Control of Expenses Computed by Permanent Establishments under the OECD Model Agreement

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SUMMARY

This paper is concerned with the different aspects to be considered when controlling expenses computed by permanent establishments under the OECD model agreement and the taxation consequences arising from their examination, specifying each regulation governing the matter and considering especially the current observations and reserves of such international body's member countries.

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INTRODUCTION

Content:

The globalization of the world economy has been one of the main consequences of the large-scale development of the goods and services trade among different countries, as a result of which companies, in trying to internalize their investments, have streamlined methods intended to channel their operations through diverse corporate structures, among which are: agencies, branches or any other type of permanent establishments.

A permanent establishment is defined as "an effective extension, in another country, of the business activity of the headquarters, which may or may not be related to the place of operations[1]. It is within this scenario that permanent establishments have arisen as a complex legal institute rooted in different company groups having their own ways to carry out activities; and this is not alien to the difficulties deriving from the international double taxation on their income, for many countries strive to impose their tax jurisdiction to assess income deriving from such international operations.

It is apparent that permanent establishments still spark concern to most tax administrations and have resulted in a complex treatment of computed expenses, especially when the same are associated to the income earned by such establishments from a foreign source.

Alternatively, the OECD model agreement, which suggests rules to avoid or mitigate the international double taxation, has reportedly and visibly predominated between the States as the main source for agreements concerning this matter. However, it is with reference to such model agreement that member countries have made observations and raised objections with the consequence of limiting its application in many cases and causing tension with the local laws of each State. This paper will try to elucidate this issue.

1 *FAÚNDEZ, Antonio, Agencias y otros establecimientos permanentes, in Manual de consultas tributarias, n° 389, (Santiago, 2010), p. 21; SAME AUTHOR, Establecimientos permanentes: aspectos tributarios (Santiago, 2009), p. 34; SAME AUTHOR, Beneficios atribuidos a establecimientos permanentes, in Revista de Derecho de la Empresa, 21 (Santiago, 2010), p. 101.*

1. IDENTIFYING THE PROBLEM

The countries that have celebrated international double taxation agreements within the scope of the OECD model agreement abide by the regulation on expenses computed by permanent establishments included in paragraph 3° of section 7, which provides: "To determine the permanent establishment's income, the deductible expenses shall be those incurred in carrying out the purposes of the business, including management and general administrative expenses incurred for such purposes, whether incurred in the State where the establishment is located or elsewhere". The cited section seems not to set a limitation on the manner the expenses are computed, which raises the first question as to whether such expenses should necessarily be tied to the taxable income or may be deducted even in the case where expenses are tied to non-taxed or exempted income.

As a consequence of the above, the application of internal regulation should be elucidated in the cases not regulated by the agreement, which on occasions become in conflict with the principles acknowledged internationally and incorporated into the cited double taxation agreements, as is the case, e.g., with the non-discrimination principles of agreements.

The above also includes the situation of expenses resulting from operations conducted between the permanent establishment and its headquarters, mainly in respect of the fact that they both constitute legally the same entity. Within the taxation sphere, the principle of considering the permanent establishment as separate from its headquarters should not be overlooked, but this also may bring doubts regarding the acts that fall within such limits.

2. PRINCIPLES TO BE CONSIDERED WHEN DETERMINING EXPENSES

The principles discussed below are vital to approach the control of expenses related to permanent establishments, the scopes of which, in my opinion, will be in constant conflict as a result of the rule antinomy, i.e., convention rules vs. local regulations.

1- The non-discrimination principle of agreements: ongoing tension with local laws?

The principle of non-discrimination of agreements provides that permanent establishments should not bear within the State in which they operate a less favorable taxation than that borne by companies of the same State for the same activity. Section 24, paragraph 3° of the OECD model agreement indicates that "the permanent establishments held by a contracting State in another contracting State shall not be subject in the second State to any taxation that is less favorable than that borne by the companies performing the same activities in the second State. This provision shall not be construed as obliging any contracting State to grant to the residents of the other contracting State the personal deductions, exemptions and tax reductions granted to its own residents in consideration of their civil status or dependant contributions".

