art. 3.4a WTA 2021). However, a PE cannot qualify as a withholding agent for the conditional withholding tax levied on dividends for purposes of the WTA 2021. This also applies to the regular dividend tax (covered by the Dividend Withholding Tax Act 1965/*Wet op de dividendbelasting 1965*), *inter alia*, due when a dividend is paid by a Dutch resident company to a non-resident shareholder. If the shares are attributable to a PE situated in the Netherlands, that PE is not required to withhold and pay dividend tax on any dividends, i.e. there is no branch profit tax.
41. In Australia, PEs of foreign residents are required to prepare accounts for tax purposes on a stand-alone basis using accounting standards, Income Tax Assessment Act 1997 Div 820-L. In India, accounts have to be drawn up for the PE as if it were a separate enterprise and are used as a basis for profit attribution, Rule 10, Income Tax Rules 1962. In Italy, PEs of foreign companies (and other types of business entities) must prepare a separate profit and loss account and balance sheet for the specific purpose of determining the income that is taxable in Italy and keeping track of the tax basis of the assets and liabilities of the PE. These accounts must be drafted according to the accounting principles, whether local GAAP or IAS/IFRS, that would have been applicable to a similar resident without, however, taking into account the circumstances that the entities may have issued securities traded in a regulated stock exchange (art. 152(1) of Italian Income Tax Code). In South Africa, so-called branch accounts that comply with the relevant accounting standards (local GAAP or IAS/IFRS) serve as the basis for the income tax returns to be filed by PEs of non-residents (Annual Notice in terms of sec. 25, read with sec. 66(1) of the Income Tax Act, 1962). These accounts form the basis to establish the taxable profit, but adjustments may be made to reflect application of art. 7 of South Africa's tax treaties (*Anglo American Corporation of South Africa Ltd v Commissioner of Taxes* 1975 (1) SA 973 (RA); 37 SATC 45). Moreover, the South African central bank views a PE as a so-called exchange control resident and will only allow the remittance of PE profits abroad if an auditor certifies the amount based on the branch accounts. In Sweden, foreign owners of Swedish branches must maintain separate accounting for the branch under the same rules as for residents, *see* ch. 2, sec. 7 and ch. 4, sec. 7 *Bokföringslagen* (1999:1078); *see also* sec. 11 *lag* (1992:160) *om utländska filialer m.m.* In the Netherlands, there is no legal requirement to prepare a separate balance sheet and profit and loss account for the PE. The PE needs to be registered with the Trade Register of the Chamber of Commerce. The annual accounts of the foreign company filed locally are also to be filed with the Trade Register of the Chamber of Commerce (art. 6 of the Act on the Formal Foreign Companies/*Wet op de Formeel Buitenlandse Vennootschappen* in connection with art. 5(d) of the Trade Register Act/*Handelsregisterwet* and art. 24(5) of the Trade Register Decree/*Handelsregisterbesluit*). However, the tax rules may contain certain peculiarities. A non-resident taxpayer with a PE in the Netherlands must keep accounts in the same way as a resident taxpayer. This non-resident taxpayer (head office) is also subject to the obligations for tax purposes, such as the submission of books and records. Reference is made to art. 47 et seq. of the General Taxes Act (*Algemene Wet inzake Rijksbelastingen*), which contain the information obligations of a taxpayer vis-à-vis the tax authorities. The accounts for determining the taxable profit of the PE should be of a separate nature; the latter is deemed not to exist if the operation of the PE is integrally incorporated into the main accounts: *compare Fiscale Encyclopedie De Vakstudie* (Fiscal Encyclopedia), *Vennootschapsbelasting* (Corporate Income Tax), Wolters Kluwer online, art. 17, para. 7.5.; *see also* the decision in NL: Court of Appeal, 28 Mar. 2000, no. 98/2474, V-N 2000/40.13 confirming that the obligation to provide information to the tax authorities also applies to non-resident taxpayers with a PE in the Netherlands; and

In relation to relief of double taxation, the OECD Model simply requires that any tax that may be levied in the PE state be "in accordance with" the treaty in order to trigger the treaty obligation for the residence state to provide double tax relief and offers alternatives for exemption or credit relief.[42] In actual bilateral treaties, typically the relief article is bifurcated to provide rules separately for each state party. At its simplest, this structure reflects that each state may prefer a different treaty relief method as between exemption and credit, but often there are deeper issues at play. For example, states may wish to provide special rules for subsidiary-parent dividends;[43] states with domestic law credit relief may wish to incorporate the details of that law, particularly in relation to the credit limit using language such as "subject to the provisions of the domestic law regarding the crediting against domestic tax of tax payable in the other State but without affecting the general principle provided in the article";[44] and states are becoming increasingly concerned about treaty abuse around relief of double taxation leading to changes in domestic tax law and/or the text of the Model provisions, which are reflected in various ways in actual treaties.[45]

In addition, just as the texts of the OECD Model relief provision have evolved, so too have the domestic law relief systems of many states – leading to divergences between relief provisions in domestic law and bilateral treaties. Two important examples in practice are the increasing adoption of participation exemptions by what were previously credit states and the cutting back of exemptions provided in domestic law in states using exemption relief in tax treaties to prevent unintended double non-taxation. In the former case, states may continue to use credit only provisions in tax treaties on the basis that, if domestic tax law provides exemption relief, then the treaty obligation to credit is not triggered as there is no residence-state tax on the income. In the latter case, in the future, states may include similar limitations in negotiating tax treaties and perhaps seek to override existing treaties without the limitations. Given the generally long life of tax treaties, obtaining harmony between treaty and domestic law relief in relation to the AOA is not always easy.

Of the states represented by the authors, a worldwide tax system would generally apply to residents of the state with a foreign PE, except for France.[46] Pursuant to a worldwide tax system, profits derived by a foreign PE of a domestic resident head office should be taxable in the residence state, as the latter considers the enterprise as one taxpayer taxable on its worldwide income. By contrast, according to a territorial tax system, the head office state would only tax the income derived from its territory so that the income derived abroad by a foreign PE should, in principle, be taxable only in that foreign state.[47] It is true, however, that some of the states with a worldwide tax system would apply a domestic law foreign PE exemption (though, in many cases, subject to some exceptions such as for low tax or passive income) or calculate foreign PE profits as such for the purposes of granting foreign tax credit relief, which makes this distinction between territorial tax systems and worldwide tax systems less relevant in practice. Distinguishing two separate entities within the same enterprise when one of these entities is located abroad is necessary for the application of domestic law for both territorial systems[48] and worldwide tax systems. The following discussion considers first states with domestic law exemption relief for foreign PE profits and then states with domestic law credit relief for such profits. In the case of domestic exemption systems, they often only apply to companies and even then have exceptions, with credit relief applying to other PE profits. Such states may or may not have exemption reliefs in treaties

S.W.C. Douma, R.J. Koopman & E.A.G. van der Ouderaa, *Algemene wet inzake rijksbelastingen* p. 164 (Wolters Kluwer 2023).

42. *OECD Model* (2017), art. 23A Exemption Method, and art. 23B Credit Method, pp. 42-43.
43. Pp. 395-396, paras. 49-54 *OECD Model: Commentary on Article 23* (2017).
44. This preference is recognized by OECD, *The Application of the OECD Model Tax Convention to Partnerships* para. 117 (OECD 1999), from which the language quoted in the text is taken. Examples among the states here are Australia, Canada, Germany, Japan (though without reference to the general principle of relief), South Africa, Sweden, the United Kingdom and the United States. The exact effect of the language is unclear. At one extreme in Australia, the Full Federal Court majority held that the reference to the general principle of relief added nothing to domestic law on relief which applied according to its terms, *Burton v Commissioner of Taxation* [2019] FCAFC 141 paras. 116-127, 164-173 (one judge reached the contrary conclusion at para. 71) whereas, for the United States, which has – over the years – experimented with various forms of wording, the position is more nuanced; the broader nature of the treaty credit is supported by P. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 Tax Law Review 1 (1982), while the 2006 US Model Technical Explanation, *see infra* n. 117, at p. 74 gives a narrower scope to the treaty credit. Italy does not generally use this language, but one exception is art. 22 of the Italy-Uruguay Income Tax Treaty (2019), which makes the treaty credit "subject to the applicable provisions of the Italian law". The Netherlands is comparable to Italy in this respect. Some more recent treaties contain this type of wording. However, the reference to domestic law concerns in particular (i) the aggregation of income sourced in the other contracting state and in third states, i.e. the joint method; and (ii) the carry-forward of excess credits, *see*, inter alia, art. 21(3), third sentence, of the UK-Netherlands Tax Treaty (2008): "This paragraph shall not restrict any allowance accorded by the provisions of the Netherlands law for the avoidance of double taxation to the extent that the calculation of the amount of the deduction of Netherlands tax concerns the aggregation of income from more than one state and the carry forward of the tax paid in the United Kingdom on the said items of income to subsequent years."
45. *OECD Model* (2017), art. 23A(4), p. 42 (switch-over clause added in 2000) and the words "except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State" in arts. 23A(1) and 23B(1), p. 42 (added in 2017 to avoid circular relief obligations, pp. 379-382, paras. 11.1-11.2 *Commentary on Article 23*).
46. A number of states, for example, Canada, Germany, Italy, Japan, Switzerland and the United States have subnational income or income-like taxes, such as trade taxes, which are in principle conceived to be territorial, though the subnational tax may use different methods to the separate entity arm's length principle for determining the taxable profits, such as water's edge formulary apportionment. Such taxes may or may not be covered by tax treaties and are not considered further in this article. In Japan under the Enterprise Tax, one of the local income taxes imposed by Japan prefectures, the tax will not be imposed on income derived by a foreign PE (art. 72-4 of the Local Tax Act).
47. In France, however, the profits of foreign PEs of French corporations subject to French CIT that are, in principle, not taxable in France due to the territorial tax system are subject to French CFC legislation if the foreign PE is low-taxed and a test of substance safe harbour is not met.
48. In France in particular, when a corporation carries out business abroad, the profits deriving from this business would be regarded as taxable in France unless it is possible to characterize a PE abroad. In other territorial tax systems, only local source income will be taxable and foreign source income deriving from activities abroad will be generally ignored, whether deriving from a PE or not.

which can potentially be broader or narrower than the domestic exemption system.

