# Chapter X

# About the Deductibility of Head Office Expenses: A Commentary on Art. 7(3) of the OECD and the UN Model

## 1. Introduction

### 1.1. The different expenses of a permanent establishment

Typically, there are three kinds of expenses that may find their way into the expense-account of a permanent establishment ("PE"). First, there are expenses proper to the branch itself, incurred where it is established: office rent, salaries of its own staff, utilities and office equipment used in the branch office, etc. There can be little discussion that these expenses may be deducted in its entirety in the country where the branch is established. With reference to art. 24(4) (non-discrimination of PE's) of the OECD Model, these expenses may not be deductible in a manner less favorable than for local enterprises.

Secondly, there are expenses the head office incurred for the exclusive benefit of the PE. Examples are the interest on a loan obtained from third parties (such as a bank) to buy the office premises of the PE, depreciation on machines bought by the head office that are transported to and operated in the PE, research and development expenses for a product made in the PE, special management services for the benefit of the branch, special accounting services relating to the reorganization of the branch, etc. Generally, these expenses will be entirely allocated to the branch they were made for.

The third group of expenses creates the most difficulties: executive and general administrative expenses. These are the expenses the head office incurs for the general management, administration and strategy of the whole enterprise, including its foreign branches. Usually, it includes office rent and utilities (phone, electricity, etc.), director's fees, travel expenses of personnel that visits the branches, general audit, general training expenses, professional services used for the whole enterprise, expenses for technology and computer software that is used in the whole enterprises, etc. These expenses are generally attributed between the head office and its PE(s) following a certain apportionment key such as turnover.

In this article the question is addressed which expenses of the second and the third group may be deducted by a PE. In other words, which kinds of services may the head office attribute to one of its PE's for tax purposes, a matter that is under treaty law most importantly prescribed by art. 7(3) of the OECD Model. How the deductible amount should be calculated is not examined in this article.

### 1.2. General rule for the determination of the income of a PE

Under tax treaty law, art. 7 (2) contains the general rule on the determination of the profit of a branch or any other kind of permanent establishment. This rule states that the profits attributed to the PE are those which the PE would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and prices of the open market. In other words, the PE must, for the purpose of determining its profit, be treated as if it was an enterprise of its own, and not just a part of the enterprise of the head office. This general rule is sometimes referred to as the "fiction of independence"[1297], because the PE is treated for tax purposes as if it is a separate entity while it has as a matter of fact no separate juristic personality.

Usually, in practice, a PE will submit its tax return in the country where it is established on the basis of accounts that are available within the enterprise and which show the profit of each branch separately. Insofar as those accounts incorporate the consequences of "agreements" with the head office, a reassessment may be in order for tax purposes in the country where the PE is situated, as explained below.

The subject matter of art. 7(2) and 7(3) is closely related[1298]. On this subject, the OECD Commentary points out that:

> *"It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length*

[1297] Endfellner, C., "Managementleistungen zwischen Stammhaus und Betriebstatte", Steuer und Wirtschaft International, Sep. 2001 (nr. 9), p. 381.; Van Crombrugge, S., "De winstbepaling van Belgische en vaste inrichtingen", Tijdschrift voor Rechtspersoon en Vennootschap, 1988, p. 397.

[1298] Burgers, I., "Commentary on art. 7 of the OECD Model: Allocation of Profits to a Permanent Establishment", in The Taxation of Permanent Establishments, *IBFD*, 1994, p. 16.

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

## 2. Head Office Expenses under Art. 7(3) OECD Model

### 2.1. General comments on the interpretation of art. 7(3) OECD Model

The text of the 3rd paragraph of art. 7 of the OECD Model reads as follows:

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

The OECD Commentary on these provisions was replaced in 1994, pursuant to an OECD Report on Attribution of Income to Permanent

Establishments[1299]. Very recently, the OECD released a discussion draft for comments entitled: "The Attribution of Profits to Permanent Establishments"[1300]. Point D of that discussion draft addresses the interpretation of art. 7(3) and is relevant for this study[1301]. In the near future, the OECD Commentary could be redrafted to take the results of this initiative into account, but it is too early to tell if there will be any significant changes.

It is noteworthy that the drafters of the OECD Model found it necessary to provide a special rule on profit determination of PE's with respect to expenses, distinct from art. 7(2). Notwithstanding that the two paragraphs are in some respects not different[1302], the general rule laid down in art. 7(2) apparently did not suffice in itself to express the intention of the drafters, and by proxy, the contracting states that adopt their text. The drafters' special attention for head office expenses is understandable. They were of course aware that many countries are wary of allowing expenses incurred abroad to be deductible for a local PE. After all, a PE is, as a non-resident, only taxable on domestic income, so reluctance to allow foreign expenses is reasonable. On the other hand, the drafters had to recognize that in most cases, a PE depends to a large extent on its head office to perform its business functions. Many PE's are not able to operate without the management and administration carried out in the head office for the purpose of the PE. Article 7(3) makes sure that such expenses would also be taken into account for determining the taxable profit of the PE.

From the ordinary meaning of the text of both paragraphs, the intention of the contracting states can be derived. Article 7(2) talks only of "attribution" of expenses to a PE for tax treaty purposes, arguably leaving room for the contracting state to disallow the deduction of that particular expense on the basis of its domestic tax law. Article 7(3) imposes in my

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[1299] OECD, Report on Attribution of Income to Permanent Establishments, *Paris*, 1993.

[1300] OECD, "The Attribution of Profits to Permanent Establishments- A Discussion Draft", *Paris*, February 2001, (hereafter referred to as "OECD Discussion Draft").

[1301] OECD, Discussion Draft, par. 161-175.

[1302] Van Raad has suggested that art. 7(3) should be deleted, or replaced by the following paragraph: "In determining the profits of a permanent establishment, there shall be allowed as deductions which it might be expected to incur if it were a distinct and separate enterprise as referred to in par. 2, including executive and general administrative expenses so incurred", in "The 1977 OECD Model Convention and Commentary: selected suggestions for amendment of art. 5 and 7", *Intertax*, 1991, p. 500.; See also Burgers, I., Taxation and Supervision of Branches of International Banks, *IBFD*, Amsterdam, 1991, p. 498.

view a further obligation on a contracting state to allow certain expenses as a deduction. In this sense there is indeed a difference between the two paragraphs[1303].

The contracting states had, by adopting this clause from the OECD Model into their treaty, the intention to make it clear that just because expenses were incurred outside of the PE's jurisdiction, or just because the expenses were not made in the exclusive benefit of the PE, said expenses may not be disallowed for tax purposes by the contracting state where the PE is situated[1304].

### 2.2. "there shall be allowed as deductions": Cudd Pressure Control Inc. vs. The Queen

The issue of the relationship between rules on deductibility of head office expenses in domestic law the tax treaty rules on the subject, and particularly the difference between the treaty "attributing" expenses and "allowing deduction" of expenses, was addressed in rather unfortunate terms by the Tax Court of Canada in the matter of Cudd Pressure Control Inc. vs. The Queen [1305].

In that case, the taxpayer Cudd is a US corporation that renders technical services to the oil industry, including controlling and repairing oil wells with a piece of equipment which is called a "snubbing unit". A customer in Canada requested the services of Cudd , which transferred its equipment to Canada and operated there with a crew during 8 months. This activity constituted a PE under the treaty. For determining its taxable profit in Canada (the profit of the PE), the taxpayer submitted that a "rent" of the equipment should be allowed for deduction in Canada. However, no real payment or booking had taken place, and the taxpayer had to argue that a "notional" expense should be allowed for deduction, which is contrary to Canadian domestic law. The tax authorities submitted that the taxpayer's interpretation finds no support in the US-Canadian tax treaty[1306]. The court agreed with the tax authorities.

