Notional Rental Charges and the Determination of PE Profits

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Introduction

David Ward made a remarkable contribution to the literature on tax treaties. The topic dealt with in this paper is one that he wrote about and one in which he took more than an academic interest: whether notional rental charges for equipment should be recognized for the purposes of the taxation, in Canada, of the profits attributable to a permanent establishment (PE).

More precisely, this paper deals with *Cudd Pressure Control Inc.*, a case that David Ward, acting for the taxpayer, lost in the Tax Court of Canada[1] and in the Federal Court of Appeal[2] (permission to appeal to the Supreme Court was denied). David subsequently had the opportunity to write on the main treaty issue raised by the case.[3] He did this with the utmost respect for the courts that had ruled against him and, it seems to me, tacit acknowledgement that the specific facts of the case could justify the courts' conclusions (although not necessarily their legal reasoning).

The Facts and the Issue

The facts of *Cudd Pressure* were fairly simple, but some of them were crucial to the legal analysis. Cudd Pressure Control Inc. (Cudd) was a US corporation that specialized in the provision of technical services to the oil industry. As the Tax Court emphasized, Cudd was in the business of providing services and not in the

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1 *Cudd Pressure Control Inc. v. The Queen*, 95 DTC 559 (TCC).

2 *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630 (FCA).

3 See David A. Ward, "Attribution of Income to Permanent Establishments" (2000) 48:3 *Canadian Tax Journal* 559-76; and David A. Ward and Colin Campbell, "A Different View of Cudd," Letter to the Editor (2008) 49:13 *Tax Notes International* 1139-40.

business of renting equipment to others (one of the important findings of fact).[4] A Canadian corporation that operated an offshore drilling rig in Canada hired Cudd to provide snubbing services[5] on that rig. These services were provided through a number of employees using two pieces of sophisticated equipment (the "snubbing units") owned by Cudd.

The relevant taxation year of the taxpayer was 1985 and the applicable tax treaty was the 1942 tax convention between Canada and the United States,[6] which was concluded well before the OECD started its work on tax treaties.

Under paragraph 3(f) of the protocol to the 1942 treaty,[7] the use of the equipment on the oil rig resulted in Cudd having a PE in Canada.

The legal issue raised by the case was related to the effect of the provisions of the 1942 treaty on the computation of the taxable income in Canada derived from the business activities carried on through the PE. This issue involved the determination of the "industrial and commercial profits" attributable to that PE under article III of the 1942 treaty[8] and the interpretation of the relationship between

4 Supra note 1, at 570: "First, the major premise for the Appellant's assumption is that it was in the business of renting equipment. . . . That premise is not supported by the evidence. The Appellant was at all times a service company. It correctly perceived the need to have on hand the requisite equipment in order to deal with the needs of its customers and, consistent with industry practice, owned all of its equipment."

5 *The Oil and Gas Glossary* (oilgasglossary.com/snub.html) defines such services as follows: "[T]o force pipe or tools into a high-pressure well . . . (i.e., to run pipe or tools into the well against pressure when the weight of pipe is not great enough to force the pipe through the bops [blowout preventers]). . . . In workover operations, snubbing is usually accomplished by using hydraulic power to force the pipe through the stripping head or blowout preventer." (Note that the website cited was inaccessible as of September 2012.)

6 Convention and Protocol Between Canada and the United States of America for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income Taxes, signed at Washington, DC on March 4, 1942 (herein referred to as "the 1942 treaty"). Since the relevant taxation year ended on June 30, 1985, the 1980 convention, infra note 17, which has effect for taxation years beginning on or after January 1, 1985, was not applicable.

7 Paragraph 3(f) of the protocol states in part: "The use of substantial equipment or machinery within one of the contracting States at any time in any taxable year by an enterprise of the other contracting State shall constitute a permanent establishment of such enterprise in the former State for such taxable year."

8 Article III(1) of the 1942 treaty read as follows: "If an enterprise of one of the contracting States has a permanent establishment in the other State, there shall be attributed to such 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."

the 1942 treaty provisions and the rules of the Canadian Income Tax Act.[9] The issue arose because the taxpayer, when computing its taxable income in Canada, sought to deduct an amount of Cdn $2,516,690 as a notional rent for the snubbing units, an amount that was considerably higher than the amount of depreciation allowed under the provisions of the ITA. This deduction was based on the assumption that the fiction of the independent enterprise applicable for the purposes of determining the profits of the PE under the 1942 treaty authorized a deduction for rent notionally charged by the US corporation to its Canadian PE.