In relation to domestic law PE exemption regimes in worldwide taxation states, Australia exempts the income coming from foreign PEs of resident companies.[49] As a result, the related expenses are not deductible.[50] There are exceptions for income that would be tainted income taxable in Australia if the PE were a controlled foreign company (CFC) and for income from international transport exempted at source by tax treaties, to both of which a foreign tax credit applies as well as to foreign PEs of other types of taxpayers, such as individuals or trusts. Australian domestic tax law does not generally apply the AOA in relation to relief but continues to use the single entity principle though, in practice, the AOA is applied to Australian banks with foreign PEs in determining domestic law relief.[51] Australian treaties usually only provide for credit relief, but the exemption is seen as treaty consistent.[52]

Germany follows a similar approach. Though Germany applies its worldwide tax system to profits of PEs of German resident companies, those profits are usually exempt from income tax and corporate tax under the tax treaties concluded with the PE states. In addition, a unilateral exemption applies for German trade tax (*Gewerbesteuer*) purposes. However, German (new) tax treaties usually include switch-over clauses for specific types of passive income derived by the PE with the effect that, instead of the exemption method, the credit method applies. Moreover, like the Australian approach, German domestic tax law provides for a unilateral switch-over clause for passive, low-taxed income if the PE were a CFC. However, for this approach, the PE could provide evidence that it passes the so-called Cadbury test applicable under EU law. Germany applies the AOA to domestic law and treaty exemption relief in outbound situations but with complications in the case of non-AOA treaties.[53]

Italy generally applies the worldwide tax system but, with a reform enacted in 2015 (effective as of 2016 for entities adopting the calendar year), it established an optional exemption regime for profits attributable to foreign PEs of resident enterprises (the branch exemption regime[54]); however, the profits of foreign PEs that would in principle be exempted under this regime are subject to Italian CFC legislation if the foreign PE is low-taxed, more than one third of its revenues are tainted income and a minimum substance safe harbour is not met. In cases not covered by the exemption, foreign tax credit relief applies under domestic law or treaties. Italy applies the AOA to the domestic law exemption relief in outbound situations but with complications in the case of non-AOA treaties.[55]

The Netherlands grants a base exemption (full exemption) for business income attributable to foreign PEs maintained by a Dutch resident entity. However, the exemption does not apply to certain low-taxed investment PEs (passive PEs that are taxed at low rates).[56] This exception is referred to as a switch-over clause.[57] There is limited incorporation of the AOA into domestic law, i.e. only in non-tax treaty situations for resident individuals/entrepreneurs and corporations with a PE abroad (unilateral relief of double taxation).[58] As noted below, the Netherlands applies the AOA by interpretation in treaty cases[59] but with similar treaty complications as for Germany and Italy.

Switzerland applies a worldwide tax system with, however, an unconditional tax exemption for profits attributable to foreign real estate and PEs.[60] Because the law provides for a complete unconditional exemption (with, in particular, no "switch-over" clause in case of low-taxed passive income), concerns of double non-taxation have arisen in connection with offshore PEs of Swiss companies. The Swiss Supreme Court has controversially addressed this concern by construing less extensively the notion of PE for outbound than inbound purposes, especially when the

49. Income Tax Assessment Act 1936, sec. 23AH.
50. Income Tax Assessment Act 1997, sec. 8-1.
51. *See infra* n. 91 and text.
52. The explanation usually given in the official explanation accompanying the Bill that enacts the treaty into domestic law, for example, Explanatory Memorandum to International Tax Agreements Amendment Bill 2016, para. 1.354, is that: "As double taxation does not arise in these cases, the credit form of relief will not be relevant."
53. *See infra* nos. 100-101 and text. The AOA in German domestic tax law applies equally to outbound and inbound situations.
54. Art. 168-ter of the Italian Income Tax Code introduced by art. 14 of Decree No. 147 of 14 September 2015. Implementing rules are set forth in the Regulation of the Director of the Revenue Agency No. 2017/165138 of 28 August 2017, which clearly indicates that the AOA must be applied for the purposes of determining the profits attributable to the foreign PEs that are exempt under this optional regime, unless the foreign state does not apply – "also pursuant to a double tax treaty in force with Italy" (*see* art. 7.2 of the implementing rules) – the AOA; in this latter case, the Italian head office can ask the Italian Revenue Agency to recognize, in full or in part, the criteria used by the other state through a unilateral procedure.
55. *See infra* nos. 108-111 and text.
56. Corporate Income Tax Act 1969 (art. 15e(2)). A foreign PE qualifies as a low-taxed investment PE if the following cumulative conditions are met: (i) the activities of the foreign PE consist of more than 50% of investing, passive intra-group financing or passive intra-group deployment of assets, e.g. leasing activities (activity test) (when determining the PE's activities, the activities of entities in which the taxpayer has an interest of at least 5%, and which interests are attributable to the PE, should on a pro rate basis be attributed to the PE); and (ii) it is not subject to a reasonable taxation according to Dutch standards (low-tax test); *see* art. 15e(7) in connection with art. 15g of the Corporate Income Tax Act 1969. An exception to the exclusion of the base exemption for a low-taxed investment PEs is possible if a tax treaty concluded by the Netherlands, nevertheless, provides for an exemption and thus does not contain a provision for "passive foreign business profits". In particular, the older Dutch tax treaties will not contain a provision for such passive foreign business profits.
57. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS* para. 6.4 (OECD 2020).
58. For situations in which a tax treaty is not applicable and where the Netherlands may grant unilateral elimination of double taxation, domestic law provides in the AOA being applied when attributing profits to a PE; (i) for individuals/entrepreneurs residing in the Netherlands who have a PE abroad, art. 9(3) of the Decree on the elimination of double taxation 2001 (*Besluit voorkoming dubbele belasting* 2001); *see* Explanatory Memorandum, Dutch Official Journal/Staatsblad 2011, 677, p. 84; and (ii) for corporations residing in the Netherlands with a PE abroad, art. 15e(6) of the Corporate Income Tax 1969 (Decree of the State Secretary of Finance of 14 June 2022, no. 2022-0000143421, Dutch Government Gazette 2022, 16683, para. 1.3 and Explanatory Memorandum, Second Chamber 2011/12, 33 033, no. 3, p. 96).
59. *See infra* nos. 125-128 and text.
60. Art. 52(1) DBG: *L'assujettissement fondé sur un rattachement personnel est illimité; il ne s'étend toutefois pas aux entreprises, aux établissements stables et aux immeubles situés à l'étranger.* ["Taxation based on personal connection is unlimited; however, it does not extend to companies, permanent establishments, or real estate located abroad."]

foreign PE is not subject to tax.[61] On the other hand, in accordance with a worldwide tax system, losses incurred by the foreign PE of a Swiss head office are deductible in Switzerland, subject to a recapture rule.[62] The uncertainty concerning the question of whether, and if so to what extent, the AOA is applicable to the allocation of profits between a Swiss head office and its foreign PE is essentially rooted in the fact that, in such an outbound case, Swiss law expressly refers to the principles of profit allocation between cantons.[63] The question has begun to be addressed by the Swiss Supreme Court in its recent case law.[64]

The United Kingdom adopted an optional exemption of the profits of overseas PEs of companies in 2011.[65] The exempted profits are calculated by applying an AOA approach as if there were a tax treaty in place containing a post-2010 version of article 7. The exempted profits are those that would be attributed to a PE using that approach. If the exemption is not availed of, credit relief applies. Historically, UK treaties contained only credit relief, but more recent treaties now provide a treaty exemption if one is available under domestic law. As with some other states, the position of the AOA under UK treaties is nuanced.[66]

Other states with a worldwide tax system and no general domestic law exemption system apply their general foreign tax credit regime to residents with foreign PEs, though some special rules may apply.

Canadian tax law does not as such regard a branch as a separate entity. Moreover, foreign PE profits are taxable but eligible for tax credit except for income from foreign life insurance business, which is exempt under special rules.[67] Nevertheless, in Canada, even though federal taxation is worldwide, separate computations are required of foreign income and of Canadian income,[68] and the revenue authorities have indicated that the approach to business profits in tax treaties is relevant for this purpose in relation to the foreign tax credit in treaty and non-treaty situations.[69]

India taxes the worldwide income of its residents, which means any income earned by a foreign PE of an Indian resident is taxable in India. Foreign income tax imposed on the foreign PE's profits can be credited against Indian income tax as per domestic tax law, read in conjunction with treaty provisions. This foreign tax credit can also be claimed for taxes paid in states with which India does not have a tax treaty. Further, Indian transfer pricing provisions are not applicable to transactions between an Indian-headquartered entity and its foreign PE.[70] India's tax treaties correspondingly do not adopt the AOA.[71]

Japan generally applies the worldwide income taxation principle to Japanese companies and resident individuals. Accordingly, profits derived by a foreign PE need to be included in the taxable income of Japanese companies and resident individuals under Japanese tax law. Foreign income tax imposed on the PE's profits can be credited against Japanese income tax, subject to the provisions of the Japanese foreign tax credit system.[72] The introduction of the AOA into Japanese domestic law also affects the calculation of foreign tax credits for foreign PEs of residents but is affected by tax treaties.[73]

No exemption is available for a South African resident head office for foreign-source income attributable to a