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[1303] A difference which is not pointed out in the OECD Commentary, par. 17.; See also OECD, Discussion Draft, par. 172. One could argue that "attribution" in art. 7(2) leads, at least with respect to expenses, to "being allowed as a deduction" in much the same way as specified in art. 7(3). This may be true (see below 4.2. b) with footnotes) but that still does not change the conclusions formulated in this article.

[1304] Discussion Draft, par. 173-174.; Van Raad, *Intertax*, 2001, p. 163-164.

[1305] Cudd Pressure Control vs. The Queen, 25 May 1995, 95 *TNI* 214-20.

[1306] US-Canada tax treaty of 1948, art. III 1; "If an enterprise of one of the contracting states has a permanent establishment in the other state, there shall be attributed to such

The Canadian Tax Court stated that the treaty only attributes and allocates income and expenses, and leaves it up to the domestic law of the states to decide whether a particular expense is deductible:

> *"The primary purpose of art. III is to enable the source country, in this case Canada, to properly determine and allocate the net profits arising from the Appellant's Canadian business. There is no definition or limitation in Articles I or III of the phrases 'net industrial and commercial profits' and 'all expenses wherever incurred'. Thus it reasonably follows that in order to determine the profits allocable to the PE reference must be made to the internal laws of the country in which the establishment is situated to determine whether the expenses claimed as a deduction are allowable".*

This consideration of the court is only partly true because it ignores the ordinary meaning of the terms "allowed as deductions" in the text of the treaty, terms which clearly go beyond attribution alone. It may not be forgotten that this consideration was made while pondering the question whether the treaty obliges that "notional" expenses must be allowed as a deduction[1307], a question that is under the domestic law of most countries answered in the negative[1308].

The court may be right in assuming that the treaty does not impose an obligation on the contracting states to allow the deduction of head office expenses in a manner contrary to *certain general* provisions of its internal law which are not addressed by the treaty. The general provisions on expenses are in my view *inter alia* the general rules concerning documents to be submitted as proof (for example rules concerning the translation of documents in a foreign language and rules on which consular procedure should be followed to prove the authenticity of foreign documents), rules on the taxable period during which expenses may be deducted and rules that contain exceptions on the deductibility on

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permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profit will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. In the determination of the net industrial and commercial profits of the permanent establishment there shall be allowed as deductions all expenses, wherever incurred, reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable."

1307 Notional expenses are expenses which a PE is required to remit to the head office without actual payment or booking entry to that effect.

1308 Ault, H.J., Comparative Income Taxation, *Kluwer*, 1997, p. 439.

certain kinds of expenses (such as entertainment expenses, non-deductible fringe benefits, certain donations, certain fines or penalties, etc.)[1309].

But, contrary to what the court states in terms that are too general, *certainly not all* internal rules on the deduction of (head office) expenses may be applied regardless of the treaty. Art. 7(2), 7(3) and other provisions of the OECD Model do impose an obligation on the contracting states to allow the deduction of expenses that are incurred for the purpose of the PE, if necessary by overriding domestic rules to the contrary. Subjecting that obligation completely to internal law may, depending on the extent of those domestic rules, come down to ignoring the terms "allowing the deduction". That interpretation is unacceptable under international law because it is an interpretation that disregards the ordinary meaning of the text of the treaty[1310]. It is also contrary to the OECD Commentary that states: "Par. 3 indicates that in determining the profits of a PE certain expenses *must* be allowed as deductions…(emphasis added)"[1311].

The contracting states intended to commit themselves to allowing the deduction of expenses which are made for the purpose of the PE, even when those expenses were incurred elsewhere or even when those expenses were not in the exclusive benefit of the PE. In any event, domestic rules that conflict with these treaty commitments cannot be called upon to disallow the expense. A domestic rule which subjects the deduction of the expense to having been incurred in that country, is therefore contrary to the treaty, and cannot be applied in a treaty situation (see below 2.6). A domestic rule which provides that only expenses which are incurred in the exclusive benefit of the local PE, may be deducted, is also contrary to the treaty, and cannot be applied in a treaty situation (see below 2.3.)[1312].

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1309 See for example the Commentary by the Belgian tax authorities on the double taxation conventions, 7/333 pointing out that head office expenses allocated to a PE in Belgium must be refused deduction because such expenses are simply not deductible for any Belgian enterprise. The Belgian Commentary mentions e.g. remuneration paid to persons without permanent employment (no longer in force), pension contributions that do not meet the requirements for deductibility, etc.
1310 Cfr. Art. 31 Vienna Convention on the Law of Treaties.
1311 OECD Commentary art. 7, par. 17.
1312 Such is the case in Belgium with art. 237 Income Tax Code ("For deduction as business expenses only expenses are allowed that exclusively concern income referred to in art. 228-231").; Peeters, B., Commentaar Dubbelbelastingverdragen, 1991, p. 103.; Malherbe, J., Droit Fiscal International, Larcier, 1994, p. 317.; The same can be said for art. 65 ter 14 of the Revenue Code of Thailand ("Are not deductible: Expenses that were not exclusively incurred for carrying on business in Thailand").

What about other rules of domestic law, which are not that clearly in contradiction to these two intentions of the contracting states? May such rules always be called upon to refuse deductibility to head office expenses, without any restrictions? In my view, one may not ignore the context of the treaty, which includes the other provisions found therein. Particularly art. 7(2) and 24(3) require further consideration: expenses that would also have been made by an independent enterprise should also be deductible for the PE, and the treatment of the expenses may not amount to a less favorable treatment than that of local enterprises. Imagine a special rule in domestic law which states that expenses, including executive and general administrative expenses, incurred by the head office for the purpose of the PE, may only be deducted by that PE if those expenses are connected with a business profit realized by the PE during the same taxable period. In my view, such a domestic rule conflicts with the ordinary meaning of the text of art. 7(3) and the context of the treaty, which pays particular attention not to tax PE's less favorably than enterprises. Indeed, an independent enterprise could also have decided to make the expense, notwithstanding the fact that the expenses might only yield a profit in subsequent years.

### 2.3. "incurred for the purpose of the PE"

#### a) *Formulating the issue*

It must be noted that in order for them to be deductible for the PE, executive and general administrative expenses and other expenses incurred in the head office must be proven to have been "*incurred for the purposes of the permanent establishment*". Expenses that do not satisfy this requirement may very well be deductible anyway under domestic law, but there is no treaty obligation on the contracting state to allow them as a deduction. The opposite is also true. As was pointed out above, the contracting state has an obligation to allow expenses as a deduction that meet this requirement.

How "direct" this expense must be incurred for the purpose of the permanent establishment, a question that is of particular importance for executive and general administrative expenses, is not explained in the OECD Commentary. In other words, is it sufficient that the expense was incurred for a service that benefits the enterprise as a whole, including its foreign PE's? Or, on the contrary, must an (executive and general administrative) expenses in order to be deductible concern the performance of services that were specifically carried out to the benefit of a particular branch? Is the answer to this question left to the domestic law of the contracting states, or is a tax treaty answer available?