The Interaction Between the 1942 Treaty and the Income Tax Act

While the treaty aspects of *Cudd Pressure* triggered a lot of international attention and comment, one could argue that the basic issue raised by the case had nothing to do with the interpretation of the 1942 treaty and was in fact a domestic law issue. That issue was related to the interpretation of section 4(b) of the Canadian Income Tax Convention Interpretation Act,[10] which reads as follows:

> 4. 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, . . .
>
> (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.

Section 4(b) of the ITCIA appears to be directly applicable to the case. Nothing in the ITA allowed Cudd to deduct a notional rent for equipment that it actually owned. In fact, the ITA clearly provided for depreciation[11] on the fair market value of the equipment when it entered Canada.[12] The attempt to deduct a notional rent was based solely on an interpretation of article III of the 1942 treaty, and the ITCIA seemed to prevent Cudd from relying on that interpretation to the extent

9 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “ITA”).

10 RSC 1985, c. I-4, as amended (herein referred to as “ITCIA”).

11 ITA paragraph 20(1)(a) and part XI of the regulations.

12 ITA subsections 13(7) and 13(9).

that there was a conflict between article III and the ITA with respect to the deduction of depreciation in relation to the equipment.

David Ward addressed the difficulty that ITCIA section 4(b) presented for the taxpayer's position by arguing that the paragraph dealt exclusively with the deduction of expenses expressly prohibited by the ITA. The Tax Court, however, rejected what it termed an "unnecessarily restrictive" view of ITCIA section 4(b):

> The Appellant's contention that paragraph 4(b) of the *Income Tax Conventions Interpretation Act* is limited only to ensure that in computing the profits deduction should not be taken for outlays and expenses which the *Income Tax Act* specifically precludes as deduction for taxpayers resident in Canada appears to be an unnecessarily restrictive reading of its language.[13]

Section 4(b) of the ITCIA was not, however, the main reason why the Tax Court found against Cudd. The primary reason (which made *Cudd Pressure* such an interesting international tax treaty case) was that the court considered that article III of the 1942 treaty did not, in fact, justify the deduction of the notional rental charge claimed by Cudd. Having decided that neither the 1942 treaty nor the ITA supported the deduction of the notional rental charge, the court found that there was no conflict between the 1942 treaty and the ITA,[14] which meant that the deduction of the notional charge should have been rejected even in the absence of ITCIA section 4(b).

The majority decision of the Federal Court of Appeal[15] did not find any error in the decision of the Tax Court. It referred to the Tax Court's conclusion on the application of ITCIA section 4(b) and to the Tax Court's factual finding that an independent enterprise would not have rented the equipment, which had been a subsidiary motive for the Tax Court. It based its conclusion on that finding of fact.[16] While the minority concurring decision of McDonald JA discussed extensively the issue of whether a notional rent could be deducted in the appropriate circumstances (and concluded that it could), it did not address the issue of ITCIA section 4(b) because of its agreement with the factual finding that an independent enterprise would not have rented the equipment in the circumstances of the case.

13 Supra note 1, at 568.

14 Ibid., at 567: "No inconsistency between Article III and domestic law exists in this context."

15 Decision of Robertson JA (Strayer JA concurring).

16 According to Robertson JA, supra note 2, at paragraphs 3-4: "I do not find it necessary to deal with the issue of whether notional expenses are deductible as a matter of law in light of the factual findings made by Judge Sarchuk. . . . Assuming, without deciding, that notional amounts may be deducted in computing the profits attributable to a permanent establishment for the purposes of Canadian taxation, pursuant to the 1942 Convention, I am of the opinion that Justice Sarchuk did not commit a reviewable error in refusing to allow Cudd to deduct an amount for notional rent in the circumstances of this case. In particular, I can find no basis for interfering with his finding of fact that the appellant's permanent establishment, treated as an independent enterprise, would have rented the snubbing units from the head office."

Another aspect of the interaction between the 1942 treaty and the ITA that was raised by the argument of the notional rental charge (but which was not discussed by the courts or, it seems, by the parties) was the extent to which the notional rental charge, if it had been accepted, should have been added to—and not have replaced—the depreciation allowed by the ITA. The position adopted by Cudd assumed logically that the notional rental charge had to replace the depreciation allowed by the ITA, but that conclusion was somewhat problematic in the light of paragraph 10 of the protocol to the 1942 treaty, which read as follows:[17]

> The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit or other allowance accorded by the laws of one of the contracting States in the determination of the tax imposed by such State.