61. lATF 139 II 78. *See* thereupon R. Danon, *Le principe de territorialité de l'impôt à l'épreuve de la planification fiscale des entreprises: réflexions à propos de l'ATF* 139 II 78 (arrêt 2C_708/2011, du 5.10.2012), Revue de droit administratif et de droit fiscal (RDAF), II/69 (5) pp. 429-444. Swiss law only provides for a definition of the PE concept for inbound purposes (*see* art. 51(2) DBG).
62. Art. 52(3) DBG: *Une entreprise suisse peut compenser les pertes d'un établissement stable à l'étranger avec des bénéfices réalisés en Suisse si l'État dans lequel cet établissement est sis n'a pas déjà tenu compte de ces pertes. Si cet établissement réalise des bénéfices au cours des sept années suivantes, l'impôt sera récupéré pendant ces exercices dans la mesure où les reports de pertes sont compensés dans l'État ou il est sis.* ["A Swiss company can offset losses incurred by a permanent establishment abroad against profits made in Switzerland if the country in which the establishment is located has not already taken these losses into account. If the establishment makes a profit in the following seven years, the tax will be recovered during those financial years to the extent that the loss carryforwards are offset in the country in which it is located."]; *see* generally thereupon among others Federal Supreme Court Judgment 2C_564/2017, 4 Apr. 2019, § 5.4; *see* generally R. Danon, D. Berdoz & T. Obrist, *Taxation of Partnerships and Branches*, in *Switzerland Business & Investment Handbook: Economy, Law, Taxation, Real Estate, Residence, Facts & Figures, Key Addresses* pp. 390-420 (C. H. Kälin ed., O Füssli & J. Wiley 2011).
63. Art. 52(3) DBG: *Dans les relations internationales, l'étendue de l'assujettissement d'une entreprise, d'un établissement stable ou d'un immeuble est définie conformément aux règles du droit fédéral concernant l'interdiction de la double imposition intercantonale.* ["In international relations, the extent of the tax liability of a company, permanent establishment or real estate is determined in accordance with federal law on the prohibition of inter-cantonal double taxation."].
64. *See infra* nos. 136-138 and text with references to the recent case law of the Federal Supreme Court.
65. Finance Act 2011 now found in ch. 3A, Part 2 of the Corporation Tax Act 2009, sec. 18A-18G.
66. *See infra* nos. 95-96 and text.
67. Income Tax Act, sec. 138(2)(a).
68. Income Tax Act, sec. 4(1). For the impact of tax treaties and the AOA for Canada as a residence state, *see infra* nos. 130-132 and text.
69. Technical Interpretation document dated 11 January 11 2001 (No. 2000-0001017 (E)), commenting on the allocation of profits to a Japanese PE under the Canada-Japan Tax Treaty (1986) for the purposes of determining foreign source income in applying the Canadian foreign tax credit limitation rules. The taxpayer's argument for an enlarged foreign source income in order to fall below the credit limit was rejected. The taxpayer argued that all the revenue from the sale should be sourced in Japan as the place of contract of sale reduced by all the costs relating to the sale. The revenue authority took the view that a notional sale of inventory manufactured in Canada and transferred at the arm's length price to the Japanese PE should be used in determining the profits sourced in Japan. A similar approach was taken in Technical Interpretation dated 11 August 2006 (No. 2006-018191117 (E)) in relation to the foreign tax credit in a non-treaty scenario. A Canadian manufacturer selling goods in the United States was subject to US state income taxes levied on a formulary basis, which were not covered by the Canada-United States Tax Treaty (1980). The taxpayer claimed a foreign tax credit under Canada's domestic tax law rules for those taxes, but the Canadian revenue authorities rejected the amount of US income determined on a formulary basis and took the view that the foreign source income should be determined by the same approach as the 2001 Technical interpretation "i.e., separate entity concept and arm's length principle" even though the relevant Canadian legislation, case law and guidance was non-prescriptive in nature and Canada usually determined foreign and Canadian income on a source basis. As the cases involved manufacture in Canada and its sale abroad, these views are consistent with the limited independence view in the OECD Commentary at that time.
70. Income Tax Act, 1961 secs. 5, 90, 91, 92B.
71. *See infra* nos. 84-87 and text.
72. Arts. 5 and 69 of the Corporation Tax Act for Japanese companies and arts. 7(1) and 95 for resident individuals.
73. *See infra* n. 103 and text.

PE and double tax relief is by way of foreign tax credit, but any tax losses derived from a foreign trade carried on through a PE are ring-fenced and cannot be set-off against the profits of the South African head office.[74] This was justified by the lack of capacity on the part of the Revenue Authority to audit loss-making foreign PEs and a concern about tax avoidance strategies.[75] South Africa does not apply the full AOA by domestic law or treaties.[76]

Sweden taxes resident companies and individuals on their worldwide income with a foreign tax credit.[77] Swedish domestic tax law has not been changed as a result of the AOA in either outbound or inbound cases, and it is yet to be determined to what extent it will be adopted in tax treaty cases in either direction.[78] Two recent decisions in the Administrative Court of Appeal in an outbound context involving pre-AOA treaties mainly concerning whether an outbound dealing in the form of a transfer of a business (largely intellectual property) by a Swedish resident company to a PE in another EU Member State gives rise to a taxing event in Sweden, with a consequent effect that any tax credit available in Sweden for PE state tax on a subsequent transfer by the PE to another company come to different conclusions apparently based on the approach of the tax administration of the PE state.[79]

In the United States, profits attributed to a foreign PE or other branch of a US corporation are fully taxed at the regular US domestic rates and are not eligible for the reduced tax rate on "foreign derived intangible income".[80] Such profits are placed in a separate ("branch") limitation category for foreign tax credit purposes and, for this purpose, US domestic tax law uses a single entity approach based on source of income and allocation of deductions in relation to determining the income subject to this limit.[81]

It is apparent from this survey that domestic tax law is a complex mix of rules in relation to foreign PEs of a resident enterprise. The domestic tax relief and other rules for resident enterprises generally are not explicitly built on the AOA (indeed, in many cases, the regimes predate the development of the AOA), yet the AOA requires the residence state to apply the AOA for relief of double taxation. To say that the AOA only acts as a limit on the amount of tax payable in the PE state ignores not only the revised language of article 7(2), which refers to article 23, but also the potential complications for the operation of residence state domestic tax relief rules, which generally are much more extensive and nuanced than the relatively brief relief provisions in the OECD Model and actual treaties. This issue is largely ignored in the 2010 Report. A similar position applies to domestic tax rules for local PEs of non-resident enterprises considered in section 2.3.

It should also be noted that, in some states, the application of the AOA may be restricted because of their domestic legal framework:[82]

– constitutional principles and/or general rules of tax law might prevent the recognition of PE profits in certain circumstances, such as the ability-to-pay principle, the principle of legality and the realization principle (no earnings may be accounted for if they have not been realized);
– the recognition of profits from a notional internal dealing may be difficult for states that have adopted the single entity approach;
– the economic ownership of assets is not recognized by civil law states; and
– case law, rulings and tax administration practice might prevent some states from adopting the AOA without changing the wording of article 7 of their tax treaties. Where states cannot internally apply the AOA, the new approach would only work in the context of tax treaties. This could restrict the future development of the AOA (i.e. its adoption in new tax treaties), as most states tend to align domestic law with their treaty practice.

2.3. The AOA is not implemented in a unified way in PE states

As the OECD recommends the application of the AOA in PE states as a standard for its members, its implementation is not mandatory. To this day, a consensus is far from being reached. A high-level summary of the position in states represented by the authors in Table 3. indicates the current position in those states, disregarding the many nuances.

2.3.1. Some states simply rejected the AOA

In India, the AOA has not been domesticated at all into income tax law. India expressed its position on article 7 and the OECD Commentaries in order to exclude the AOA:[83]

74. Proviso (b) to sec. 20(1) of the Income Tax Act, 58 of 1962. Domestic law uses actual income and deductions for tax purposes, and it is unclear whether intra-entity "dealings" can be recognized.
75. Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000, p. 7. The feared tax avoidance was explained as "the possibility of a person starting a foreign operation in a branch in order to utilise the losses against the South African income and then converting the branch into a separate subsidiary company when it becomes profitable. This would have the effect that the income could be exempt once the branch showed a profit while the losses previously allowed would not be recouped."
76. *See infra* n. 88 and text.
77. *See* ch. 3, sec. 8 (individuals) and ch. 6, sec. 4 (legal entities) *Inkomstskattelagen (1999:1098), lag (1986:468) om avrakning av utlandsk skatt.*
78. *See infra* nos. 118-124 and text.
79. *Kammarrätten i Stockholm*, 26 Jan. 2022, Cases 2434-20, 2435-20, 2436-20; *Kammarrätten i Jönköping*, 15 May 2024, Cases 2294-22, 2295-22. Various views about the application of the AOA in Sweden are also discussed in these cases.
80. IRC sec. 11(a) (tax rate for corporations), 61 (gross income includes income from all sources); 250(b)(3)(A)(i) (foreign derived intangible income), Treas. Reg. sec. 301.7701-2(a) (branches, divisions and business entities disregarded as separate from owners all treated similarly (as part of owner)).
81. IRC sec. 904(d)(1)(B), (d)(2)(J), Treas. Reg. sec. 904-4(f). For the position of the credit under tax treaties, *see supra* n. 44 and *infra* nos. 112-117 and text.
82. R. Bernales, *The Authorized OECD Approach: An Overview*, in *Taxation of Business Profits in the 21st Century* sec. 6.5.2. (C. Gutiérrez & A. Perdelwitz eds., IBFD 2013), Books IBFD.
83. *OECD Model* (2017), p. 625, para. 1.1. It seems that India does not accept the 2008 Commentary to the extent that it accepts elements of the AOA; in Transfer Pricing Profile, *supra* n. 4, India, July 2021. It states "India does not follow the Authorised OECD Approaches for the attribution of profits to PEs (AOA). Instead, the attribution of profits to PEs is done

Table 3. Adoption of AOA in PE state (Yes/No)

State	Generally		Banks	
	Domestic law	Treaty policy[1]	Domestic law	Treaty policy
Australia	N	N	Y	Y
Canada	N?	?	?	?
France	Y	N	Y	N
Germany	Y	Y	Y	Y
India	N	N	N	N
Italy	Y	Y	Y	Y
Japan	Y	Y?	Y	Y?
Netherlands	N	Y	N	Y
South Africa	N	N	Y?	Y?
Sweden	N	Y	N	Y
Switzerland	Y	Y	Y	Y
United Kingdom	Y	Y	Y	Y
United States	N	Y?	N	Y?