The principle of non-discrimination of agreements is a manifestation of the arm's length principle of taxpayers, in respect of which the elements that are to be compared will link a permanent establishment with a resident of the State in which it operates. In this sense, the non-discrimination principle of agreements operates

between taxpayers but not between States. According to GARCÍA[2], what should prevail in the resolution of this matter is not the elimination of the international double taxation borne by the permanent establishment but rather that the taxation in the relevant State should not be greater than that borne by a comparable establishment[3]. Now, in my opinion, comparative criteria should not be limited only to the type of activity carried out by the taxpayers, but should also take into account the income nature and the type of tax assessed on such activity, which should necessarily be considered in light of the local laws.

The OECD's comments on the model agreement indicate that the equalitarian treatment with relation to permanent establishments should operate in the following six areas: (i) tax liquidation; (ii) special treatment of dividends earned by permanent establishments; (iii) tax structure and rate; (iv) withholding of tax on dividends, interest and royalties for permanent establishments; (v) discount of taxes paid abroad; and (vi) extension to the permanent establishments of the benefits of double taxation treaties signed with third countries[4]. However, the scope of section 24 of the model agreement has not been unanimously accepted by OECD's member States, and reservations have been made to its application[5]. Notably, many countries which are not members of the OECD frequently consult these comments as a way to interpret their agreements, but the diverse reservations made by the member States to the cited section 24 clearly keep such countries at a distance from the interpretive scope of such comments.

These precedents lead to permanent tension between the agreements and the local laws and result in each country construing the non-discrimination principle and establishing comparative criteria based upon its own legislation. Such tension is inevitable if the agreement fails to specify the comparative criteria to be considered for the non-discrimination principle, and each State will fill any gaps in the agreement with its local regulations.

2. Jurisdictional factors determining the application of taxes to income attributable to permanent establishments

Outside the sphere of the OECD model agreement, the tax legal hypothesis described in each piece of legislation should be supported by principles tied to jurisdictional factors that determine the application of the income tax. These principles are related mostly to a State's territory or a taxpayer's residence.

In this sense, if the territoriality principle is applied as a jurisdictional factor, a distinction should be made between the national source income and the foreign source income. The national source income will consist of the income attributed to permanent establishments deriving from property located in the State where they operate or carry out activities. Alternatively, foreign source income will derive from property located or activities carried out in a country different from the country where such establishments operate.

The residence principle is a second factor that may influence the application of taxes. Broadly,

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2 *GARCÍA, Francisco, La cláusula de no discriminación en los convenios para evitar la doble imposición internacional, in Fiscalidad Internacional, (Madrid, 2005), p. 927.*

3 *Ibid., p. 934.*

4 *Paragraphs 24 to 54 of section 24 of the OECD's comments.*

5 *Australia, Canada and New Zealand made objections to such section; the United States reserved the right to apply their taxes on branches; France reserved the right to apply the provisions in paragraph 1° to individuals only; the United Kingdom objected to the second phrase of paragraph 1°; Switzerland reserved the right to not include paragraph 2° in their agreements; Greece, Ireland, Luxemburg and the United Kingdom reserved the right to restrict the application of paragraph 6° to the taxes included in the agreement (OECD, Modelo de convenio tributario sobre la renta y sobre el patrimonio, in Instituto de Asuntos Fiscales, [Madrid, 2005], pp. 324-325).*

this principle states that the residents of a State will pay taxes on income of any precedence. The double taxation phenomenon may arise in the case that a resident earns income from a foreign source that is subject to taxes in the State where it is originated. This principle constitutes the primary basis for the application of taxes by States. Hence, in Chile this principle is acknowledged in section 3° of the Income Tax Act; in Peru, it is regulated in section 6° of the Income Tax Act; in Mexico, it is provided in section 1° of the Income Tax Act; in Argentina, in section 1° of the Income Tax Act; etc.

Now, in the sphere of the OECD model agreement, the residence principle constitutes the general rule for assessment used by the contracting State bound to assess income. The right of taxation is conferred exclusively upon the State where the taxpayer resides; this means that where income is earned by a taxpayer in a contracting State where they do not reside, such State may not impose a tax, but rather the right of taxation will remain in the contracting State where taxpayer resides, thereby avoiding the double taxation of income.