### *b) A business connection*

Whatever the treatment prescribed in domestic law, there is no treaty-obligation to allow any expense for deduction by the PE unless it was incurred *for the purposes of the PE*. The text does not state: “for the purposes of the enterprise” or “for business purposes”. The drafters clearly wanted to establish a relation, a connection between the expense and the PE. In my view, this means that there must be some real ‘business connection’ between the expense and the benefit of the branch[1313]. The same goes for executive and general administration expenses, which can be clearly deduced from the text (“including executive and general administration expenses *so incurred*”).

That the PE necessarily always benefits in some way from any head office expenses because they are a part of the same enterprise, and that “automatically” what is good for the whole enterprise also benefits its different components in some way, is in my opinion not a sufficient argument. If that argument would be followed to its logical conclusion, it would not be necessary for the enterprise to demonstrate any connection for the expenses with the PE *at all*. This is contrary to the text of art. 7(3) which states that “there shall be allowed as deduction expenses *which are incurred for the purposes of the permanent establishment* including executive and general administrative expenses”. This might just as well be read as “there shall be allowed as deduction *only* expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses”.

If that ‘business connection’ is present in a particular case is of course a question of fact. In my view, the nature of that business connection is not entirely left to domestic law, although the domestic laws of most countries will have a rule which will lead to the same result. The context of the treaty requires that due consideration is made for art. 7(2). In other words, art. 7(2) must be taken into account for the interpretation of “for the purpose of the PE” in art. 7(3). The “for the purpose of the PE” must therefore be seen in the light of what a distinct and separate enterprise engaged in the same or similar activities under the same or similar

[1313] Gouthiere, B., Les impots dans les affaires internationals, Editions Francis Lefebvre, 1991, p. 197.: (“Les dépenses visées sont celles qui ont été engagées ‘aux fins de l’établissement stable’, c’est à dire pour lui permettre d’exercer ses functions”).

conditions and dealing wholly independently with the enterprise of which it is a PE, might be expected to do. It is a treaty obligation on the contracting state to allow head office expenses as a deduction for the PE if they were incurred for the purposes of the PE, which must be interpreted as "an expense an independent enterprise would also have made".

In my view, in order to assess what an independent enterprise would have done, it can be useful to review the relationship between the activity of the PE on the one hand and the activity of the head office on the other hand. If their activities are related in such a manner that commercial, administrative and other expenses made in the head office for the whole enterprise can also benefit the PE, it will be easier to demonstrate that an independent enterprise would also have made the expenses. Also, chances are that a PE which can work independently of the head office, i.e. has its own resources for management and administrative services, for research, for advertising, etc., it will have less need for head office services than a PE which has limited facilities of its own.

*c) No exclusive benefit necessary*

Although the expense must be incurred for the purposes of the PE, this requirement may not be interpreted in a way that only expenses which provide an exclusive, specific advantage to the PE are taken into account. It suffices that the business connection between the expense and the PE is so that an independent enterprise would also have made the expense, even when there is no proof available that the profit of the PE has or will increase because of it.

That this is the intention of the drafters of the treaty can be concluded from the explicit mention of "executive and general administrative expenses". By their very nature, such expenses can almost never be clearly identified as benefiting a particular part of the enterprise. To mention explicitly that such expenses must also be deductible recognizes this characteristic and therefore domestic rules to the contrary cannot be applied in a treaty situation.

De Hosson has criticized what he sees as the inclination of the OECD's Committee on Fiscal Affairs to require a "strict benefit test" to be fulfilled in this respect[1314]. Exactly how strict the OECD sees this benefit is however not entirely clear in the first place, (as De Hosson also points

[1314] De Hosson, F., "Allocation of headoffice costs", *Intertax*, 1994, p. 248.

out[1315]), as is shown demonstrated by the following quotations on this issue:

> *"Any payment for services rendered between associated enterprises would be required or allowed for tax purposes only if a real benefit has accrued to the enterprise that has been charged for such services"*[1316]

> *"Intra-group service activities may vary considerably among MNE [multinational enterprises] as does the extent to which those activities provide a benefit, or expected benefit to one or more group members"*[1317]

> *"Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position"*[1318]

> *"A more complex analysis is necessary where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. In a narrow range of such cases, an intra-group activity may be performed relating to group members even though those group members do not need the activity"*[1319].

*d) International case law*

The opinion that a business connection between the expense and the PE must be shown is in my view supported by the international case law on this subject. Both the Bundesfinanzhof and the Corte di Cassazione have accepted the deduction of general administrative head office expenses, but not without proof of any connection or benefit for the PE itself.

The Italian case[1320] involved the Italian branch of a Belgian bank, and the Court decided that the correct allocation key for the head office expenses

[1315] Ibid, ft. 1314, p. 248.
[1316] OECD Report on Transfer Pricing, 1979, p. 151.
[1317] Transfer Pricing Guidelines, 7.4.
[1318] Transfer Pricing Guidelines, 7.6.
[1319] Transfer Pricing Guidelines, 7.9.
[1320] Corte di Cassazione, No. 14016, 14 December 1999, Il Fisco, 28/2000, p. 9339.

is to be based on actual rendering of services by the head office to the PE, rather than the fulfillment of general management duties. In that case, the expenses concerned meetings, seminars, publication of brochures, market research and analysis and visits of the head office's management. The taxpayer had made available to the tax authorities (1) a "cost-sharing agreement" between head office and PE, (2) names of the employees directly involved in the performance of the services and (3) a detailed description of type and amount of the expenses needed and incurred for the above performance. The Court held that this could be deemed sufficient proof[1321]. This decision was criticized by Italian scholars, also because it did not address the possible incompatibility of its decision with art. 7(3) of the tax treaty[1322]. In my opinion, however, it is not necessarily at odds with art. 7(3) of the OECD Model if that paragraph is interpreted along the lines that were drawn above, and it is in line with the other case law cited below.

A year later the Italian Supreme Court was again called to decide on the tax merits of head office expenses[1323]. This time, the Italian branch of a Hong Kong airline deducted the general and administrative expenses allocated to it. The tax authorities refused the deduction because there was no sufficient link to the business operation of the branch (including costs related to flights that only did a stop-over in Italy). The Court pointed out, however, that under Italian law it suffices that there is a business purpose for an expense made. It is not necessary that actual income is generated. It is also noteworthy that the Court went out of its way to refer to art. 7(3) of the OECD Model, even when the case did not fall under tax treaty law (the head office being in Hong Kong). In its considerations, the Court interpreted art. 7(3) as requiring that the general and administrative expenses be "ordinary and necessary", which clearly supports this author's contention that a business connection with the PE or a business purpose of the PE must be demonstrated.

In the German case[1324], the court stated: "management and general administration expenses of a head office are to be attributed to its branch

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[1321] Rotondaro, C., "Supreme Court rules on the deductibility of head office expenses", *E.T.*, 2000, p. 239.

[1322] Belluzzo, L., "Spese di regia. Alcune note in tema di imposte dirette a margine della sentenza della Corte di Cassazione n. 14016/1999", Il Fisco, 28/2000, 9231, who refers to the OECD Commentary and the OECD Report of 1994.

[1323] Corte di Cassazione, No. 10062 of 1 August 2000, commented by Rossi, A., *Tax Notes International*, 2001, p. 21184.

[1324] Germany-Canada DTA, art. III (4) "In determining industrial or commercial profits of a permanent establishment there shall be allowed as deductions all expenses if and insofar the expenses concern a specific service from the head office to the branch or if and insofar the expenses concern services that are in the benefit of the whole enterprise, including that of the branch” [1325]. One must be wary to interpret and translate this decision correctly. The court refers to the “gesamtunternehmensinteresse” to proof the service expense, and it is my understanding the court did not try to say that all head office expenses are ipso facto also in the benefit of the branch. Regardless of the treaty, the court applied a rule of German domestic law providing that an economic connection (not a necessity) between the service and the branch must be demonstrated[1326]. In earlier German case law the importance of costs being incurred on behalf of the PE was also stressed[1327].