1. This column refers to the state's general preference in treaty negotiations to include the 2010 article 7 or equivalent wording, not the outcome in actual treaties. As noted, some states consider that the AOA applies to the pre-2010 wording of article 7, at least for certain treaties. Hence, "N" in the treaty policy columns is not conclusive on whether a state applies the AOA to some of its treaties.

> India reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update, subject to its positions on that previous version. It does not agree with the approach to the attribution of profits to permanent establishments in general that is reflected in the revised Article, in its Commentary and in the consequential changes to the Commentary on other Articles.

Indian courts have upheld the attribution of profits on an ad hoc basis using the domestic tax provision, primarily in cases where the taxpayer did not maintain books or produce any analysis or where the transfer pricing documentation did not reflect all functions performed by the PE.[84] Further, a 2020 amendment provides for the attribution of profits to a PE under safe harbour rules and through advance pricing agreements (APAs).[85] In a few cases resolved under APAs, the formulary approach advocated by a 2019 consultation paper[86] has been used yielding a higher outcome than under an arm's length price approach. A Delhi High Court decision recently approved by the Supreme Court of India has supported the view that the PE must be treated as a distinct entity for tax purposes and that the profits of a PE should be attributed on a stand-alone basis without recourse to the fact that the foreign entity had sustained losses.[87]

Australia (in a reservation) and South Africa (in a position) have also rejected the AOA and have not changed their general domestic law. Australia uses the single entity approach for taxing PEs in Australia (apart from Australian PEs of foreign banks, *see* section 2.3.2.) while, in South Africa, domestic law uses the single entity approach and it is unclear whether intra-entity "dealings" can be recognized under tax treaties.[88]

As noted in section 1.3., some elements of the AOA – particularly the two-step process (*see* section 1.2.) – were included in the 2008 Commentary, qualifying the reliance on the financial accounts of the PE that previously applied.[89] Other elements that were arguably new in 2008 are (i) the use of the term "dealing" to describe intra-entity interactions which are recognized as the equivalent of transactions for PE attribution purposes, though the idea had been present in the OECD Commentary from 1963 in relation to banks and from 1994 in relation to the main business lines of other enterprises (*see* section 1.3.); (ii) the view that a PE could have attributable profits even if the enterprise overall had losses; and (iii) the updated mate-

in accordance with rule 10 of its Income-tax Rules, 1962, read with the relevant Double Taxation Agreement."

84. Income Tax Rules 1962, Rule 10.
85. The Finance Act 2020 amended the Income-Tax Act 1961 to include secs. 92CB and 92CC.
86. *See infra* n. 158 and text.
87. *Hyatt International Southwest Asia Ltd v Additional Director of Income Tax* 2025 INSC 891, para. 23. This effectively rejects the relevant business approaches reading profits in the 2008 version of art. 7(1) as referring to overall profits of the enterprise, *see* sec. 1.4., but does not imply adoption of the AOA.
88. OECD Model (2017), p. 198, para. 99 (Australia), p. 625, para. 1 (South Africa). In their Transfer Pricing Profiles, *supra* n. 4, Australia (July 2021) and South Africa (July 2025) affirmed this position. Australia's domestic transfer pricing law was modernized in 2013 with rules for PEs closely modelled on the pre-AOA OECD art. 7 but still using the single entity approach with the OECD Commentary (2008) required to be taken into account in the interpretation of the rules, Income Tax Assessment Act 1997 subdiv. 815-C. South Africa is part of a group of 16 non-OECD member countries that rejected the new art. 7 of the *OECD Model* (2010) in positions on the *OECD Model* (2017), *see infra* n. 233, but "will interpret Article 7 as it read before the 2010 Update in line with the relevant Commentary as it stood prior to that update". This position is understood in South Africa to mean that all tax treaties with the old wording of art. 7 will be interpreted based on the 2008 version of the OECD Commentary on Article 7. It is untested before South African courts if the 2008 Commentary can be reconciled with the wording of tax treaties concluded before then, particularly whether "dealings" can be recognized especially since this is not possible under domestic income tax law principles.
89. *OECD Model* (2017), para. 16, now qualified by paras. 17-18, pp. 204-205.

rial on "free capital" allocation to PEs.[90] For the purposes of the AOA discussion in this article, the authors treat the states that follow article 7 in the 2008 Model and Commentary as rejecting the AOA.

2.3.2. *Some states have implemented the AOA in their domestic law before and after 2010 generally or for banks*

In the case of pre-2010 domestic law, at least three states had a form of AOA in their domestic laws: Australia (in relation to foreign bank PEs), France and the United Kingdom. The Australian and French legislation occurred even before the AOA had been heard of. While, as noted in section 2.3.1., Australia's general transfer pricing legislation of 1982, 2012 and 2013 is written in terms of the single entity rule and, thus, does not generally recognize intra-entity transactions, in 1994 Australia enacted AOA-equivalent rules in its domestic law for PEs of foreign banks which were then, for the first time, allowed to operate in Australia in branch form; the domestic law AOA for foreign banks is optional, and most have more recently opted out.[91]

Most other states adopting the AOA or its equivalent in domestic law have done so generally. Due to its territorial tax system, France applies a separate entity approach under domestic law that is similar to the AOA and, in many respects, goes beyond the AOA as it applies even to items of income not covered by the AOA.[92] However, France's tax treaties do not usually include the wording based on the 2010 OECD Model.[93]

After the AOA had appeared in embryo in 2001, the United Kingdom adopted the AOA in domestic law in 2003 applying to all sectors[94] and its preferred treaty policy approach is to include the AOA. However, the United Kingdom does not include the AOA in the treaty if the other contracting state does not adopt the AOA. In relation to pre-AOA treaties, UK courts have held, in relation to article 8(2) of the United Kingdom-Ireland 1975 treaty, which adopted the OECD pre-AOA version of article 7, that "[a]lthough there may be a number of different ways of giving effect to article 8(2), the [AOA allocation of capital rule enacted in UK law in 2003] is undoubtedly one of them and there is nothing in the language of article 8(2) which prevents that being adopted by the UK".[95]

The UK HMRC stated in 2022 that:[96]

> The UK sees the AOA as informative for cases where the tax treaty contains the pre-2010 version of Art 7. Therefore, the UK would consider the application of the AOA in practice but we would look to the earlier guidance on any areas where Article 7 conflicts with the AOA.
>
> UK domestic rules on profit attribution are not completely in line with the new Article 7, particularly in respect of the marking-up (or not) of internal dealings. As with the old Article 7, UK domestic rules only allow for dealings to be passed on at actual cost. This can cause some conflict with the AOA even in cases with a new Article 7 treaty. In such cases, we apply the AOA to the extent that the Treaty overrides the domestic position but there can be situations where the UK position is not aligned with the AOA.

Several states have implemented the AOA since 2010 in domestic tax law, usually for application to both inbound and outbound PE cases but with the major impact on inbound cases.

This is firstly the case for Germany where the AOA was implemented in domestic law in 2013 for both inbound and outbound cases[97] and applies in principle to all sectors. The rationale behind the application of the AOA in German tax law is to ensure taxation of cross-border transactions clearly and uniformly for all investment alternatives – corporations, partnerships, PEs – regarding profit accrual or profit distribution.[98] In addition, courts had already extended an approach similar to the AOA to sectors other than banking where administrative guidelines admitted the application of a similar approach.[99] For both inbound and outbound PEs, if Germany has con-