The exception to the rule lies in the source principle for cases expressly provided for in the model agreement. This is the situation of permanent establishments, where the income obtained in the contracting State where they operate, in accordance with paragraph 1° of section 7°, shall also be subject to taxes in such contracting State. Now, to avoid or mitigate the double taxation of income in this exceptional case, the model agreement provides in sections 23A and 23B that the State where the permanent establishment resides should allow a tax relief through two methods: exemption and charging expenses or credit[6].

Notwithstanding the above rules, the model agreement says nothing about the income obtained by a permanent establishment in a State different from that where it operates. In my opinion, paragraph 1° of section 7° of the model agreement only refers to profits earned by a permanent establishment in the contracting State where it operates, thus providing sufficient grounds to apply the internal regulation to the taxation of profits obtained by the permanent establishment in a State different from that where it operates. In this sense, to determine the rules for assessment of such income, we should resort to the territoriality principle previously discussed with relation to the income earned by a permanent establishment from a foreign source, although in this case in accordance with the national laws of each contracting State. In Chile, the Internal Revenue Service[7] has stated that the permanent establishment is considered non-resident, so it will pay taxes in the source State only in respect of income obtained in such State, and, therefore, it will not pay taxes in that State in respect of the income obtained in the other contracting State or a third State[8].

The criterion of considering the permanent establishment as non-resident in the country where it operates is widely accepted among countries, and is supported in the dependence on a non-resident. For control purposes, tax administrations generally require foreign companies operating with permanent establishments to fix a known domicile, which may generate some confusion at the time of rendering a resident of such State, and serious consequences at the time of liquidating a certain tax. For the same reason, the establishment of a known domicile for control purposes may only be effective in the event of an inspection. It is in this scenario that the legal basis makes sense,

6 *In Chile, pursuant to section 41C with relation to section 41A letter B of the Income Tax Act, the companies incorporated in the country which operate with permanent establishments located abroad may opt for the credit method, with certain limits established by the regulation.*

7 *Inspection body responsible for interpreting administratively the fiscal regulation through its National Director.*

8 *Official Letter n° 2.556 of the Internal Revenue Service, dated June 8 of 2004.*

of taxing permanent establishments only in respect of the income obtained in the contracting State where they operate, supported by the "dependence" on the headquarters' residence[9].

Alternatively, in the context of double taxation agreements, GARCÍA states that the failure to consider the permanent establishment a resident company of the relevant State originates from the impossibility to consider it a person of the contracting State[10]. This author bases his theory on the fact that a permanent establishment is not a legal person and, therefore, should not be considered a person of the State in which it operates and, consequently, it could not be considered a resident of such State.

Now, based on the above stated rules, the expenses should be determined which will be related to the income subject to the fiscal burden in the State in which the establishment operates, by applying the residence principle contemplated in the model agreement and the territoriality principle established in the national laws of each State, something we will discuss in the following paragraphs.

3. EXPENSES RELATED TO INCOME ATTRIBUTABLE TO PERMANENT ESTABLISHMENTS

Paragraph 3° of section 7° of the OECD agreement model provides that expenses tied to income attributed to a permanent establishment should be allocated to the pursuance of corporate purposes. But the cited rule fails to specify whether the expenses whose reduction is sought should or should not be tied to the income attributed to the permanent establishments bound to be subject to a certain fiscal burden[11]. On this regard, it is indispensable to discuss the concept of income attribution in order to determine later the taxable income.

1. Income attributable to permanent establishments

BETTINGER defines attributable income as "that resulting from any corporate activity, as well as that deriving from the sale of goods or real property by the headquarters within the national territory, or by another establishment held by the resident abroad, or directly by the resident, as per the case"[12]. In this sense, the income to be attributed to a permanent establishment will determine, on the one hand, the fiscal burden taxable in the country where it operates; and, on the other hand, it will be essential for the headquarters to invoke income intended to attenuate or reduce the international double taxation[13].