To the extent that the interpretation put forward on behalf of Cudd would have had the effect of replacing the depreciation allowed by the ITA by a notional rental charge, it would, literally speaking, have restricted a deduction granted by the domestic law of Canada. Since it clearly would have been absurd to grant both the depreciation and the notional rental charge, allowing only the depreciation provided by the ITA, as the courts did, avoided that problem.

Did the 1942 Treaty Allow the Notional Rental Charge?

If one ignores the prohibition of ITCIA section 4(b) and the factual finding that Cudd's PE would not have rented the equipment if it had been a separate independent enterprise, the argument for a notional rental charge has a certain attraction. This is due to the fact that, under the wording of the 1942 treaty, the taxpayer apparently did not have to establish that the deduction of a notional rental charge was *required* by the 1942 treaty. Since the 1942 treaty provided that the industrial and commercial profits of the PE had to be "determined on the basis of the separate accounts pertaining to such establishment,"[18] it seems that all that the taxpayer had to do was to establish that the accounts prepared for the PE, which showed the notional rental charge, conformed with the provisions of the 1942 treaty.[19]

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17 The difficulties raised by that provision, which is now a regular feature of US and Canadian tax treaties and is found in article XXIX(1) of the current treaty, have been analyzed by Brian J. Arnold, "The Relationship Between Tax Treaties and the Income Tax Act: Cherry-Picking" (1995) 43:4 *Canadian Tax Journal* 869-905. See the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

18 Second sentence of article III(1) of the 1942 treaty.

19 Expert witnesses who testified at the Tax Court hearings offered different opinions as to whether it was appropriate, for accounting purposes, to recognize the notional rental charge (see supra note 1, at 561-63).

The provisions of the 1942 treaty were clearly inspired by the work that Mitchell B. Carroll did for the League of Nations in the late 1920s and early 1930s. That work led to the drafting, by the League of Nations Fiscal Committee, of the 1933 draft multilateral convention for the allocation of business income between states for the purposes of taxation[20] (and, when it was realized that few countries were willing to sign that multilateral convention, to its redrafting into a set of model provisions for the negotiation of bilateral conventions).[21] The provisions of article III of the 1942 treaty are very close to the first part of article 3 of the 1933 draft convention, and therefore it is not surprising that David Ward based a large part of his arguments on that draft convention and on the work of Mitchell B. Carroll.

As was noted by the Tax Court, however, the 1933 draft convention prepared by the League of Nations and the work of Mitchell B. Carroll did not provide a clear answer to the question of whether a notional rental charge was appropriate in the circumstances of *Cudd Pressure*:

> The general view of the Fiscal Committee of the League of Nations with respect to allocating incomes was that it was advisable to prescribe only general principles due to the diversity of national laws and the extreme complexity and variety of the individual cases which might arise. Accordingly the selection of a method of allocation should depend, insofar as possible, on recognized methods of operation for the particular type of enterprise and upon practicability.[22]

In fact, as explained below, the international consensus that has developed since the mid-1950s (with the work on the OECD convention[23] and, more recently, on the UN convention)[24] is that the notional rental charge approach should be rejected in such a case.

20 See "Draft Convention Adopted for the Allocation of Business Income Between States for the Purposes of Taxation," in League of Nations Fiscal Committee, *Report to the Council on the Fourth Session of the Committee*, League of Nations doc. C.399.M.204.1933.II.A (Geneva: League of Nations, 1933) (setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=8&division=div1).

21 See League of Nations Fiscal Committee, *Report to the Council on the Fifth Session of the Committee*, League of Nations doc. C.252.M.124.1935.II.A (Geneva: League of Nations, 1935) (setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=9&division=div1).

22 Supra note 1, at 570.

23 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2010) (herein referred to as "the OECD model").

24 United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/PAD/SER.E/21, 2001 (herein referred to as "the UN model").

The OECD View on the Argument of a Notional Rental Charge

On a superficial reading, the commentary on article 7 of the 1963 draft convention[25] of the OECD did not appear to address the issue of notional rental charges. It did, in fact, deal with that issue through the reference to notional royalties, which it did not recognize.