*e) Examples*

As an illustration, the example can be given of a consulting enterprise that buys a publishing business in another country, which then becomes its PE. Although some of the executive and general administrative expenses made by the head office are also made for the purpose of the PE’s publishing activity (auditing the PE, travel expenses of managers visiting the PE, etc.) many of the executive and general administrative expenses made by the head office for the whole enterprise will concern the main, consulting activity (advertising, market research, most of the salaries and benefits of the central management, etc.). The possible indirect benefit for the branch of those expenses made for the main activity of the enterprise, is in my opinion too insufficient to be counted for most practical purposes, and are not deductible for the PE under tax treaty law.

Another example of a business connection not being available would be the situation where a local branch’s only activity is the sale of the

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reasonably allocable to the permanent establishment, including executive and general administrative expenses so allocable”.

[1325] Bundesfinanzhof, BStBl., II, 1989, p. 140.; A comment on this decision was written by Oho, W. and Heinzerling V.C., *Intertax*, 1989, p. 321-324, and noted by Vogel, K. On Double Taxation Conventions, 3 rd ed, Kluwer, 1997, p. 450.; The German Ministry of Finance issued a letter in response to this decision addressing mostly the valuation of assets transferred between head office and PE: Letter of 12 February 1990, BStBl. 1990, I, p. 72.; The lower court decision at hand was Hesse, 8 December 1983, No. 5K 248/81, Entscheidingen der Finanzgerichte, 1984, No. 7, p. 367.; The lower court decision was commented upon in European Taxation, 1985, p. 115-116.

[1326] As noted by Baker, Ph., Double Taxation Conventions and International Tax Law, second edition, Sweet & Maxwell, London, 1994, p. 184.

[1327] Bundesfinanzhof, F.R. 24/1988, 678. Compare with French Conseil d’Etat, 7 February 1983, *RJF*, 1983, p. 496.

enterprise's finished products (say, computer equipment) in the country where it is established. Imagine that such a PE, assuming it is one, would be asked by its head office to contribute to the expensive research and development of the enterprise relating to producing new software. This would not meet the standard "for the purpose of the PE", because an independent enterprise would not have allowed those expenses in its expense account. The business of the PE is merely the sale of computer equipment which it acquires from manufacturers. An independent business that only sells pre-fabricated products usually does not invest in manufacturing research and development. It simply acquires the merchandise that is currently available at market prices, and sells them. It may also be noted that an independent enterprise would pay prices for the products that already include a profit margin for seller that is sufficient to cover his research and development. For the buyer to nonetheless participate in research expenses would come down to a double deduction of the same expenses[1328].

That an exclusive, specific benefit for the PE is not required under treaty law may be illustrated by the example of an oil company that incurs expenses for a P.R.-campaign to improve the public's perception of the company. In that campaign, television spots broadcasted over worldwide satellite TV highlight the companies' concern for the environment, etc. A local sales-office, which also comes into contact with the public, may deduct its share of the campaign even when no proof is available that the branch will sell more oil products on its local market as a consequence of the campaign, because an independent enterprise might have made the same expense as well. If the branch of the oil company would have no contact with the public, however, for example because it only performs financial services, the deduction would not be allowed because an independent enterprise would in that situation not have incurred the PR-expenses.

### 2.4. "expenses which are incurred"

Is there any particular significance of the mention "expenses which are incurred"? Must expenses be really paid, merely booked, or is it sufficient that they were only allocated (notional expenses)?

The question of notional expenses has been answered differently by international case law. In the already cited decision of the Canadian Tax Court, it was held that the treaty does not oppose the application of

[1328] OECD Transfer Pricing Guidelines, 7.26.

Canadian tax law, which provides that expenses must be booked[1329]. The court of Hesse reasoned along the same lines, by deciding that expenses which are attributable to a permanent establishment are not apportioned for purposes of commercial law, may not be deducted for tax purposes[1330]. That decision was however quashed by the Bundesfinanzhof[1331]. In this decision, the court considered that for the deductibility of expenses, rather than the existence of a commercial booking, an economical connection[1332] is the crucial factor. It may be pointed out that both court decisions applied their own domestic law and are in that sense in line with one another. Finally, a related issue was raised before the Supreme Court of India[1333] but considered only on its merits under domestic law. The Indian Government retroactively introduced ceilings for remittances abroad in its commercial and financial law. Remittances already made during previous years which exceeded the ceilings installed were disallowed by the tax authorities. The Supreme Court held that the embargo on foreign remittances in general law had nothing to do with disallowing expenses for income tax purposes[1334].

As was mentioned earlier, Van Raad[1335] has criticized the decision of the Canadian Tax Court in support of the deductibility of notional expenses. The OECD Commentary on art. 7 is not clear on this issue. In par. 16, it stipulates that “the deduction allowable to the PE for any of the expenses attributed does not depend upon the actual reimbursement of such expenses by the PE”[1336], but in par. 21 it is stated that for certain (management) expenses “no account should be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management”.

### 2.5. “including executive and general administrative expenses”

[1329] Cudd Pressure Control vs. The Queen, 25 May 1995, 95 *TNI* 214-20.
[1330] Hesse, 8 December 1983, No. 5K 248/81, Entscheidingen der Finanzgerichte, 1984, No. 7, 367.; *European Taxation*, 1985, p. 115-116.
[1331] Bundesfinanzhof, BStBl., II, 1989, p. 140.
[1332] “wirtschaftlichen Verlassungszusammenhang”; par. 4 Abs. 4 and par. 50 Abs 1 Satz 1 EstG.
[1333] Coca Cola Export Corp. vs. ITO, 30 March 1998, 97 Taxman 475.
[1334] Kably, L., “India Supreme Court ules payments to parent company deductible”, *TNI*, 1998, p. 89.
[1335] K. Van Radd, “The deemed expenses of a PE”, *Intertax*, 2001, p. 163-164.
[1336] OECD Commentary, art. 7, par. 16.

The paragraph particularly refers to executive and general administrative expenses made for the whole enterprise, indicating that this must be one of the main reasons why art. 7(3) was created in the first place. The treaty, nor its Commentary offer any definition of “executive and general administrative expenses”.

To determine which expenses are meant, two factors must be taken into account: the ordinary meaning of the words, and their context, particularly the mention of the words “whether in the state in which the permanent establishment is situated or elsewhere”. This context indicates that these expenses are not incurred by the PE itself, nor by the head office for the exclusive benefit of the PE, but for the benefit of the whole enterprise including its PE. By their very nature, these expenses were incurred for the enterprise *as a whole*[1337], and connecting them to one particular place of business is always difficult or impossible. As mentioned above, this may be seen as recognition of the fact that it may not be possible to prove the exact benefit for the PE concerned, because that is the very nature of executive and general administrative expenses.

In practice, executive and general administrative expenses often include the following costs in the basis of the apportionment: certain head office expenses that are related to the overall management of the enterprise (office rent, depreciation and expenses related to office equipment, salaries and benefits of directors), periodic meetings of the managers of several branches, expenses related to personnel that is regularly sent to the PE including their travel expenses to the PE and back, training and education which foreign employees are required to follow as a matter of standard practice, audit expenses, market research and analysis, marketing costs for the overall enterprise (general advertising printing corporate brochures that include a reference to the branch, global website, international call-center, expenses for international trade fairs and presentations etc.), expenses for public relations and lobbying, regular professional advice, etc.