Paragraph 2° of section 7° of the OECD model agreement provides that in order to determine a permanent establishment's profits, the establishment must be considered a different

9 *FAÚNDEZ, Antonio, Op. cit. (n° 1) Agencias, p. 65-65.*

10 *GARCÍA, Francisco, El Establecimiento Permanente. Análisis jurídico tributario internacional de la imposición societaria (Madrid, 1996), p. 435.*

11 *In Chile, pursuant to section 31 of the Income Tax Act, the expenses that are deductible from the gross income are all those required to produce it, either paid or owed, and which are allocated to the business activity. The above cited rule should be supplemented with the provisions in letter e) of number 1° of section 33 of the same act, which also provides that the expenses should in addition be tied to the income subject to a fiscal burden. As a consequence, expenses tied to non-income revenues or exempted income are not considered expenses.*

12 *BETTINGER, Herbert, Efecto Impositivo del Establecimiento Permanente, (Mexico, 2008), p. 113.*

13 *FAÚNDEZ, Antonio, Op. cit. (n° 1), Beneficios, p. 102.*

and separate company from its headquarters[14]. However, such paragraph fails to specify the manner of determination of such profits. In the opinion of BAKER and COLLIER, which I uphold, the local laws need not be adapted in each jurisdiction to the concept of a separate company or the prudence principle; in other words, each jurisdiction should decide on its own how to determine a company's taxable profits and how income is attributed to a permanent establishment under the local laws[15]. Nevertheless, the provisions in paragraph 1° of section 7° should not be disregarded, which state that the profits subject to a fiscal burden shall correspond to the profits that may only be attributable to a permanent establishment, which implies that the State in which such establishment operates may not tax the profits obtained by the headquarters in the same State through other means.

The States have adopted three methods to determine the income attributed to a permanent establishment, namely: (i) the direct method, whereby the permanent establishment's profits are determined on the basis of its own income, regardless of the headquarters' total profits; (ii) the indirect method, whereby the company's total profits are considered in order to distribute them to the permanent establishment proportionately to certain auxiliary factors, as is the case of, e.g., Switzerland, where the total income of a company is distributed among several permanent establishments in proportion to their separate profits, calling this method "total distribution of income"[16]; and (iii) the mixed method, an application of both the direct and the indirect methods, but where either one prevails over the other.

The mixed method is applied in countries such as Germany, where the direct distribution method prevails over the indirect method[17]. It is also applicable in Chile, with predominance of the direct method, governed in section 38 of the Income Tax Act. This rule establishes that the Chilean source income of a permanent establishment is determined based upon its own income, regardless of the headquarters' total profits; however, rather than a prevalence of the direct method over the indirect method, the latter is applied by the tax inspection authority where the actual income cannot be determined through the former[18].

The expenses deductible by the permanent establishments should necessarily by tied to the income attributed in conformity with the methods discussed above; however, where the expense is tied to exempted or non-taxed income, it may be reduced if the relevant legislation expressly sets forth such limitation, a situation we will deal with in the next paragraphs.

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14 The doctrine has been split internationally into two theories: (i) the relevant business activity approach, in which the permanent establishment's income is determined by considering the business activity of the headquarters as a whole; i.e., as an "individual company" of which the permanent establishment is a part. In this way, upon determining the headquarters' global income, this income is attributed to the permanent establishment. And (ii) the functionally separate entity approach, where the income attributed to a permanent establishment is that obtained as a separate entity from the company to which it belongs. This criterion is adopted in the OECD's comments on the model.

15 Compare with BAKER, Philip and COLLIER, Richard, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 28.

16 Ibid., p. 37. A study conducted by Sven Olof Lodin and Malcolm Gammie, which proposes schemes for applying a common corporate tax system in the European Union and which is clearly reflective of an indirect method. This system is called Home State Taxation, and broadly provides that a corporation residing in a certain State should calculate the taxable base not only of such corporation but of all its branches situated in the States that abide by the system, in conformity with the fiscal regulation of the State of the corporation (RAVENTÓS, Stella, La Reestructuración Empresarial como Instrumento de Planificación Fiscal Internacional, in Centro de Estudios Financieros, (Madrid, 2005), p. 1.184.