The definition of "royalties" in the 1963 draft convention included "payments for the use, or the right to use, industrial, commercial and scientific equipment." The inclusion of such payments in the definition of royalties was proposed in the first report by Working Party no. 8[26] of the Fiscal Committee of the OEEC, which included the following draft article on the direct taxation of patent royalties and similar payments:

> (1) Royalties and other amounts received as consideration for the use of, or the right to use, any patent, licence to use a patent or other intellectual property (licence d'exploitation), copyright, design or pattern, trade mark, or similar right (except a right to work natural resources) or manufacturing process shall be taxable only in the State of which the taxpayer is a resident.
>
> (2) There shall be treated as royalties all rents and amounts similarly received as consideration for the renting of cinematograph films (including cinematograph films intended to be exhibited by television), for the use of industrial, commercial or scientific equipment and for the supply of information concerning industrial or commercial experience.[27]

The working party justified the inclusion of "rents . . . for the use of industrial, commercial or scientific equipment" in the definition of royalties, which had not been a feature of the Mexico and London model conventions,[28] by the fact that these payments had been treated as royalties in recent treaties concluded between OEEC member countries and that the "guiding idea of the Working Party was to submit to the Fiscal Committee a draft the substance of which would conform to the Conventions concluded by most of the O.E.E.C. countries."[29]

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25 Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963) (herein referred to as "the 1963 draft convention").

26 That working party was composed of the delegates for Germany and Luxembourg.

27 Organisation for European Economic Co-operation, "Report on the Direct Taxation of Patent Royalties and Similar Payments," document FC/WP8(58)1, February 12, 1958, in the OEEC archives found in the "History of Tax Treaties Data Base," at the *History of Tax Treaties* website (www.taxtreatieshistory.org).

28 League of Nations Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations doc. C.88.M.88.1946.II.A (Geneva: League of Nations, 1946) (setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=15&division=div1).

29 Supra note 27, at 5.

The report of the working party was discussed by the Fiscal Committee at its 8th session on May 5-7, 1958.[30] The issue of the inclusion of rental payments for equipment in the definition of royalties was specifically addressed during the meeting.[31] The committee then decided that the issue of royalties derived from a country where the recipient had a PE should be re-examined after the report of Working Party no. 7 on the allocation of profits to PEs and subsidiary companies had been discussed; it was also agreed that "a copy of this report would be sent as soon as possible to Working Party No. 7."[32]

A few months later, the issue of the recognition of notional charges in the form of royalties was raised in the first report of Working Party no. 7. In that first report, Working Party no. 7 raised the question of whether notional royalties should be allowed as deductions and expressed the view that "in order to avoid difficulties in practice," such a deduction should not be allowed:

> 3. The Group desires in submitting its Report to draw attention to several matters which arise and on which they would be glad to have the Committee's views and comments. In the order in which they appear in the text or draft Article A and of the Commentary they are: . . .
>
> (b) the question whether interest, royalties and other similar payments made by a permanent establishment to its parent enterprise should be allowed as deductions in computing the permanent establishment's taxable profits; (paragraph 16 of the Commentary); . . .
>
> 16. The first of these cases relates to interest, royalties and other similar payments made by a permanent establishment to its parent enterprise. On this matter the Group, leaving theoretical views out of consideration, are of the opinion that, in order to avoid difficulties in practice, such payments should not be allowed as deductions in computing the permanent establishment's taxable profits.[33]

Three weeks after the Working Party no. 7 report was produced, the Fiscal Committee discussed both the second report of Working Party no. 8, which again included a definition of royalties that applied to rental payments for equipment,[34]

30 "Minutes of the 8th Session," document FC/M(58)3, June 16, 1958 in the Data Base, supra note 27.

31 Ibid., at 9: "As regards paragraph 2, the Delegate for Germany remarked to the Delegate for Portugal that royalties for the use of industrial, commercial, or scientific equipment are not treated in the same way in all countries (industrial and commercial profits, rentals, etc.) and that the draft Article, in treating them like royalties, did so only in order to settle cases of double taxation."

32 Ibid.

33 Organisation for European Economic Co-operation, "Report on the Allocation of Profits to Permanent Establishments and Subsidiary Companies," document FC/WP7(58)1, September 4, 1958, in the "Data Base," supra note 27.