90. *OECD Model* (2017), para. 11, p. 203, paras. 46-49, pp. 211-212; whether these views can be applied to the pre-2010 version of art. 7 is contentious in some states. For "free" capital, *see* sec. 3.3.1.
91. The legislation applies the AOA by statute to Australian branches of foreign banks (Income Tax Assessment Act 1936 Part IIIB) by treating them as in effect Australian subsidiaries of the bank and originally adopted a regulatory capital approach to their capitalization. Foreign banks have elected for Pt IIIB not to apply in more recent times for various reasons, partly having to do with the domestic implementation of hybrid mismatch rules. While the ATO generally applies the single entity approach, *see* Taxation Ruling TR 2001/11, for resident banks and foreign banks electing out of Part IIIB it accepts that separate PE accounts of the kind contemplated by the AOA are, subject to conditions about functions and documentation, acceptable as a proxy for the single entity approach, and indeed the ATO generally requires such an approach for bank PEs, *see* Taxation Ruling TR 2005/11 and Practical Compliance Guideline PCG 2017/8 dealing, respectively, with notional interest income and expense and notional gains and losses on derivatives arising from dealings.
92. *See* for instance FR: *Conseil d'Etat*, 21 Dec. 2022, n°450796, min. c/ *Sté Bupa Insurance Ltd*, applying transfer pricing principles to a transfer of intangible asset between a French branch and a Danish head office of an insurance company.
93. In Transfer Pricing Profile, *supra* n. 4, December 2021, France states: "France has not adopted the AOA for the attribution of profits to PEs. Nonetheless, France has already used this method to solve MAP cases for fiscal years post-2010. In practice, this methodology was used to solve cases involving the banking sector regarding the question of capital allocation." However, in the France-Luxembourg tax treaty signed on 20 March 2018, the new 2010 version of art. 7 was included for the first time in a tax treaty concluded by France.
94. Finance Act 2003 sec. 149, now located in the Corporation Tax Act 2009 sec. 19-32. Detailed guidance is provided by the HMRC International Tax Manual at INTM267000 and INTM267120, but this Manual has no statutory basis. There is no consultation paper nor parliamentary debate giving details about the rationale behind the adoption of the AOA. Although the adoption of the AOA predated the OECD Model change, it was likely influenced by the PE attribution work being done by the OECD at the time.
95. *Irish Bank Resolution Corporation v HMRC* [2020] EWCA CA 1128, para. 40. As the case concerned a bank, application of the AOA to capital allocation is not necessarily inconsistent with pre-AOA treaties, *see* sec. 3.3., but the language of the decision does not seem to have been limited to banks.
96. Transfer Pricing Profile, *supra* n. 4, UK, February 2022. HMRC noted that the United Kingdom had "17 double tax treaties in force incorporating the new version of Article 7" at that time.
97. Foreign Tax Act sec. 1(5).
98. *See* BR-Drs. 302/12, p. 100 and No. 2 and 3 of the Finance Ministry Regulations of 13/10/14, last change 12/20/2022 – *Verordnung zur Anwendung des Fremdverleichsgrundsatzes u Betriebstätten nach § 1 Abs. 5 des Außensteuergesetzes (Betriebsstättengewinnaufteilungsverordnung* – BsGaV available in German only.
99. *See* e.g. *Bundesfinanzhof* of 22 Aug. 2011, I B 169/10; of 18 Sept.1996, I R 59/95; of 4 Nov. 2021, I B 44/21; of 5 June 24, I R 3/22; also, for details, *see* the updated Finance Ministry Regulations (BsGaV).

cluded a tax treaty with the other state and the AOA has been implemented in it, then the AOA is applicable; if the AOA has not been implemented in the other state (which is currently still the vast majority of the tax treaties that Germany has concluded), a distinction must be made. Insofar as the other state already applies the AOA itself, it is also considered binding in Germany. If, on the other hand, it can be proven that the AOA has not been implemented in national law in this state and is not applied, the AOA does not apply in Germany either.[100] The prerequisite is that the taxation in the state of activity corresponds to the terms of the deviating tax treaty and that applying the AOA in Germany would result in double taxation. The taxpayer must apply for non-application of the AOA and provide evidence that all requirements are met. However, if the cause of the distortion does not lie in the different legal situations between national regulation and the respective tax treaty – but rather in the divergent national implementation of the AOA – the taxation conflict then cannot be eliminated via the escape clause, but at best within the framework of a mutual agreement procedure (MAP) based on the OECD PE report.[101]

Japan[102] adopted the AOA under its internal tax law for both inbound and outbound cases with effect from 2016 partly to unify the attributable income method adopted in Japanese tax treaties and the entire income method adopted in Japanese internal tax law. The AOA was also necessary to clarify the tax treatment of internal transactions between head offices and their PEs or between two PEs. Under the prior internal tax law of Japan, no internal transactions were recognized for the purpose of calculating income of PEs except for internal interest of banks and financial institutions. On the other hand, under the amended internal tax law, which fully adopts the AOA, all internal transactions are recognized by PEs of all industrial sectors. It is worth noting that, although Japan has not officially published its policy on tax treaties, it appears that the adoption of the AOA provisions in its treaties depends upon which state is the other contracting state.[103] In fact, if a tax treaty that is styled on the pre-2010 version of the OECD Model is applicable, Japan will not apply the AOA. In Japan, it is generally understood that a treaty – including an income tax treaty – always prevails over domestic law, including domestic tax law. Article 98(2) of the Constitution of Japan, providing that “treaties concluded by Japan and established laws of nations shall be faithfully observed”, is interpreted to mean that treaties are superior to domestic statutes.

Italy also explicitly introduced the AOA in its domestic legislation in 2015 when the domestic rule governing the taxation of Italian PEs of non-resident enterprises was amended to make it clear that the attribution of profits would have to follow the AOA.[104] The AOA is also explicitly or implicitly referred to in other domestic law statutes, such as those dealing with (i) the exit taxation (assets of Italian PEs moved abroad);[105] (ii) the tax basis recognition for inbound reorganizations (foreign assets moved to Italian PEs);[106] and (iii) the optional exemption of foreign branch profits.[107] From the PE state perspective, the introduction of express reference to the AOA not only aligned the Italian domestic tax law with the approach recommended by the OECD but also created a context of greater certainty for taxpayers by removing the “force-of-attraction” principle, which entailed the attribution to an Italian PE of items of income derived also from activities carried out in Italy by the non-resident enterprise that were not directly connected with those exercised through such PE; the “force-of-attraction” principle was contrary to the OECD Model, and its interpretation through the years gave rise to tax disputes and uncertainty. However, even before the 2015 reform, Italian tax authorities[108] and

100. Under the so-called escape clause, *see* Foreign Tax Act sec. 1(5), sentence 8; for discussion of this clause, *see* S. Hentschel, G. Kraft & T. Moser, *Permanent Establishment Taxation in Germany in a Post-AOA-Implementation Era: A Primer on Exceptions and Problem Areas*, 58 Eur. Taxn. 2/3 p. 73 (2018), Journal Articles & Opinion Pieces IBFD. In its Transfer Pricing Profile, *supra* n. 4, December 2021, Germany seems to indicate that, under its treaties, the AOA applies for all OECD member countries except in relation to transactions in intellectual property but, for non-OECD member countries, the pre-AOA approach applies unless the treaty clearly incorporates the AOA. At that time, Germany had eight treaties incorporating the AOA.
101. *See* No. 426 of the Finance Ministry Circular of 12/22/16: Administrative principles on the allocation of profits of permanent establishments (available only in German).
102. Japanese tax law has domesticated the AOA in the 2014 tax reform, which was brought into force on 1 Apr. 2016. The most useful guidance issued by the Ministry of Finance of Japan regarding the adoption of the AOA is “All of Revised Tax Laws (*kaisei zeiho no subete*) (2014 version)”, which is available in Japanese only. The part of pp. 670-835 of the above guidance is on the adoption of the AOA. For discussion of the changes, *see* Y. Masui, *Introduction of the Authorised OECD Approach into Japanese Domestic Law*, 69 Bull. Intl. Taxn. 9, p. 510 (2015), Journal Articles & Opinion Pieces IBFD.
103. Since the introduction of the new law, Japan has signed more than 20 income tax treaties (including amendments) with various states with some including the AOA provisions, and some not. In its Transfer Pricing Profile, *supra* n. 4, July 2021, Japan indicated that 10 treaties contained the new art. 7 and that, for other treaties, the approach in the *OECD Model* (2008) applies.
104. Art. 7 of Law Decree No. 147 of 14 September 2015 amended art. 152 of the Italian Income Tax Code (*see also* the implementing rules set forth by Regulation of the Director of the Revenue Agency No. 2016/49121 of 5 April 2016, which however deals exclusively with the attribution of free capital to Italian PEs of foreign banks). However, according to the Italian Supreme Court (*see* decision No. 8500 of 25 March 2021), the 2015 reform merely codified a rule that could already be inferred from other statutes, including the transfer pricing legislation (consistent with this approach, *see also* IT: SC, 19 Sept. 2019, Case No. 23355; and IT: SC, 18 July 2022, Case No. 22545).
105. Art. 166 of the Italian Income Tax Code.
106. Art. 166-bis of the Italian Income Tax Code.
107. Art. 168-ter of the Italian Income Tax Code. Conversely, the AOA is not explicitly referred to in the domestic foreign tax credit statute (art. 165 of the Italian Income Tax Code), which applies to foreign PEs of Italian enterprises that have not elected for the branch exemption regime. However, the AOA may be read into the foreign tax credit provision by way of the combined application of art. 165(2) (which sets the criteria to determine whether an item of income is foreign-sourced and refers to art. 23), art. 23 (sourcing rules for non-resident persons, including sourcing rule for non-residents earning business income which must be read in light of art. 152(2)), as well as art. 152(2) (domestic rule referring explicitly to AOA).
108. *See* Circular Letter No. 32 of 22 September 1980, which clarified that internal dealings between a PE and its head office fall under the arm’s length principle and that the amounts granted by the head office to the PE, instead of being treated as an increase of the free capital of the PE, may be considered as a loan generating interests deductible in the hands of the PE. Such position was subsequently recalled by Ruling No. 9/2555 of 31 January 1981, Circular Letter No. 165/E of 24 June 1998, Ruling No. 69/E of 1 June 2005 and Ruling No. 44 of 30 March 2006.

courts[109] had already clarified that the arm's length principle applies to internal dealings between a PE and its head office.[110] In principle, Italy's position is that the AOA is applicable in treaty situations even if the treaty includes the pre-2010 version of article 7. This emerges clearly from the tax authorities' practice and case law when Italy is the PE state, but Italy's position should not in principle change when Italy is the state of the head office that must grant credit for taxes paid in the PE state. However, Italy's domestic rules on the branch exemption regime suggest that, for foreign tax credit purposes (under both domestic law and treaties), Italy could be open to accept – in full or in part – deviating criteria (i.e. non-AOA approaches) utilized by the foreign state, especially if this other state grounds its position on an applicable treaty with Italy that contains the old version of article 7.[111] In this regard, it is worth nothing that Italy has signed 12 treaties after the publication of the 2010 OECD Model; only 5 of these treaties use the new OECD wording, whereas the other 7 treaties still use the pre-2010 version of the article. This can most likely be explained by the treaty policy of the other contracting state.