17 NAUMANN, M., FÖRSTER, H. and ROSENBERG, O., Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 344.

18 On this regard, I suggest reading of Beneficios atribuidos a establecimientos permanentes, in Revista de Derecho de la Empresa, 21 (Santiago, 2010), by Antonio FAÚNDEZ.

2. Deductible expenses under the OECD model agreement

The determination of the permanent establishment's expenses is regulated in paragraph 3°, section 7° of the OECD model agreement, which provides: "To determine the permanent establishment's income, the deductible expenses shall be those incurred in carrying out the purposes of the business, including management and general administrative expenses incurred for such purposes, whether incurred in the State where the establishment is located or elsewhere". This rule is supported by the principle of separate company established in paragraph 2° of section 7° discussed previously.

The first thing that should be noted is that paragraph 3° of section 7° of the OECD model agreement seems not to establish any limitations on the manner expenses are calculated, and includes the expenses generated in another State. This rule fails to specify whether the expenses tied to non-taxed or exempted income are to be considered expenses. In view of this omission, the provisions in paragraph 2° of section 3° of the model agreement should be taken into account, which state that in order that any contracting State should apply the agreement at a certain moment, any term or expression not defined therein shall have the meaning assigned by the State's legislation at that time, unless the context should imply otherwise. But the context of the rule of paragraph 3° of section 7° does not envisage any solution to the problem analyzed, leaving no other choice but to apply the internal legislation of the State in which the permanent establishment operates; and so where the internal laws so provides it, the expenses tied to non-taxed or exempted income shall not be accepted as expense[19]. The proposed solution resolves the determination of expenses in the same manner as that established for a company incorporated in the same State where the permanent establishment operates, which requires abiding by the non-discrimination principle of agreements.

Particularly in the case of Chile, pursuant to subsection one of section 38 of the Income Tax Act, the income of a permanent establishment is determined on the basis of the actual income obtained from its operations within the country; however, given that such establishment is considered non-resident, it will only pay taxes in Chile on Chilean source income, a situation regulated in section 3°. In this sense, the foreign source income of a permanent establishment operating in Chile will not be subject to taxes by reason of that establishment being non-resident, and for the same reason, under the letter e) of number 1° of section 33 of the Income Tax Act, expenses tied to non-taxed or exempted income shall not be charged.

Now, well, the accountability of the permanent establishment may reflect expenses originating in a country different from that where it operates, which could be allocated to the generation of income in the State where it carries out its business activity. In these cases, the taxpayer is responsible for providing due evidence of this circumstance as per the formalities and conditions established in the internal laws. The problem arises upon the accountability of expenses tied to both the headquarters and the permanent establishment, in which case such expenses should be separated or prorated. The OECD has stated that in respect of the general administrative expenses incurred by the company's headquarters, it may be fit to compute a proportional portion in accordance with the relation between the sales volume of the permanent establishment (or possibly its gross profits) and the sales volume of the company as a whole[20].

19 *Supra cit. n° 11.*

20 *Subparagraph 16 of paragraph 3° of section 7° of the OECD model agreement. In Chile, the subsection two of section 27 of the Fiscal Code establishes the authority of the Internal Tax Service to separate or prorate expenses in the case that taxpayer fails to accompany documentation or provides incomplete information.*

On the other hand, a great number of specific problems may arise in practice, but as a general rule the determination of profits attributable to a permanent establishment should always be based on such establishment's accountability, to the extent that it is representative of the real situation. On the contrary, if the accountability does not reflect the actual facts, then new accounts should be created or the original accountability should be corrected using the market normal values[21]. In this sense, the OECD has expressed that upon reviewing the headquarters' and the permanent establishment's accountability and finding that some items depict entirely artificial functions instead of actual economic functions of the different parts of the company, then such items may be disregarded and proper adjustments should be made[22]. This situation may occur, for example, where the sales made by a permanent establishment are accounted for as a primary activity implying insurance and freight expenses and it is determined in reality that they constitute only an intermediary activity, in which case they cannot be considered expenses.