The question may be raised if expenses that the head office incurs for the purposes of the whole enterprise, including the PE, but which do not occur regularly such as most of the examples above, can also be deemed to have the character of “executive and general administrative expenses”. Examples of such less common expenses would be expenses related to a

[1337] “executive and general administrative expenses incurred for the purposes of the enterprise *as a whole”* (emphasis added), art. 7(3) of the UK–Azerbaijan DTA, February 23, 1994. See also UK-Indonesia DTA, April 5, 1993, art.7(3).

(management, financial, etc.) reorganization of the whole enterprise, research and development, special technical assistance by the head office for example in the course of introducing a new production method in all the branches of the enterprise, or an exceptional promotion campaign (World Cup or Olympic Games).

Some tax treaties indicate that only regular, recurring expenses are meant with executive and general administrative expenses. The Japanese treaty with Australia, for example, reads: "including *ordinary* executive and general administrative expenses"[1338].

The answer to that question is however not really of a practical interest. Both recurring and less common expenses may be deducted by the PE as long as they were incurred for the purposes of the PE, and the end-result should therefore be the same, irrespective of the names the taxpayer gives to different categories of expenses.

It may be pointed out in this context that while calculating the basis-amount which is to be divided over different parts of the enterprise using some allocation key, expenses which are proper to the head office or one of the other branches, must be removed[1339].

2.6. "whether in the state in which the permanent establishment is situated or elsewhere"

One of the core intentions of the contracting states when adopting art. 7(3) in their tax treaty, is to make it clear that it suffices for expenses to be incurred for the purpose of the PE, regardless of the place where the expense is actually paid or booked. It is noteworthy that the paragraph does not limit the deductibility of the expenses to being incurred either in the state in which the permanent establishment is situated or in the other contracting state. In other words, expenses that were incurred in a third country may still be deducted by the PE as long as the other conditions of the article are also met.

But, there is more to be concluded from "whether in the state or elsewhere". In my view, by stipulating that the place where the expenses were incurred is irrelevant as long as they were incurred for the purpose of the PE, the contracting states are no longer free to impede the

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[1338] Japan-Australia DTA, 20 March 1969, art. 4(3).

[1339] Commentary of the Belgian tax authorities on double taxation agreements (Com.Ov.) 7/311.

deductibility of expenses just because they were incurred abroad. Within the context of the paragraph it can be argued that all expenses incurred for the purposes of the PE must be given the same treatment. In other words, expenses may not be discriminated on the basis of *where* they were incurred.

This is not to say that the contracting states are forbidden to apply basic conditions of domestic law on the deductibility of expenses. It does however mean that they may not apply those domestic rules that lead to a less favorable treatment of expenses just because they were incurred abroad. As a rule, *the expenses incurred for the purposes of the PE abroad must be just as deductible as if they would have been incurred in the country where the PE is situated*, or, if one prefers, expenses may as it were *not be discriminated on the basis of where they were incurred*. The latter obligation is even explicitly stated in the German-Indian[1340] and the US-Indian tax treaties[1341], but is in more general terms certainly also found in art. 24(3) OECD Model. The OECD Commentary on that provision states:

> *"Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishments a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises (emphasis added)"*[1342].

It makes sense that the contracting states wished to include this (prohibition on the discrimination of expenses on the basis of where they were incurred) in the treaty. After all, as was already pointed out, a PE is, as a non-resident, only taxable on domestic income, so reluctance to allow foreign expenses is reasonable. Also, the possibilities of the state to verify the veracity of expenses paid abroad are limited. That is why countries may often have rules that in some way restrain, or even prevent, the deductibility of expenses incurred abroad for the purposes of a domestic PE. Other (or perhaps even the same) countries would on the other hand reject the deductibility of expenses a head office makes for the sake of its foreign branches. The drafters of the treaty were very aware of

[1340] Par. 1(d) Protocol DTA Germany-India.
[1341] Final Protocol 12 September 1989.
[1342] OECD Commentary on art. 7, par. 24 a); See also Van Raad, K., Non-discrimination in international tax law, *Kluwer*, 1986, p. 147.

these circumstances, and wished to make sure that also in this respect, the overlapping of domestic tax laws did not lead to double taxation.

Consequently, certain restrictions or conditions found in domestic law on the deductibility of foreign expenses that were incurred for the purposes of the PE, and that only affect expenses incurred abroad, cannot be applied in a treaty situation. Clearly, such would be the case if domestic law rejects all expenses incurred abroad. The same goes however when a higher burden of proof is required for expenses required abroad than for domestically incurred expenses (for example, to be "necessary for" instead of just "related to" the PE) under domestic law and regulations. In my view, tougher requirements on documentation may also be deemed incompatible with art. 7(3) if they are unreasonably more strict than domestic rules[1343]. Also, requiring that foreign expenses must have been really paid while domestic expenses are deductible when incurred, would not be compatible with art. 7(3).

## 3. Head Office Expenses of Permanent Establishments under Art. 7(3) of the UN Model: Derogations with the OECD Model

### 3.1. General remarks

The UN Model deviates on several points from the OECD Model Tax Convention. Although executive and general administrative expenses are also under the UN Model Tax Convention allowed as a deduction for the PE, no such deduction may be made in respect of *interest, royalties and fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management*.

The text of art. 7(3) of the UN Model is as follows[1344]:

> In the determination of the profits of a permanent establishment, there shall be allowed as deductions

[1343] A translation of certain documents would not be an unreasonable requirement, but demanding a certificate signed by the foreign tax authorities about the veracity of every expense, for example, is in my view incompatible with art. 7(3) and 24(3).

[1344] The text of art. 7(3) of the UN Model was not changed in 2001. Note that the UN Model 2001 still reads: "In the determination of the profits…" just like in the 1963 OECD Model. Since 1977, the OECD Model reads: "In determining the profits…". Although the Ad Hoc Group of Experts set out to adopt the UN Model to the more recent OECD version wherever possible, the first sentence of 7(3) has apparently been overlooked.

> expenses which are incurred for the purposes *of the business* of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. *However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices*. (difference with OECD Model in italics)

The reason for the UN reluctance to allow the deductibility of such expenses can be traced back to the Manual for Negotiating Tax Treaties between Developed and Developing Countries[1345]. Under title V, Members from seven countries pointed out that through the allocation of inflated head office expenses, management fees and misallocation of research marketing expenses, they are losing tax revenue.

Partly because the UN addition already in 1980 went, perhaps unintentionally[1346], further than the OECD Commentary, and partly

[1345] "Tax Treaties Between Developed And Developing Countries, Sixth Report", 1976, Prepared By The United Nations Department Of Economic And Social Affairs (Part II).

[1346] There is some evidence that the UN Group of Experts believed that with this provision, they actually just restated explicitly and clarified the treatment of such expenses under the OECD Model (UN Commentary on 7/3, par. 1). It is now however accepted that the text of the addition goes further than only restating explicitly what would also be the result under the OECD Model.

because of the amended position the OECD has taken since 1994[1347], there may now be a considerable difference in treatment of certain head office expenses depending on whether the tax treaty follows the OECD or the UN Model in art. 7 (3)[1348].