2.3.3. Some states apply the AOA through their treaties but did not integrate it into their domestic law

In this section, the article considers (i) a state where the application of the AOA is relatively clear (for both post-AOA and pre-AOA treaties – the United States); (ii) a state where the application of the AOA is uncertain for pre-AOA and post-AOA treaties (unless the OECD 2010-2017 language is used – Sweden); and (iii) states where the issue is more nuanced: treaties with the AOA language will clearly be interpreted in accordance with the AOA, whereas other treaties may or may not be so interpreted depending on the circumstances (Netherlands, Canada and Switzerland). The position here is broadly the converse of the states under section 2.3.2., where the issue is whether domestic law incorporating the AOA operates for treaties, with varying answers in relation to treaties which do not incorporate the 2010-2017 OECD language.

The AOA is not implemented in US tax law, which adopts the single entity principle, and US tax authorities generally take the position that – unless a treaty has been negotiated to include AOA language – traditional rules, including domestic law rules, must be applied.[112] This is reflected in a statement published by the US Treasury Department in 2007, which was decidedly ambivalent with respect to the AOA (then under development):[113]

> [W]hile we fully support the Authorized OECD Approach (AOA) for attributing profits to a permanent establishment (PE), it will not apply to most existing U.S. tax treaties. We generally provide in Article 7(3) for a "reasonable allocation of certain expenses," which is not consistent with the arm's length approach of the AOA. …. We cannot apply the AOA to most existing treaties. Where we do apply the AOA, it will apply in its entirety.[114]

The text of article 7(2) in both US Models (2006 and 2016) includes language, though not identical with the OECD 2010-2017 versions, using AOA terminology more broadly. The 2006 Model includes the sentence: "For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment." The 2006 Model contains a note to article 7(3) on deductions spelling out in some detail how the AOA operates, which is further elaborated in the Technical Explanation to that Model, including important changes under the AOA such as markups on intra-entity services and attributing capital to PEs.[115] The 2016 US Model is weaker in this respect, as it provides only for "*taking into account* the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise" [emphasis added] and omits the note found in the 2006 Model. There is no Technical Explanation to the 2016 Model so that no explanation of the change is provided. As discussed in section 3.3.3., this retreat from the more affirmative 2006 formulation may be considered consistent with the fact that the wording of the note – in respect of the attribution of capital in the 2006 US Model and in actual treaties, but not the 2016 Model – provides some discretion in the case of financial enterprises.

109. *See*, inter alia, Judgments No. 113 and 117 of February 2010 of the Provincial Tax Court of Milan; Judgment No. 475 of December 2010 of the Provincial Tax Court of Milan; and Judgment No. 62 of June 2012 of the Regional Tax Court of Lombardy.
110. Art. 152(3) of the Italian Income Tax Code now expressly states that dealings between domestic PEs and the non-resident enterprises to whom they belong are explicitly subject to domestic transfer pricing rules.
111. For an explanation of why Italian courts use the AOA also in the context of pre-2010 treaties, *see* G. Maisto & C. Silvani, *Italy: Retrospective Application of the OECD Report on the Attribution of Profits to Permanent Establishments (Supreme Court, Case No. 8500 of 25 March 2021)*, in *Tax Treaty Case Law around the Globe 2022* (E.C.C.M. Kemmeren et al. eds., IBFD 2023), Books IBFD. In its Transfer Pricing Profile, *supra* n. 4, December 2021, Italy indicated: "Tax treaties that do not contain the AOA may also be interpreted dynamically, to the extent that it does not imply an infringement of the Treaty, given that the AOA is also provided for by domestic legislation." In relation to the domestic exemption regime, *see supra* n. 54 and, in particular, art. 7.2 of Regulation of the Director of the Revenue Agency No. 2017/165138 of 28 August 2017 (setting forth implementing rules for the branch exemption optional regime), which, on the one hand, states that the AOA must be applied for the purposes of determining the profits attributable to the foreign PEs that are exempt under this optional regime, but, on the other hand, specifies that "if the foreign State does not apply, also pursuant to a double tax treaty in force with Italy" the AOA, then the Italian head office can start a unilateral APA proceeding with the Italian Revenue Agency to obtain recognition, in full or in part, of the criteria used by the other state for the purposes of the exemption.
112. *See* generally R. Stack, *US Tax Policy and Attribution of Profits to Permanent Establishments*, 13 World Tax J. 3 (2021), Journal Articles & Opinion Pieces IBFD; and Transfer Pricing Profiles, *supra* n. 4, US, February 2022.
113. *Treasury Clarifies U.S. Position Regarding Interim OECD PE Profit Allocation Guidance*, Bloomberg BNA Daily Tax Report (8 June 2007). The United States bases its rejection of the AOA on the deduction rule in art. 7(3) like the United Nations, *see infra* n. 150.
114. Note that this statement dates from 2007, so reference to "the AOA . . . in its entirety" was prior to even the 2008 proposal and should be read accordingly.
115. This Note and its Technical Explanation is discussed further in relation to attribution of capital to bank PEs *infra* nos. 198-204 and text. For the US Model and Technical Explanation (2006) and the US Model (2016), *see* US Department of the Treasury, *Policy Issues, Tax Treaties*, available at https://home.treasury.gov/policy-issues/tax-policy/treaties, top of page (2016) and bottom of page (2006).

The US tax authorities have litigated (unsuccessfully) under two older treaties preceding the AOA to apply a US domestic law formulary approach for attributing insurance company profits or a bank's interest expense, respectively, to a US branch of a treaty state resident.[116] The United States, however, did not enter a reservation in respect of the AOA in connection with the 2010-2017 updates of the OECD Model. Further, article 7 of the 2016 US Model Income Tax Treaty includes general language reflecting certain AOA principles,[117] and similar language has been included in certain treaties signed in recent years. To what extent, if any, AOA principles would be considered by US courts to go beyond rejecting mandatory formulary apportionment is unclear.

An example of a state where domestic tax law has not changed, but the position of the AOA in domestic law and tax treaties is somewhat unclear, is Sweden. With respect to tax treaties, Sweden has incorporated the wording of the AOA in its preferred negotiating position from 2012 and also follows it in its treaty practice (*see*, for example, the 2015 tax treaty with the United Kingdom).[118] Concerning domestic law, the position currently is being tested in the courts. A PE is considered an independent enterprise under case law.[119] However, there are no rules in the Income Tax Act on what assets and liabilities are to be attributed to the PE. In a Supreme Administrative Court case from 1998, it was determined that shares in a subsidiary could be linked to a PE if the holding was linked to its activities.[120]

The main issue in later lower court cases has been how to interpret the meaning of the "linked to" activities test, and especially whether the PE must fulfill the significant people functions criteria of the AOA. The National Tax Agency, in a formal statement,[121] has declared its position that guidance can be obtained from the OECD AOA reports in assessing whether shares in subsidiaries can be linked to the PE. The Stockholm Court of Appeal decided in 2024 that the OECD Commentaries can be used as guidance when domestic law and the OECD Model are based on the same principles.[122] When it came to the issue of significant people functions, the Court stated that Swedish law does not contain such a requirement. Consequently, the Court of Appeal held that there were strong arguments in favour of the conclusion that, on the issue of attribution of shares of a subsidiary to a PE in Sweden, the OECD report and domestic law are not based on the same principles. The decision has been appealed to the Supreme Administrative Court which, in December 2024, granted certiorari.[123] Considering the history of the case, it will not be surprising if the decision of the Court of Appeals is upheld.[124]

In the Netherlands, the AOA is in principle only applicable if this approach is explicitly included in article 7 of a particular tax treaty (mix of pre-2010 and post-2010 treaties).[125] Nevertheless, there is a possibility to opt for the AOA even in situations where the applicable tax treaty contains a pre-2010 version of article 7 of the OECD Model, in view of the dynamic method as applied in the Netherlands. This is subject to the condition that the profit allocation based on the AOA is also applied consistently in the other contracting state concerned.[126] Fur-