34 Organisation for European Economic Co-operation, "Second Report on the Direct Taxation of Patent Royalties and Similar Payments," document FC/WP8(58)2, September 3, 1958, in the

and the first report of Working Party no. 7, which recommended that notional royalties should not be allowed as deductions in computing the profits attributable to a PE.[35] In fact, the minutes of the meeting suggest that these two reports were discussed one after the other, starting with the report of Working Party no. 8, and that during that discussion, the delegate for Greece raised the issue of the inclusion of rents for industrial, commercial, and scientific equipment.[36]

Given how these reports were drafted and discussed by the Fiscal Committee, it seems clear that Working Party no. 7 (when it worked on its first report on the issue of attribution of profits to PEs) and the Fiscal Committee (when it had a first discussion of that report) were well aware that the term "royalties" included rental payments for equipment.

Both the proposal that rental payments for the use of industrial, commercial, and scientific equipment be included in royalties and the proposal that notional royalties not be allowed as deductions in determining the profits of a PE were adopted by the Fiscal Committee and were included in the 1963 draft convention.[37] There were no relevant changes in the 1977 model double taxation convention.[38] In the 1992 model, however, the definition of royalties was modified to exclude from that definition "payments for the use, or the right to use, industrial commercial or scientific equipment."[39] This change was made as a result of the 1983 report on the taxation of income derived from the leasing of industrial, commercial, or scientific equipment,[40] and seems to have been made without anyone thinking about the treatment, for the purposes of article 7, of notional rental charges.

"Data Base," supra note 27, at page 5, which included a slightly revised definition of royalties that also covered rental payments for industrial, commercial, or scientific equipment: "2. There shall be treated as royalties all rents and similar payments received as consideration for the use of, or the right to use, industrial, commercial or scientific equipment and for the supply of information concerning industrial, commercial or scientific [equipment]."

35 "Minutes of the 9th Session," ibid., document FC/M(58)4, October 31, 1958.

36 Ibid., at 7-10 (items VI and VII of the minutes).

37 Supra note 25. The definition of "royalties" in article 12(2) included "payments of any kind received as a consideration . . . for the use of, or the right to use, industrial, commercial, or scientific equipment." Paragraph 15 of the commentary on article 7 included the following: "The first of these cases relates to interest, royalties and other similar payments made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. *In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits*" (emphasis added).

38 Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977).

39 "The Revision of the Model Convention," report adopted by the Council of the OECD on July 23, 1992.

40 Organisation for Economic Co-operation and Development, "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment," in *Trends in International Taxation* (Paris: OECD, 1985), 9-16. The report was adopted by the Council of the OECD on September 13, 1983.

Shortly after that change was made, however, the OECD had the opportunity to revisit its position on the issue of notional rental charges. In its 1993 report on the attribution of income to permanent establishments,[41] the Committee on Fiscal Affairs examined the application of article 7 to various types of transfers between a head office and a PE. On the basis of the replies provided to a questionnaire sent to the OECD member countries, the report addressed the issue of the transfer of goods, including equipment, as follows:

> It would seem that the arm's length price principle is accepted *for final transfers of goods* when those goods still have a firm market value subsequent to the commercial year during which they are transferred, depreciation allowances being subsequently allowed on the basis of this transfer value. This applies not only to tangible assets in general (raw materials, semi-finished or finished products *and industrial equipment*) but also to certain intangible assets (know-how, patents and trademarks)—although, of course, final transfer of a patent or of know-how is quite exceptional.
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> In all other cases, notably as regards central administrative services, the right to use intangible assets, *temporary assignment of industrial equipment*, transfers of equity holdings and national currency or foreign currency assets (receivables and liquidities), *the general rule is allocation of actual (historic) cost*. For instance, temporary assignment of equipment will carry a transfer price that generally corresponds to the accounting depreciation of the goods concerned. *Most countries therefore exclude royalties or lease payments and even exchange losses or gains on transfers of foreign currency assets*. . . .
>
> Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods then it will normally be appropriate for the provisions of paragraph 2 of Article 7 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. *As indicated in paragraph 13 above, there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material, i.e. in the case of a plant, the depreciation costs suffered while the plant is in use in particular parts of the trade*.[42]

The conclusions of the 1993 report made their way into the commentary on article 7 through the 1994 update of the commentary on the OECD model, when the above-quoted paragraph of the report was included in the commentary as paragraph 17.3.