### 3.2. "of the business of the PE"

The first deviation found in the UN Model (both 1980 and 2001) is the addition of "expenses which are incurred for the purposes *of the business of* the PE". The OECD Model does not mention the words in italic, which leaves "for the purposes of the PE". Does this distinction play a significant role in the interpretation of the paragraph? The UN Commentary does not offer any explanation on the reason for the small addition.

Because executive and general administrative are also included, however, the benefit of which is by their very nature more difficult to determine and attribute, one may not assume that only expenses which deliver an exclusive benefit for that particular PE's business are deductible.

In conclusion, therefore, it seems to me that the purpose of this addition was merely to reinforce the view that the expenses which are allocated to the PE must have a business connection with the activity of the PE, along the same lines as I argued above with respect to the OECD Model.

### 3.3. "specific services performed or management"

Expenses allocated to the PE that concern fees or commissions for "specific services performed" or "for management" are singled out as non-deductible under the UN Model version of art. 7(3). There are different ways to interpret the UN exception, and the confusion id mostly caused by the exception to the exception, namely "*otherwise than towards reimbursement of actual expenses*".

First, one could argue that internal services are not excluded, but the price charged for those services may only be based on expenses that were actually paid by the head office to perform the service. In case the head office performed a specific legal service using its own in-house lawyer, for example, only the salary of the lawyer, his travel expenses, his

[1347] The OECD Commentary on the subject was only changed in 1994, pursuant to the Report on Income of Permanent Establishments of 1993. This is 14 years after the publication of the UN Model Tax Convention 1980.

[1348] Vogel, K. "Double Taxation Conventions", 3rd edition, Kluwer, 1997, p. 451.

administrative expenses, may be taken into account to allocate the cost to the PE. The legal service may not be charged at a market price. A second possible interpretation is that all internal services are excluded under the UN exception. Only services the head office obtained from third parties for the purposes of the business of the PE, may be allocated to that PE at the actual amount that was expended.

An example may illustrate the difference between the two interpretations. Imagine a PE of a bank that changes its computer software system. The PE decides it needs to train its employees on how to work with the new system. Two possibilities present itself: the head office could send some employees to instruct the PE's personnel, or an independent company could be hired. The independent company charges by hourly rates, which comes down to 200.000 USD. If the head office sends the instructors, the actual costs would be their salary during the time spent, increased with travel expenses, living expenses, costs to print manuals, etc. amounting to 120.000 USD. What may be deducted in case an internal service is performed?

In my view, the first interpretation (allowing the internal service, but without a profit margin) is the most in line with the context of the treaty provision. One must namely keep in mind that art. 7(2) is closely related to the application of art. 7(3) and due consideration must therefore be given to for as much as possible interpreting art. 7(3) in a manner consistent with what the result would have been for independent enterprises. Disallowing all consideration for intra-group services, whatever their price-level, is manifestly not what would have happened between independent enterprises[1349]. It is also a result that is not consistent with art. 24(5). What is more, by allowing the internal service, but without a profit margin, the intention of the drafters of the UN Model, namely to avoid base erosion where possible, is still met. If the head office would for example charge a large management fee to its PE for purposes of base erosion, the larger part of that fee would not be deductible because it exceeds the mere actual costs of supplying the service (namely only the salary of managers involved, administration expenses, etc.). With respect to the example above 120.000 USD may thus be deducted by the PE if the head office furnishes the service. The 200.000 USD may only be deducted if the service is performed (possibly through the head office) by an outside party.
One could argue that since the intention of the drafters of the UN Model was to reduce the possibilities for tax avoidance, the taxpayer should be

[1349] See for example the OECD Guidelines on transfer pricing, part V.

able to deduct the expenses anyway if it can be demonstrated that no such motive exists. In my view, that would however be an example of treaty interpretation that is not supported by the plain meaning of the text (which does not mention the motivation of the taxpayer anywhere) and is therefore not to be used lightly. It do not think that this provision of the treaty can be interpreted as an obligation on the contracting state to allow the deduction once the taxpayer proves there is no tax avoidance motive. Also, domestic law and regulations may be more liberal in this respect than the treaty.

The UN exception does not address the concentration of services in a group services company. To avoid having much of their internal service-expenses disallowed, taxpayers such as banks could setup a group services company that would furnish the services to the branches of the enterprise, say for a software reorganization project, or for other expensive internal services. That way, art. 7(3) UN Model would not come into play because the services are not furnished by the head office. Instead, art. 5(3)b) UN Model may lead to source taxation but certainly not in all possible situations[1350].

Expenses of this specific nature include cost contributions for research and development of products produced in the PE, specific management services (such as in case of a reorganization, or for trouble-shooting), training and staff education services which are only used in the PE, design and use of technology specifically made for the PE, etc.

## 4. Other Tax Treaties

### 4.1. Art. 7(3) in the US Model

The US Model tax treaty reads in art. 7(3):

> "In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purpose of the permanent establishment, including *a reasonable allocation of* executive and general administrative expenses, *research and development expenses, interest and other expenses incurred for the purposes*

[1350] This author's article "P.E. implications when furnishing consulting services under OECD and UN Model Treaties", *Tax Notes International*, 21 May 2001, p. 2623-2636.

> *of the enterprise as a whole (or part thereof which includes the permanent establishment)*, whether incurred in the state in which the permanent establishment is situated or elsewhere" (difference with OECD Model in italics)

The Technical Explanation to the US Model points out that "This rule is not limited to expenses incurred exclusively for the purposes of the PE, but includes a reasonable allocation of expenses incurred for the enterprise as a whole"[1351]. Indeed, as the Technical Explanation also notes, the US Model is in this respect in substance the same as the OECD Model, but more detailed[1352].

### 4.2. Variations on art. 7(3) in tax treaty practice

Several variations on art. 7(3) can be found in particular tax treaties which are not in line with the OECD or even the UN Model. A brief inquiry has shown that three different kinds of additions to the Models can be found.

#### a) *Reservation for applying domestic law*

Certain tax treaties provide that while expenses incurred for the purpose of the PE are deductible whether they are incurred in the state where the PE is situated or elsewhere, such deduction is still subject to the domestic law of the state where the PE is located.

As an example, art. 7(3) of the Canada-Hungary[1353] tax treaty may be quoted:

> "In the determination of the business profits of a permanent establishment, there shall be allowed those expenses *that are deductible under the laws of the contracting state in which the permanent establishment is situated* and that are incurred for the purposes of that permanent establishment including executive and general administrative expenses, whether incurred in the state in which the permanent establishment is situated or elsewhere" (emphasis added).

Similar provisions can for example be found in the Canadian tax treaties with India[1354], Argentina[1355] (Protocol) and Lebanon[1356]. Certain Indian

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[1351] Technical Explanation, par. 95.
[1352] Technical Explanation, par. 95.
[1353] Canada-Hungary DTA, April 15, 1992, art. 7(3).
[1354] Canada-India DTA, January 11, 1996 (new), art. 7(3).

treaties such as those with Australia[1357], Bangladesh[1358], Belgium[1359], France[1360], Germany[1361] and the US[1362] contain a similar reservation, as does the Malaysian treaty with Bangladesh[1363], the French treaty with Australia[1364].