116. *National Westminster Bank, PLC v. Internal Revenue Service*, 512 F.3d 1347, (Fed. Cir. 2008); and *North West Life Assurance Company of Canada v. Commissioner*, 107 T.C. 363 (1996).
117. United States Model Income Tax Convention 2016 available at https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf, p. 15. Specifically, under art. 7(2), profits attributable to a PE would be "the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise". Similar language is included in signed (in 2013 and 2022) but not ratified treaties. Similar but somewhat different language was included in the US Model (2006).
118. *See* prop. 2015/16:7, esp. p. 52 where clear reference is made to the 2010 changes of the OECD Model.
119. RÅ 1971 ref. 50.
120. RÅ 1998 not. 229.
121. *Skatteverkets ställningstagande 2023-11-27, dnr 8-264615 Allokering av dotterbolagsandelar till fast driftställe. See also* Transfer Pricing Profile, *supra* n. 4, Sweden, December 2021.
122. *Kammarrätten i Stockholm*, 17 July 2024, cases 2595/23 and 2596/23.
123. Mål nr 5375-5376-24. According to the Transfer Pricing Profile (*supra* n. 4) for Sweden, December 2021, the Swedish tax administration applies the OECD Commentary (2008) to treaties based on the pre-AOA version of art. 7 and the principles of the AOA to treaties with the new version of art. 7.
124. For a recent description and analysis, *see* J. Ax & T. Söderlund, *Allokering av dotterbolagsandelar till fast driftställe -en omtvistad fråga trots klart rättsläge*, *Svensk Skattetidning 2023* pp. 347-362, and the same authors, *Allokering av dotterbolagsandelar till fast driftställe – En uppdatering och reflektion, Svensk Skattetidning 2025* pp. 26-34. The Swedish tax administration takes the view that the 2008 Commentary applies to all pre-AOA treaties, *see* Transfer Pricing Profile, Sweden, December 2021.
125. There is no specific reference to the AOA under the rules on non-resident tax liability for individuals/entrepreneurs and corporations. According to *Fiscale Encyclopedie De Vakstudie* (Fiscal Encyclopedia), *Vennootschapsbelasting* (Corporate Income Tax), Wolters Kluwer online, art. 17, para. 22, the AOA does not apply to non-resident taxpayers with a PE located in the Netherlands.
126. Decree of the State Secretary of Finance of 14 June 2022, no. 2022-0000143421, Dutch Government Gazette 2022, 16683, para. 1.3. The possibility to opt for the AOA with respect to the tax treaties based on the pre-2010 version of the OECD Model was confirmed by the District Court of North-Holland in its decision of 24 October 2018, ECLI:NL:RBNHO:2018:9192, V-N 2019/13.2.2. The Court referred to the option provided for in the Decree of 15 January 2011, no. IFZ2010/457M, BNB 2011/91 (old), i.e. the predecessor of the Decree of 14 June 2022, which allows an allocation based on the AOA in relation to art. 7 of the France-Netherlands Tax Treaty (1973) (which is based on the OECD Model (1963)). However, on appeal, the Amsterdam Court of Appeal in its decision of 22 December 2020, ECLI:NL:GHAMS:2020:3634, V-N 2021/14.1.2 was unwilling to recognize the possibility of opting for the AOA. Instead, the Court of Appeal examined whether the 2010-2017 Commentary could be applied because it took the view that the differences in the wording between art. 7 of the tax treaty in question (based upon the OECD Model (1963)) and art. 7 of the 2010-2017 OECD Model (incorporation the AOA) were not as such that the OECD Commentaries could not be applied dynamically. However, the limited dynamic application of the 2010-2017 OECD Commentaries followed by the Court did not allow the AOA to be applied in this case because it went beyond a mere clarification. Advocate-General Wattel in his Advisory Opinion of 26 August 2021, ECLI:NL:PHR:2021:769, V-N 2021/52.8 considered the application of the AOA, but concluded that the issuance costs in question (in relation to shares and convertible obligations/ *Obligations Remboursale en Actions*) were not really covered by the OECD Commentaries on Article 7 (nor by those of 2010-2017). In its decision of 17 May 2024, ECLI:NL:HR:2024:706, BNB 2024/79, the Supreme Court on further appeal referred only to the wording of art. 7 of the France-Netherlands Tax Treaty (1973) and the Commentary on Article 7 of the OECD Model (1963). According to the Supreme Court, this anterior Commentary is of great importance for the interpretation of art. 7 of the tax treaty in question. The Supreme Court did not take

thermore, it is part of the Dutch tax treaty policy to seek the inclusion of the AOA in its tax treaties. The Netherlands has included the AOA in various treaties concluded since the 2011 Tax Treaty Policy Memorandum but not in all.[127] The State Secretary for Finance's Decree of 14 June 2022[128] confirmed that the AOA in principle only applies when a corresponding article 7 of the 2017 OECD Model is included in a particular tax treaty.

In Canada, the limited independence form of the AOA is said to be relevant to the allocation of profits to PEs by the revenue authorities,[129] and the general AOA language along with the TPG are referred to in the exchanges of notes on the 2007 protocol to the Canada-United States 1980 tax treaty, which adopts the AOA.[130] In a landmark decision, *Cudd Pressure Control Inc v The Queen*,[131] decided prior to the AOA's introduction, the question arose of whether notional expenses attributable to a taxpayer's PE in Canada could be deducted for Canadian tax purposes. The judges held that notional expenses are generally not deductible, but one judge said that such deductions may be possible in some cases. This is also addressed under the Canadian Income Tax Conventions Interpretation Act, which prohibits such deductions except if there is an agreement entered into between the competent authorities of the parties to the tax convention in question, and if such agreement expressly provides for the deduction.[132]

Thus, some pre-AOA administrative practice and case law suggest the possibility of an approach similar to the AOA for domestic law and tax treaties.

There is broad agreement on the fact the allocation of profits to the Swiss PE of a foreign enterprise which is based on an independence fiction is potentially consistent with the AOA.[133] The law indeed provides in this regard that taxpayers who have their registered office and effective management abroad are separately liable to tax on the profits they make in Switzerland.[134] For tax purposes, the Swiss branch of a foreign enterprise is assimilated to the Swiss enterprise to which it most closely or factually resembles, e.g. a joint-stock corporation.[135] Switzerland, however, has not explicitly implemented the AOA in its domestic legislation and, thus, formally applies the AOA only through its tax treaties.[136] In this regard, however, a majority of Swiss tax treaties are based on the 2008 OECD Model,[137] whereas others are patterned upon the 2010 OECD Model. While Switzerland has not made any reservation or observation to the 2010 and 2017 Commentaries on Article 7, and generally endorses the AOA as a matter of tax treaty practice, Switzerland has agreed to deviate from this policy at the request of selected treaty partners.[138]

the AOA into account. The District Court of Zeeland-West-Brabant in its decision of 11 November 2019, ECLI:NL:RBZWB:2019:4920, V-N 2020/8.10 and on appeal the Hertogenbosch Court of Appeal in its decision of 13 April 2022, ECLI:NL:GHSHE:2022:1198, V-N 2022/31.1.3, allowed a reliance on the AOA. On appeal in cassation, the Supreme Court did not explicitly comment on this view of the Court of Appeal in its decision of 17 April 2025, ECLI:NL:HR:2025:55, BNB 2025/74. *See also* the decision of the Court of Appeal of The Hague of 27 October 2021, ECLI:NL:GHDHA:2021:2143, V-N 2022/7.7, in which the former 2011 Decree and the AOA were considered. In this respect, the taxpayer's reliance on this Decree on the basis of the principle of legitimate expectations may be a relevant feature.

127. This has been realized in eight treaties or protocols since 2010, and the Tax Regulation Netherlands-Curacao (2015), but at least seven post-2010 treaties still contain a provision corresponding to the pre-2010 version of art. 7.
128. Decree of the State Secretary of Finance of 14 June 2022, no. 2022-0000143421, Dutch Government Gazette 2022, 16683.
129. *See supra* n. 69.
130. Note No JLAB-0112 (often referred to as Annex B), 21 September 2007, para. 9 available at https://home.treasury.gov/system/files/131/Treaty-Canada-Pr2-Note-9-21-2007.pdf. In its July 2025 updated Transfer Pricing Profile, *see supra* n. 4, Canada's revenue authorities state, "Canada has three tax treaties containing an Article 7 broadly in line with the OECD Model Tax Convention 2010 and 91 treaties containing an Article 7 as it read before 2010. ... There is no implementation of the AOA where the applicable tax treaty does not contain the new version of Article 7 (OECD MTC 2010 and later)."
131. 98 DTC 6630.
132. Sec. 4 of the Canadian *Income Tax Conventions Interpretation Act*, about PEs in Canada provides:

   Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that where, for the purposes of the application of the convention, the profits from a business activity, including an industrial or commercial activity, attributable or allocable to a permanent establishment in Canada are to be determined for any period,

   (a) there shall, except where the convention expressly otherwise provides, be included in the determination of those profits all amounts with respect to that activity that are attributable or allocable to the permanent establishment and that would be required to be included under the Income Tax Act, as amended from time to time, by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period; and

   (b) there shall, except to the extent that an agreement between the competent authorities of the parties to the convention expressly otherwise provides, not be deducted in the determination of those profits any amount with respect to that activity that is attributable or allocable to the permanent establishment and that would not be deductible under the Income Tax Act, as amended from time to time, by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period.
133. Art. 52(3) DBG: *Dans les relations internationales, l'étendue de l'assujettissement d'une entreprise, d'un établissement stable ou d'un immeuble est définie conformément aux règles du droit fédéral concernant l'interdiction de la double imposition intercantonale.* ["In international relations, the extent of the tax liability of a company, permanent establishment or real estate is determined in accordance with federal law on the prohibition of inter-cantonal double taxation."].
134. Federal Supreme Court Judgment 2C_972/2018 of 2 October 2019, para. 5.
135. Art. 52(4) DBG: *Les contribuables qui ont leur siège et leur administration effective à l'étranger doivent l'impôt sur le bénéfice qu'ils réalisent en Suisse.* ["Taxpayers who have their registered office and effective management abroad are liable to tax on the profits they make in Switzerland."]. Losses incurred by the foreign head office are obviously in such case not deductible in Switzerland.
136. *See* for example tax treaties concluded with Cyprus (2014), Hungary (2013) and Iceland (2014).
137. *See* for example recently P. Brulisauer, *Unternehmensgewinne*, in *Internationales Steuerrecht, der Schweiz* p. 252 (R. Stocker & S. Oesterhelt eds., Stämpfli Verlag 2023); C. Martin, V. Chand & N. Burkhalter, *Arm's Length Principle from a Swiss Perspective: Profit Allocation to Inbound and Outbound Permanent Establishments*, Intertax, pp. 67-68 (2022).
138. *See* for example the Switzerland-Australia tax treaty of 30 July 2013 and the comments of the Swiss Federal Council (FF 2014 1, p. 6) in its dispatch to the treaty: "In 2010, the OECD established new rules on the allocation of profits of a company between its headquarters and permanent establishments. Switzerland has incorporated these new rules into its treaty policy; however, Australia, under its domestic law, cannot apply them. It has therefore been agreed to incorporate the text of Article 7 of the 1980 Convention into the AUS DTA." In its July 2021 Transfer Pricing Profile, *see supra* n. 4, Switzerland states, "In practice and if the other Competent Authority agrees, Switzerland will tend to follow the AOA even if the treaty has not been updated with the new version of Article 7."

