Editorial

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Quasi-transactions

In this month's issue of *Intertax* you will find an outline of a study by the German Institute of Certified Public Accountants ('IDW'), called: 'Determination of profits of permanent establishments'. The study demonstrates that, as a matter of principle, payments of interests, royalties, etc. made by a permanent establishment to its head office should be deductible for tax purposes (and taxable in the head office country).

The acceptance of the principle by a well-established institute as IDW, indicates an important development in this particular area. It seems that the German tax authorities – unofficially – also share this view and, more recently, the trend was picked up by the Fiscal Committee of the OECD which established a sub-committee to study the issue.

It is, as such, remarkable that until now little attention has been paid to the disregard of payments of interest, royalties, etc. between permanent establishment and head office. The practice is in clear conflict with the general rule laid down in 1977 OECD Model Article 7 (2) which provides that profit shall be 'attributed' to the permanent establishment on the basis of the assumption that the permanent establishment is an independent enterprise. This principle would imply that the permanent establishment must be deemed able to conclude any contract with its head office – including license and loan agreements – an independent enterprise would conclude. The IDW study calls these agreements 'quasi-transactions'. The current practice under most tax treaties, nevertheless, does not allow the deduction of the related 'deemed' expenses. Although the actual text of 1977 OECD Model Treaty is not specific on the issue, the OECD Commentary on Article 7 (paras. 16 and 17) makes it clear that these expenses should not be allowed as deductions when computing the permanent establishment's taxable profits.[1]

The historic origin of the limitation is not clear. It has been suggested, though, that such a limitation was simply a normal practice in most countries at the time (1933) Mitchell B. Carrol conducted his equiry into 'the apportionment of profits' on request of the Fiscal Committee of the Leage of Nations.[2] His description of general rules followed in the majority of countries was used by the Committee as the basis for a Draft Convention on the Allocation of Profits of International Enterprises (1935). This draft model, and later League of Nations and OECD draft models, took it for granted that the limitation would apply and no specific language in the treaties was considered necessary. Even in the offical commentaries to the draft models there is no explanation to be found for this deviation from the general principle. The most recent Commentary of 1977 refers simply to 'special problems' without bothering its readers with further details.

The usual argument that a permanent establishment can legally not enter into a contract with its head office makes little sense, since the deemed independence of the permanent establishment is the very essence of the profit attribution principle laid down in 1977 OECD Model Article 7 (2). In other words, a head office can also not 'sell', in a legal sense, goods to its permanent establishment,but there is little doubt that the transfer of the goods will be taken into account on basis of a deemed sale. There is no clear reason then why this principle would not apply to the use of funds or intangibles by the permanent establishment.[3]

To be sure: there are indeed problems which need to be solved when quasi-transactions are accepted as a basis for the profit calculation of both head office and permanent establishment. One of them would, of course, be how these deemed transactions are to be recorded in order to be acceptable. Another one would be whether the 'quasi-transactions'-principle works both ways, for example, can a permanent establisment make a 'loan' to its head office?

In one of the forthcoming issues of *Intertax* we hope to publish an article which discusses in depth these and other questions relating to this important development.

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[1] The United Nations Model (1980) contains specific language in the actual text of Article 7(3) prohibiting the deduction of these expenses. *See also* Manual for the negotiation of bilateral tax treaties between developed and developing countries, New York (1979), at p. 57.

[2] Taxation of Foreign and national Enterprises, League of Nations, Geneva 1933. *See* C. van Raad, *Beweeglijkheid in het internationaal belastingrecht*, Deventer 1987, p. 15.

[3] *See also* Christoph Bellstedt, *Die Besteuerung international verflochtener Gesellschaften*, Cologne 1973, p. 235 and G.J. van Leijenhorst, The Allocation of Profits to Permanent Establishments, *Intertax* 1980/1, p. 34.