3. Expenses related to operations between the permanent establishment and the headquarters.

Both doctrine and jurisprudence agree that the permanent establishment and its headquarters constitute the same entity for legal purposes, something that approximates reality if we consider that the former is an extension of the latter in terms of their economic activity. This varies when assessing each entity's taxation, in which case, pursuant to paragraph 2° of section 7° of the OECD model agreement, they will be considered two separate and independent companies. This separation has more often than not resulted in serious problems when delimiting businesses as a single entity for legal purposes and separate and independent companies for tax purposes.

The main consequence of considering the permanent establishment and its headquarters a single entity is the absence of legal obligations between them. As a rule, any contractual obligation presupposes the concurrence of two persons: one as creditor and one as debtor[23].

As a result, if the accountability of the permanent establishment records expenses reportedly tied to agreements celebrated with its headquarters, such entries should be corrected. This situation occurs, for example, where expenses are accounted for as a result of lease contracts between the permanent establishment and its headquarters.

The foreign jurisprudence reports cases in which the Courts have expressly rejected the deduction of certain expenses tied to agreements celebrated between the permanent establishment and its headquarters, as exemplified in a ruling issued by the Federal Court of Appeals of Canada, in declaring that the income from a rental paid by a permanent establishment in Canada could not

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21 Subparagraph 14 of paragraph 2° of section 7° of the OECD model agreement.

22 Subparagraph 12.1 of paragraph 2° of section 7° of the OECD model agreement.

23 Section 1.437 of the Chilean Civil Code provides: "Obligations may arise from the real concurrence of the will of two or more persons, as in the case of agreements or conventions; the voluntary action of a person that bound themselves, as in the acceptance of a inheritance or bequest and in all quasi-contracts; or as a consequence of any deed resulting in slander or damages to another person, as in torts and unintentional torts; or by operation of law, as between parents and children subject to parental rights and duties".

In this same sense, the tax inspection authority of Chile (Internal Tax Service) in establishing interpretation criteria declared in the Official Letter Nº 800 of 2008 that: "[…] pursuant to the tax legislation and in light that the headquarters and its agency abroad are the same legal person, an agency abroad may not hold the capacity of creditor of its headquarters in Chile because any obligation presupposes the existence of different legal subjects under section 1.437 of the Civil Code. As a consequence, upon the headquarters in Chile and its agency abroad constituting the same legal person, the existence of credits and reciprocal obligations between both entities is not legitimate, and therefore, the tax adjustments for money correction provided for in section 41 of the Income Tax are not applicable…" Furthermore, the Internal Tax Service, in the Official Letter Nº 1.276 of 2007, stated: "[…] it is

be deducted at its headquarters based in the United States[24]. In the same sense, Swedish courts have established that foreign headquarters and a Swedish permanent establishment cannot enter into a loan agreement, and therefore, the permanent establishment cannot deduct interest paid to the foreign headquarters[25].

The OECD has indicated that in the case of payments made to the headquarters by its permanent establishments for interest on loans, the issue arises mainly for two reasons: (i) from a legal standpoint, the transfer of capital as interest payment and the commitment to reimburse it on a certain date is in fact a formal act inconsistent with the authentic legal nature of the permanent establishment; and (ii) from an economic standpoint, the internal debts and credits may be inexistent, because if a company is financed, only or mainly through equity capital, the deduction of interest that manifestly was not payable is not legitimate. While it is true that symmetrical charges or revenues do not misrepresent a company's global profits, it is not less true that partial income may be altered arbitrarily[26]. It further states that if the debts assumed by the headquarters on behalf of the company were used exclusively to finance their activity or, clearly and exclusively, the activity of a certain permanent establishment, the problem would only be a matter of undercapitalization of the effective user of such loans. In fact, the loans taken by the headquarters of the company will normally be used to cover their own needs up to a certain extent, while the rest of the borrowed funds will be allocated to provide the permanent establishments with basic equity[27].