41 Organisation for Economic Co-operation and Development, *Model Tax Convention: Attribution of Income to Permanent Establishments*, Issues in International Taxation no. 5 (Paris: OECD, 1994). The report was adopted by the Council of the OECD on November 26, 1993.

42 Ibid., at 17-19 (emphasis added).

The situation remained unchanged until the OECD undertook work on what became known as the "AOA" (authorized OECD approach). That work was undertaken with the objective of providing a more consistent interpretation and application of the rules of article 7. The decision was made to develop an approach that

> was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade.[43]

A preliminary draft of the report that would ultimately include the results of that work was released on August 2, 2004.[44] The 2004 draft included an elaborate discussion of the issue of internal transfers of assets and proposed a new and different approach under which a notional rental arrangement documented as such by the taxpayer would be recognized "if, in fact, the original economic owner of the asset continues to bear the economic risk and take the key entrepreneurial risk taking decision in respect of that asset":[45]

> The question then becomes how to account for the acquisition and use by the PE of an asset, either acquired from a third party or transferred from another part of the enterprise, when computing the amount of profit that should be attributed to the PE. Should the PE be treated as having "bought" the capital asset from the head office? Should the PE be treated as leasing or renting the capital asset? Is it possible for the PE to be treated as a participant in a "CCA" type activity in respect of the capital asset?
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> Where a physical asset has been transferred from one part of the enterprise to another, such a transfer is clearly an economically significant event and will pass the threshold test for the recognition of an internal dealing. The question to be determined is the character of that dealing. An important factor in determining the character of the dealing is the documentation produced by the taxpayer at the time of the transfer. The dealing may be characterised in the documentation as a rental agreement, an outright sale or as the commencement of a "CCA" type of activity. As is always the case with intra-enterprise transfers, however, the documented characterisation of the dealing will only be respected for tax purposes if the documentation reflects the economic reality. *Documentation which characterises the dealing as, for example, a rental arrangement, will*

43 Organisation for Economic Co-operation and Development, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, July 22, 2010), at paragraph 4 of the preface (herein referred to as "the 2010 report").

44 See Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishment—Part I (General Considerations)* (Paris: OECD, August 2, 2004).

45 Ibid., at paragraph 202.

> *only be recognised if, in fact, the original economic owner of the asset continues to bear the economic risk and take the key entrepreneurial risk taking decision in respect of that asset.*[46]

In the final version of the 2010 report,[47] however, that approach was rejected in favour of a position that is more in line with the view advocated by the OECD since the first report of Working Party no. 7, which was produced in 1958 and according to which, as a general rule, a notional rental charge should not be recognized. The final version of the 2010 report provides that "in the absence of circumstances in a particular case that warrant a different view,"[48] the proper approach is to consider that equipment used by a PE should be considered to be "economically owned" by the PE and should therefore result in depreciation as opposed to a notional rental charge:

> When the OECD member countries discussed how to attribute tangible assets within the single enterprise, different views were expressed. At one end of the spectrum, a view was expressed in favour of applying to tangible assets the general principles as set out in Section B-3(i), *i.e.* attributing tangible assets based on a determination of the significant people functions relevant to the economic ownership of said assets, by means of a functional and factual analysis of the case. At the other end of the spectrum, the view was expressed that place of use should be the sole criterion for attributing tangible assets to a PE, especially in those cases where a fixed place of business PE (Article 5(1)) existed precisely due to the presence in the host country of those tangible assets.
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> Having discussed the practical implications of each of these two options, the OECD member countries concluded that in practice in most cases they should both arrive at the same or at not significantly different results, that is:
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> - Where a PE is treated as the economic owner of a tangible asset, it will typically be entitled to deductions for depreciation (in the case of depreciable assets) and interest (in the case where the asset is wholly or partly debt-financed).
> - Where a PE is treated as the lessee of a tangible asset, it will typically be entitled to deductions in the nature of rent.
>
> Over the useful life of the asset, the deductions allowable in the two cases may not differ significantly in practice although of course, the two cases may result in quite different profit allocations in any given year or span of years. *As a consequence, there was a broad consensus among the OECD member countries for applying use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. This is regarded as a pragmatic solution for attributing economic ownership of tangible assets under the authorised OECD approach.*[49]

46 Ibid., at paragraphs 201-2 (emphasis added).

47 Supra note 43.

48 Ibid., at paragraph 75.

49 Ibid. (emphasis added).