For domestic tax purposes, the application of the AOA, as a matter of principle, is generally advocated by scholars.[139] In the same vein, Swiss courts have started to align their decisions with the AOA, or at least ensuring compatibility of methods, especially in international situations. In a judgment of 16 December 2019 published in the official register and involving the foreign PE of a Swiss airline company, the Federal Supreme Court considered in an *obiter dictum* that the application of quota-based methods traditionally applied in inter-cantonal relations are no longer admissible in international relations after article 7(4) of the 2008 OECD Model was abolished.[140] This conclusion was subsequently confirmed (although in a more nuanced fashion and with more emphasis on the wording of article 52(3) of the DBG) in a subsequent judgment of 5 August 2020.[141] In light of this evolution, it is therefore fair to say that there is growing alignment between Swiss domestic international tax practice and the AOA.[142]

2.4. AOA complicates further work on PE profit attribution

In June 2012, less than 2 years after the completion of the 10-plus-year PE attribution project, the G20 supported the OECD in investigation of the BEPS problem and the OECD produced its Action Plan in mid-2013, with Action 7 on preventing the artificial avoidance of PE status requiring the OECD to "also address related profit attribution issues".[143] While the development of changes to the PE definition was concluded on schedule in 2015,[144] the PE attribution issues dragged on until 2018.

The PE definition was widened by the BEPS work in two areas, namely the narrowing of the preparatory or auxiliary activity exclusion (extension of the preparatory or auxiliary limitation to all subparagraphs of the exception and the anti-abuse rule directed at splitting PE locations or entities involved to get access to the exclusion) and the broadening of the agency PE rules (by extension of the activities giving rise to a PE and limiting the independent agent exception). The result was an increase in the range of activities constituting a PE.

General transfer pricing principles based on functions, assets and risks do not depend on an enterprise resident in one state having either an associated enterprise resident in or a PE located in another state. If the enterprise has personnel carrying out activities (functions), assets located or risks associated in some way with the other state, then potentially profits could be allocated under transfer pricing principles to that other state. Under tax treaties, particularly articles 7 and 9 of the OECD Model, no business profits can be allocated to the other state unless there is an associated enterprise resident or PE located there, though tax may be possible if some other article using a different connection to the other state for a particular form of income derived by the enterprise (such as rent from or gains from alienation of immovable property, dividends or interest) is applicable to those profits and permits taxation by that other state.

In this sense, articles 7 and 9 introduce thresholds unrelated to underlying transfer pricing principles that must be satisfied before transfer pricing can allocate profits to a state. Of course, it will not always be easy to produce the happy outcome for taxpayers that the thresholds are not passed, but they are fundamental to the international tax system. If that is correct, then the change to the PE definition should not matter – it just gives greater scope for the operation of existing underlying transfer pricing principles. So, it may be thought surprising that WP6 struggled significantly and required two public discussion drafts (in 2016 and 2017) before coming up with final results in 2018 illustrating the transfer pricing (PE profit attribution) results of the changes to the PE definition. Conversely, the existence of the thresholds may produce a potential misalignment with the AOA in cases in which the existence of a PE may not be accompanied by the identification of significant people functions or the attribution of the economic ownership of assets, with the consequence that no income would be attributable to the PE.[145]

Though there were several problems that WP6 had to face in the exercise, the main one was the AOA. WP6 issued a draft blithely assuming that everybody was on board with the AOA and analysed the issues accordingly. The main (but by no means only) criticism of the draft was its use of the AOA. By this time, the exercise was being conducted under the auspices of the Inclusive Framework on BEPS, which was created shortly after the delivery of the 2015 BEPS Reports with the main objective of attaining global agreement on BEPS rather than just agreement of OECD and G20 member states. The word "inclusive"

139. *See* sources cited in *supra* n. 137.
140. ATF 146 II 111, 3.5.3. *See* thereupon C. Martin, V. Chand & N. Burkhalter, *Arm's Length Principle from a Swiss Perspective: Profit Allocation to Inbound and Outbound Permanent Establishments*, Intertax, p. 76 (2022).
141. Federal Supreme Court Judgment 2C_1116/2018 of 20 August 2020. *See* thereupon C. Martin, *Swiss Supreme Court Restates Principles of International Profit Allocation under Swiss Domestic Law*, Kluwer International Tax Blog, and C. Martin, V. Chand & N. Burkhalter, *Arm's Length Principle from a Swiss Perspective: Profit Allocation to Inbound and Outbound Permanent Establishments*, Intertax, p. 76 (2022).
142. In the same vein, P. Brulisauer, *Unternehmensgewinne*, in *Internationales Steuerrecht, der Schweiz* p. 252 (R. Stocker & S. Oesterhelt eds., Stämpfli Verlag 2023); and C. Vilaseca, *L'impact des directives OCDE 2017 en matière de prix de transfert et de l'approche autorisée ("AOA") sur la pratique suisse: étude au regard de la jurisprudence récente du Tribunal fédéral*, RDAF 2022 II 24.
143. G20, Leaders' Declaration, June 2012 para. 48, available at https://g20.org/wp-content/uploads/2024/10/G20_Mexico_2012_communique-1.pdf; and OECD, *Action Plan on Base Erosion and Profit Shifting* pp. 19-20 (OECD 2013), Primary Sources IBFD.
144. OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
145. OECD, *Public Discussion Draft: BEPS Action 7 Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD 2016); OECD, *Base Erosion and Profit Shifting (BEPS) Public Discussion Draft BEPS Action 7 Additional Guidance on Attribution of Profits to Permanent Establishments* (OECD 2017); and OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments BEPS Action 7* (OECD 2018). For the converse case, *see*, for example, the comment of the Federation of German Industries to the OECD, *Public Discussion Draft: BEPS Action 7 Additional Guidance on the Attribution of Profits to Permanent Establishments* (2016).

is intended to show that the OECD is taking on board and giving a voice to concerns of non-OECD member countries (largely developing countries). As discussed in section 2.3., significant differences of view exist within the OECD on the AOA, and the AOA has also been rejected by India and South Africa, the non-OECD countries represented here. The first discussion paper was, unsurprisingly, roundly criticized for its lack of inclusiveness. WP6 then retreated to providing high-level general principles on which everyone agreed but produced significant diversity of opinion as to what they mean. They have no OECD official status like the OECD Model and Commentary, 2010 Report and the TPG and have not yet had any impact on the content on them.

While a lot can be said about the specifics of the two drafts and the report, the main takeaway of this 5-year exercise is that the AOA will prove to be a significant barrier to future work on PE profit attribution by WP6 and the OECD because of the diversity of opinion on the underlying principles of PE profit attribution. Indeed, the main BEPS work by the OECD on digitalization of the economy since 2015 has been on whether and how to replace (in whole or in part) or supplement the thresholds and profit attribution principles.

The difficulties in applying the AOA to a widened PE definition also presents a barrier to any policy approach that relies upon widening further the PE concept. As a solution to the taxation of the digital economy, some countries have considered adopting a "virtual PE" concept, based, for example, on a significant economic presence (sufficiently large number of online customers located in the territory).[146] Defining such a virtual PE is not particularly difficult; determining the profit attributable based upon the AOA is practically impossible. How can one apply an approach based upon a functional analysis of functions, assets and risks when the PE is purely notional? In effect, a virtual PE approach must abandon the AOA in favour of a gross revenue approach or some approach based on an alternative method of determining net profits. The difficulties with the AOA impede any solution to the problem of taxing foreign residents who trade in a country in the absence of a physical PE.

2.5. No consensus on the method of profit allocation

It will be apparent that the AOA has produced changes in the treatment of attribution of profits to PEs in various states' domestic laws and under some treaties, but more obviously it is clear that the AOA has not received general acceptance among the states represented here, leading to further diversity of views among states. As noted previously, one of the ongoing drivers of OECD work in this area has been to remove the significant variations in state practices. In terms of this objective, the OECD has not progressed farther than before the recent attribution work was undertaken. Indeed, the desire to produce the best method of attribution without regard to history and past practice seems to have backfired by entrenching differences between the OECD pre- and post-2010 versions of article 7 and stymied further development, as the pre-2010 work is now frozen in place and will not be further developed by the OECD, while additional OECD work on improving PE attribution has not been very productive because it starts with the AOA which does not have general consensus, as amply demonstrated in the 2018 BEPS Action 7 Report.

Part of the criticism of the AOA relates to the interaction with domestic laws of states. For instance, under the domestic law of states that have adopted a single entity approach, it may be impossible or very difficult to recognize profits from a purely notional internal dealing. There is also case law and guidance in some states which may make it difficult to adopt the AOA without an explicit change in the wording of article 7 of their tax treaties.[147] Where states can or do not internally apply the AOA, the new approach would be operative only if required under tax treaties and states clearly differ on when this occurs.[148] This situation seems to have further restricted the future development of the AOA, as most states align domestic law with their treaty practice. It remains to be seen whether there is enough flexibility in the AOA to overcome these difficulties.[149]

146. India has adopted a significant economic presence approach in domestic law, which has been held by courts to be overridden by tax treaties with service PE provisions, *see* A. Goyal & K. Sharma, *Virtual Permanent Establishment – A New Nexus to Tax?*, 114 Tax Notes Intl. 1899 (24 June 2024), so that the issue does not arise under current treaties but India has broader domestic attribution rules and in APAs has used formulary methods for attribution, *see supra* nos. 83-87 and text.

147. For example, Australia, India, South Africa and the United States.

148. *See* sec. 2. generally and Bernales, *supra* n. 82, at pp. 172-180.

149. P. Baker & R.S. Collier, *General Report*, in *IFA Cahiers 2006 – Volume 91B. The attribution of profits to permanent establishments* pp. 21, 27 and 31 (IFA 2006), Books IBFD.