Treaties that have such a reservation must, in my opinion, not be interpreted differently than was explained above. It is true that, too a certain extent, domestic law is not interfered by treaty law when it poses conditions to the deductibility of expenses. One may think of requirements relating to documents to be submitted as proof, the taxable period expenses may be deducted and general exceptions on the deductibility on certain expenses (such as entertainment expenses)[1365]. The reservations of the type discussed here may in any event be seen as an explicit authorization for subjecting the deductibility to *such general rules of internal law*, rules that in my view might be applied also without such reservation. That is however all which may be deduced from this reservation. It may not be interpreted to allow the contracting states to subject the deduction to all rules of internal law. We must assume that the contracting states did have the intention to commit themselves to something more than to what their own domestic law already provided for. The opposite interpretation would come down to disregarding almost half of the text of the paragraph (in the example of Canada-Hungary DTA), namely “and that are incurred for the purposes of that permanent establishment including executive and general administrative expenses, whether incurred in the state in which the permanent establishment is situated or elsewhere”. If the contracting states wished to simply apply their domestic law with respect to the expenses of a PE, why bother adding the rest of the text? Why does the text not simply read: “In the determination of the business profits of a permanent establishment, there shall be allowed those expenses that are deductible under the laws of the contracting state in which the permanent establishment is situated”?

1355 Canada-Argentina DTA, April 29, 1993, art. 7(3).
1356 Canada-Lebanon DTA, December 29, 1998, art. 7(3).
1357 India-Australia DTA, July 25, 1991, art. 7(3).
1358 India-Bangladesh DTA, August 27, 1991, art. 7(3).
1359 India-Belgium DTA, April 26, 1993 (new), art. 7(3).
1360 India-France DTA, September 29, 1992, art. 7(3)(a).
1361 Germany-India DTA, art. 7(3) and (4).
1362 Final Protocol 12 September 1989.
1363 Malaysia-Bangladesh DTA, April 19, 1983, art. 7(3).
1364 Protocol (relating to the DTA of 1976) of June 19 1989 art. 6(3).
1365 See above

This argument may be seen in the light of the object and purpose of tax treaties, which is to avoid double taxation by means of restrictions on the domestic tax laws of the contracting states. In view of this object and purpose, it is clear why the contracting undertook the effort to include art. 7(3), even with a reservation. The treaty (the reservation) cannot be interpreted in such a manner that the treaty adds to the conditions that already exist for deductibility under domestic law rather than it eliminates them, and thus increases the likelihood of double taxation rather than reducing it. This is manifestly in contradiction with the object and purpose of double taxation conventions, and therefore it is warranted to give a rather strict interpretation to the type of reservations that are discussed here.

The US Treasury Technical Explanation of the US-Indian tax treaty [a treaty that includes a reservation for applying domestic law in art. 7(3)] does *not* support my interpretation of such reservations. With respect to that treaty, the US Treasury seems to accept that, pursuant to the reservation, the deductibility of (head office) expenses incurred abroad for the purposes of the PE are subject to all rules of domestic law, even those which conflict with the general principle of the paragraph:

> *"Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for expenses incurred for the purposes of the permanent establishment. Deductions are to be allowed regardless of where the expenses are incurred. The paragraph specifies that a deduction is to be allowed for a reasonable allocation of expenses for research and development, interest, executive and general administrative expenses and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment). The language of this paragraph differs from that in the U.S. Model in one significant respect. Under the U.S. Model, deductions are not subject to the limitations of local law which may conflict with the general principle of the paragraph. Paragraph 3 in the Convention provides for such deductions in accordance with the provisions of and subject to the limitations of the taxation laws of the State in which the permanent establishment is situated.*
>
> *Indian law limits certain deductions of a permanent establishment with respect to head office expenditures. The deduction of amounts characterized as executive and general*

*administration expenditures (not interest) is capped at five percent of the adjusted total income of the permanent establishment. This limitation was included in the Convention because of the difficulties India has had in verifying claimed deductions for head office expenses and because of the desire of the Indians to avoid litigation on this issue. In practice, the Indian taxing authority does not inquire extensively into deductions that do not exceed the five percent cap. The amount permitted to be deducted is understood by India to be an approximate average of head office executive and general administrative expense incurred by non-Indian companies for the purpose of their permanent establishments in India. However, the rule does not provide absolute certainty that U.S. companies with a permanent establishment in India will be able to deduct from their income subject to Indian tax the entire amount of head office expense incurred for the purpose of the permanent establishment"*[1366].

On the other hand, with respect to similar but not identical terms in the US treaty with Lithuania ("a contracting state may, consistent with its law impose limitations on deductions, so long as these limitations are consistent with the concept of net income"[1367]) the US Treasury downplays the effect of such a reservation. Now, it seems that only general, less important limitations (such as entertainment expenses) may be applied as a consequence of the reservation:

*"The last sentence of the paragraph, which is neither in the U.S. Model nor in the OECD Model, allows each Contracting State, consistent with its law, to impose limitations on the deductions taken by the permanent establishment as long as the limitations are consistent with the concept of net income. This language was provided at the request of the Lithuanian delegation. The language allows the United States and Lithuania to place limits on certain deductions, for example, entertainment expenses. However, it would not permit the Contracting States to deny a deduction for wages or interest expenses since such expenses are so fundamental that denial of*

[1366] US Treasury Technical Explanation on the US-Indian DTA of 12 September 1989, par. 5 and 6 on art. 7.
[1367] US-Lithuania DTA, January 15 1998, art. 7(3).

*deductions would be inconsistent with the concept of net income"*[1368].

*b) Additional reference to an independent enterprise*

Certain tax treaties adopt the reference art. 7(2) makes to independent enterprises once more in art. 7(3). As in the treaty between Malaysia and Canada[1369], an addition to that effect reads:

> "…expenses *which would be deductible if the permanent establishment were an independent enterprise*…(emphasis added)"

Similar provisions are found (among others) in the Canadian treaties with Jamaica[1370] and Malaysia, and the Malaysian treaties with Albania[1371], Australia[1372], Austria[1373], Bangladesh[1374], Belgium[1375], Finland[1376], Taiwan[1377] and the Czech Republic[1378]. See also Australia's treaties with Argentina[1379], the Philippines[1380] and South Africa[1381]; the UK's tax treaties with Austria[1382], Cyprus[1383], Malta[1384], Morocco[1385], Israel[1386], Jamaica[1387] Japan[1388] and Kenya[1389]; France with Singapore[1390].

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[1368] US Treasury Technical Explanation to the US-Lithuanian DTA of 15 January 1998, par. 102.; Art. 7(3) of the US treaty with Latvia and its Technical Explanation are identical to the ones with Lithuania.
[1369] Malaysia-Canada DTA, October 15, 1976, art. 7(3).
[1370] Canada-Jamaica DTA, March 30, 1978 (new), art. 7(3).
[1371] Malaysia-Albania DTA, January 24, 1994, art. 7(3).
[1372] Malaysia-Australia DTA, August 20, 1980, art. 7(3).
[1373] Malaysia-Austria DTA, September 20, 1989, art. 7(3).
[1374] Malaysia-Bangladesh DTA, April 19, 1983, art. 7(3).
[1375] Malaysia-Belgium DTA, October 24, 1973, art. 7(3).
[1376] Malaysia-Finland DTA, March 28, 1984, art. 7(3).
[1377] Malaysia-ROC DTA, July 23, 1996, art. 7(5).
[1378] Malaysia-Czech Republic DTA, March 8, 1996, art. 7(3).
[1379] Australia-Argentina DTA, July 1, 1999, art. 7 (3).
[1380] Australia-Philippines DTA, May 11, 1979, art. 7 (3).
[1381] Australia-South Africa DTA, July 1, 1999, art. 7(3).
[1382] UK-Austria DTA, April 30, 1969, art. 7(3) (other than expenses which would not be deductible if the permanent establishment were a separate enterprise).
[1383] UK-Cyprus, June 20, 1974, art. 8(3).
[1384] UK-Malta, May 12, 1994, art.7(3).
[1385] UK-Morocco, September 8, 1981, art.7(3).
[1386] UK-Israel, September 26, 1962, art. 3(4).
[1387] UK-Jamaica, March 16, 1973, art. 5(4).
[1388] UK-Japan, February 10, 1969, art. 8(3).
[1389] UK-Kenya, July 31, 1973, art. 8(3).
[1390] France-Singapore DTA, September 9, 1974, art. 7(3).