Now, under certain circumstances, deducting expenses tied to certain operations carried out between the permanent establishment and its headquarters would in fact proceed, intended to materialize businesses bound to generate taxable income, as for example, the expenses incurred in transferring goods from the headquarters to the permanent establishment, which are intended for sale in the State where the latter operates. SKAAR[28] points out that the transfer of goods, services and intangible property between the departments of the same taxpayer will not be taxable; rather, the taxable event occurs when the goods or merchandise is transferred later by the permanent establishment to a third party. Likewise, VON UTHMANN[29] argues that in Sweden the transfer of assets from the headquarters to a permanent establishment, under the general internal principles and the fiscal credit of the relevant double imposition agreement, will not pay taxes

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concluded that the shares that are to become part of the effective capital held by the foreign agency in the country for its business activity do not purport the sale of such securities, because the holder thereof remains being the same legal person. Such shares may only be allocated to the performance of operations in Chile, but the ownership thereof shall remain unaltered".
In Australia, in the Max Factor case, the Supreme Court ruled that an entity cannot earn profits from business conducted with itself. Likewise, in India, the courts have ruled that a permanent establishment and its headquarters are part of the same legal entity and cannot earn profits from each other (BAKER, Philip and COLLIER, Richard, Op. cit. [n° 15], p. 38.)

24 *Ruling issued in the matter of Cudd Pressure, 1999, 1 CTC 1 (FCA), cited by DARMO, Marc and SMIT, Carrie, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 236.*

25 *VON UTHMANN, Karin, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 640.*

26 *Subparagraph 18 of paragraph 3° of section 7° of the OECD model agreement.*

27 *Subparagraph 18.1 of paragraph 3° of section 7° of the OECD model agreement. It should be noted, however, that the OECD comments recognize special situations, in the case of interest payments made among the different parts of a financial company (e.g., a bank) for advances and similar concepts (other than provision of capital), based upon the close relationship between the granting and reception of advances and the corporate purpose of such companies.*

28 *SKAAR, Arvid, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 525.*

29 *VON UTHMANN, Karin, Op. cit. (n° 25), p. 639.*

until the assets are sold to a third party alien to the company.

However, in other legislations, such as in South Africa, there are special rules governing the transfer of assets between headquarters and permanent establishment, which are rendered by such legislation as a sale at market price and an immediate sale at such same value. This same rule applies inversely; that is, in the case of a South African permanent establishment that transfers an asset to non-resident headquarters[30]. In this State charging the expenses incurred in such operations would be legitimate.

4. CONCLUSIONS

The analysis of the formulated hypothesis shows that the OECD model agreement proposes a generic regulation regarding expenses that can be charged to income attributed to a permanent establishment, a situation that is complex given the innumerable situations that may arise from the operations conducted between a permanent establishment and its headquarters. In this scenario, the internal legislation will fill the gaps not allowed for in the relevant agreement.

The principles determinant of the jurisdictional factors in the taxation of income attributed to permanent establishments should be fully considered at the time of assessing expenses. The complexity will lie in the establishment of the boundaries of application of the agreement rules and the internal legislation, particularly where the permanent establishment intends to charge expenses tied to income obtained in a State different from the one in which it operates.

From the analysis of the above, within the context of paragraph 3° of section 7° of the OECD model agreement, it is not possible to specify whether the expenses tied to non-taxed or exempted income can be accepted as such, leaving no choice but to apply the internal legislation of the State where the permanent establishment operates; and in this sense, where the internal legislation so provides it, the expenses tied to non-taxed or exempted income may not be charged as such.

Alternatively, where expenses tied to both the headquarters and the permanent establishment are accounted for, such expenses should be separated or prorated. In the specific case of general administrative expenses incurred by the headquarters on behalf of the company, it may be appropriate to calculate a proportional part according to the relation between the sales volume of the permanent establishment and the sales volume the whole company. If upon reviewing the accountability of the headquarters and the permanent establishment there are items depicting purely artificial functions instead of the actual economic functions of the different parts of the company, then such items may be disregarded and the pertinent adjustments may be made.

Lastly, in view that the permanent establishment and its headquarters constitute the same entity, if the accountability of such establishment records expenses reportedly tied to agreements celebrated with its headquarters, then such entries should be corrected and the expense should be included in profits. Now, under certain circumstances, deducting expenses tied to certain operations between the permanent establishment and its headquarters would indeed proceed, specifically upon carrying out business with third parties, resulting in taxable income.

30 *HATTINGH, Johann y NEWTON, Basil, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 578.*

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