With this additional reference to art. 7(2), the contracting states intend to point out beyond any doubt that the arm's length standard likewise applies for expenses of the PE[1391]. In my view, as was already pointed out above, even without stating so explicitly, "incurred for the purposes of the PE" in art. 7(3) must be explained within the context of art. 7(2), namely with reference to what an independent enterprise would have done. The text of the OECD Model, however, leaves some doubt on this issue, because art. 7(2) starts with "subject to the provisions of paragraph 3…", which is one reason why the contracting states may state so explicitly. This question was also considered in the Discussion Draft[1392], where it was suggested that no modification of the arm's length standard was intended for art. 7(3), admitting however that another interpretation cannot be excluded.

c) *Expenses "directly related", "related" or "attributable to the activities" of the PE*

Certain tax treaties have adopted a specification in art. 7(3) which states that only expenses "directly related" to the PE may be deducted, while not excluding executive and general administration expenses. This mention can i.e. be found in the UK-Italian tax treaty[1393]. Thailand also has a few tax treaties which deviate from both the UN and the OECD Model in this respect. The Thai treaties with Belgium[1394], Canada[1395] and the UK[1396] require the expenses to be "related" (UK) or "directly related" to the PE.

It is unclear how "directly related" must be interpreted. Surely, it does not mean that only expenses made for the exclusive benefit of the PE may be deducted, because "executive and general administration expenses" (which are never in the exclusive benefit of the PE) have not been excluded from the paragraph[1397]. Therefore, it seems to me that by adding "directly related" to the treaty text, while keeping the reference to executive and general administration expenses, the contracting states only meant to emphasize that a business connection with the PE must be

[1391] OECD Commentary art. 7, par. 17.
[1392] Discussion Draft, par. 168-173.
[1393] UK-Italy DTA, October 21, 1988, art. 7(3).
[1394] Thailand-Belgium DTA, October 16, 1978, art. 7(3).
[1395] Thailand-Canada DTA, April 11, 1984, art. 7(3).
[1396] Thailand-UK DTA, February 18, 1981, art. 8; See also UK-Morocco DTA, September 8, 1981, art.7 (3).
[1397] See also the Belgian Commentary of the Thai-Belgian tax treaty: Com. Ov 7/301.1.

demonstrated for all expenses allocated to it. In essence, therefore, there is no real difference with art. 7(3) of the OECD Model[1398].

The same reasoning as above can in my opinion be applied to "expenses that are attributable to the activities of the permanent establishment" such as in art. 7(3) of the US-Italy tax treaty, as long as executive and general administrative expenses are not omitted[1399]. The US Technical Explanation for that treaty supports this view[1400].

## 5. Summary

In almost all countries, a PE is, in the country where it is situated, only taxable on net-profit it has realized within that country. To determine that net-profit, expenses of the PE must obviously be taken into account. No special problems arise for expenses that were made by the PE, in the exclusive benefit of the PE, in the country where it is located. But there are several reasons why problems may arise in connection to the deduction of other expenses, namely those which have to be "paid" to the head office. First of all, those expenses are incurred abroad while a PE is only taxable on domestic income. Secondly, certain expenses such as executive and general administrative expenses are not incurred of the exclusive benefit of the local PE as the requirement may be under domestic law. Thirdly, because tax authorities are wary that expenses for head office services are "abused" for tax avoidance and profit repatriation purposes, a concern closely connected to the reduced possibilities for obtaining foreign information. And finally, because no real contracts can exist between head office and PE in the legal sense of the word.

[1398] One can reach the same conclusion by following another line of reasoning. In any event, the specification of "directly related" must be interpreted so that it does not contradict the mention of executive and general administration expenses in the same paragraph. What if one assumes that this specification excludes expenses the head office made for the purposes of the overall enterprise, including the PE, but which cannot be deemed of an "executive" of "general administrative" nature? Above, problems related to the lack of definition of "executive and general administration expenses" were already pointed out. If this interpretation is followed, "directly related" means that certain head office expenses such as research or a special publicity campaign, are only deductible by the PE is they directly relate to it. Such is, in my view, however also the case under art. 7(3) of the OECD Model.

[1399] US-Italy DTA, August 25, 1999, art. 7(3).

[1400] US Treasury Technical Explanation to the US-Italian tax treaty of 25 August 1999, par. 95 ("in substance the same as the US Model…")

On the other hand it has to be recognized that, probably even more so than is the case with local subsidiaries of multinational enterprises, the PE to a certain depends on the business functions of the head office to carry out its business activity, and that expenses incurred by the head office for the benefit of the PE should be taken into account if the taxable net-profit is to approximate the commercial net-profit. Also, for all the reasons stated above, there is a high likelihood that economic double taxation might occur between head office and PE.

The most important tax treaty-answers, found in art. 7(3) of the **OECD Model**, to these problems can be summarized as follows:

(1) Article 7(3) imposes a duty upon the contracting states to allow the expenses that qualify for the other conditions found in the paragraph for deduction. It is not merely an attribution rule and when deductibility is in order under the treaty, most provisions of domestic law to the contrary are overridden. Only the general rules concerning the deductibility of expenses, that apply to resident enterprises as well, can be called upon to disallow an expense that otherwise qualifies, such as rules concerning timing and exceptions for certain expenses (e.g. entertainment expenses);

(2) The main condition of art. 7(3) is that the expenses must be "incurred for the purposes of the PE". This means that a business connection must be demonstrated. It is not enough to argue that all expenses of the whole enterprise necessarily, automatically, also benefit its PE's. This condition must be seen in the context of art. 7(2): A (head office) expense may be deemed to have been incurred in the purpose of the PE if an independent enterprise would also have made it;

(3) The reference in art. 7(3) to "executive and general administrative expenses" can be seen as a recognition of the fact that it is not necessary to demonstrate an exclusive, or immediate benefit for the PE when deducting a head office expense (e.g. a global PR campaign);

(4) Article 7(3) also introduces a rule against the discrimination of expenses on the basis of where they were incurred, comparable to art. 24(4). Consequently, rules of domestic law that render the treatment of expenses incurred abroad les favorable, are to be considered in conflict with the treaty.

The purpose of the **UN Model**'s derogations from the OECD Model is twofold:

(1) To emphasize the need for a "business connection" between (head office) expense and PE ("for the business of the PE");

(2) To point out that the head office may not add a profit to internal services performed for the PE so that base erosion using e.g. management fees is curbed.

Other **tax treaty practice** shows some variety of provisions with respect to head office expenses, but most of those variations, in my view, do not alter the essence of the OECD Model provision very much:

(1) The reservation for rules of domestic law only emphasizes that general rules on the deductibility of expenses that apply to local enterprises may be involved to disallow expenses incurred abroad as well;

(2) The reference to independent enterprises of art. 7(2) is in any case part of the context of art. 7(3);

(3) All other ways of emphasizing the business connection between the expense and the PE ("related", "attributed", "directly related") does not alter the result of art. 7(3) in the OECD Model, unless (executive and general administrative) expenses incurred abroad are simply excluded.