European and International Tax Moot Court Competition - 2007/2008

Memorandum for the applicant
Memorandum for the defendant

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Il presente lavoro nasce dalla partecipazione dell’Università Luiss Guido Carli alla *European and International Tax Moot Court Competition* organizzata dalla *European Tax College Foundation* di Lovanio.

Si tratta di una competizione che simula un processo, in cui le delegazioni di alcune università europee ed americane si affrontano su uno specifico tema di diritto tributario internazionale e/o comunitario. Simulando un’udienza dinanzi all’autorità giudiziaria di un ipotetico Stato, le differenti squadre hanno proceduto, in questa edizione, alla redazione di un ricorso in cui sono state trattate, principalmente, le tematiche concernenti a) i caratteri identificativi della nozione di stabile organizzazione, con particolare riferimento ai profili di durata dell’installazione; b) la soggettività di un ente trasparente a fini convenzionali; c) l’attribuzione di profitti e di costi ad una stabile organizzazione, con particolare riferimento alla qualificazione dei relativi redditi.

I paragrafi da 1 a 5 del *Memorandum for the applicant* e i paragrafi da 1 a 5 del *Memorandum for the defendant* sono stati redatti dal sig. Mario Bendoni.
I paragrafi da 6 a 12 del *Memorandum for the applicant* sono stati redatti dal sig. Andrea Melchiorri.
I paragrafi da 13 a 16 del *Memorandum for the applicant* sono stati redatti dal sig. Fabio Massimo Silvetti.
I paragrafi da 6 a 13 del *Memorandum for the defendant* sono stati redatti dalla sig.na Giulia Ceccarani.
I paragrafi da 14 a 19 del *Memorandum for the defendant* sono stati redatti dal sig. Roberto Formisani.
I lavori sono stati diretti dal Prof. Giuseppe Melis e dal Dott. Eugenio Ruggiero quali *team coach* della delegazione LUISS.

La delegazione italiana, al termine della fase orale, ha conseguito il premio per il “*Best oral team on behalf of the applicant*”. 
## TABLE OF CONTENTS

I. LIST OF SOURCES .................................................................................................................. 6  
II. STATEMENT OF FACTS ........................................................................................................ 11  
III. ISSUES .................................................................................................................................... 13  
IV. ARGUMENTS .......................................................................................................................... 16  
1. GENERAL REMARKS ON METHOD ...................................................................................... 16  
2. NOTION OF PE ........................................................................................................................ 17  
3. VP’S PRESENCE AND ART. 5(3) CMTT ............................................................................ 18  
4. VP’S PRESENCE AND GENERAL DEFINITION OF PE ..................................................... 19  
5. BELONGING OF THE HYPOTHETICAL PE ........................................................................... 20  
6. ATTRIBUTION OF PROFITS TO THE PE .............................................................................. 22  
7. THE SEPARATE ENTITY APPROACH AND THE NOTIONAL LEASING CONTRACT ....... 22  
8. ARM’S LENGTH PRINCIPLE AND THE DETERMINATION OF THE RENTAL CHARGES ................................................................................................................................. 24  
9. INCURRED EXPENSES UNDER ART. 7(3) ............................................................................ 25  
10. THE REVISED COMMENTARY TO ART 7(3) ..................................................................... 27  
11. MP TAX RETURN .................................................................................................................. 28  
12. AN APPLICATION OF THE SEPARATE ENTITY APPROACH ......................................... 29  
13. JURIDICAL PROBLEMS WITH PROFIT DISTRIBUTION AND STATEMENT OF PURPOSES ................................................................................................................................. 29  
14. LOGICAL INCOMPATIBILITIES BETWEEN POSITIONS OF THE PE AND QUALIFICATION AS ROYALTY ............................................................................................................. 31  
15. PRACTICAL UNSUITABILITY OF ART. 12 (2) CMTT ......................................................... 32  
16. CHARACTERIZATION AS ROYALTY AND ITS INCONVENIENCY ................................... 34  
V. LIST OF ABBREVIATIONS .................................................................................................... 38
# MEMORANDUM FOR THE DEFENDANT

## TABLE OF CONTENTS

I. LIST OF SOURCES .................................................................................................................. 40

II. STATEMENT OF FACTS .......................................................................................................... 44

III. ISSUES .................................................................................................................................... 46

IV. ARGUMENTS .......................................................................................................................... 49

1. GENERAL REMARKS ON METHOD ..................................................................................... 49

2. NOTION OF PE ......................................................................................................................... 50

3. ACCORDING TO ART. 5(3), A PE EXISTS ........................................................................... 51

4. ACCORDING TO THE GENERAL DEFINITION, A PE EXISTS ........................................... 52

5. BELONGING OF THE PE TO VP ............................................................................................ 53

6. INADMISSIBILITY OF THE APPLICANT REQUEST .............................................................. 55

7. THE IMPOSSIBILITY TO DEDUCT THE “NOTIONAL RENT” .................................................. 56

8. THE DEALINGS BETWEEN THE PE AND VP ...................................................................... 57


10. THE AMOUNT OF MONEY ASKED FOR THE RENT IS NOT APPROPRIATE ..................... 58


12. THE ECONOMIC SIGNIFICANCE OF THE “ECONOMIC OWNERSHIP” ................................ 60

13. CONCLUSIONS ON PROFITS ATTRIBUTION ..................................................................... 61

14. THE ROYALTIES TOPIC: THE TAX ADMINISTRATION OPINION ..................................... 61

15. APPLICABLE TAX REGIME ................................................................................................. 62

16. THE INCOME QUALIFICATION ............................................................................................. 63

17. BENEFICIAL OWNERSHIP ................................................................................................... 65

18. CLAIMANCE OF THE TAX CREDIT ....................................................................................... 66

19. CONCLUSIONS ....................................................................................................................... 67

V. LIST OF ABBREVIATIONS ..................................................................................................... 68
European Tax Moot Court Competition 2007/2008

MEMORANDUM FOR THE APPLICANT

Registration number: G/001
I. LIST OF SOURCES

Scholars


AVERY JONES J. F., The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model, in Dir. Prat. Trib., 1984, p. 1630;


CARIDI A., *Proposed Changes to the OECD Commentary on Article 5: Part. II - The Construction PE Notion, the Negative List and the Agency PE Notion*, in *European taxation*, 2003, p. 38;


RUSSO R. – PEDRAZZINI E., *The only way is the way through: Taxation of Partnerships in Italy*, in *European Taxation*, 2005, p. 142;


**Jurisprudence**

Federal Court of Appeal of Canada, *Dudney v. The Queen*, 99 DTC 147 (T.C.C.), 2000 DTC 6169 (F.C.A.);


**OECD Documents**

*Report on the Attribution of Profits to Permanent Establishments*, Paris, 2006;

*Commentary on Model Tax Convention with respect to taxes on income and on capital*, Paris, 2005;

*The Application of the OECD Model Tax Convention to Partnerships*, Paris, 1999;


Treaties

Model Convention with respect to Taxes on Income and Capital, Paris, 2005;

II. STATEMENT OF FACTS

Mud Pressure (MP) and People Power (PP) are two companies that provide services for the construction industry. MP is the owner of an unique construction machine, called RockMelterBelter, and PP provides the employees servicing the machine. In order to provide the RockMelterBelter service, MP and PP have formed a Venture Partnership (VP) in State M. The profits of VP are evenly split between MP and PP. MP and PP are both 100% subsidiaries of a holding company called Mud Pressure People (MPP), and are both resident in State M.

VP was called in by Careless Construction Ltd (CC), a company that was in the process of building a couple of skyscrapers on some reclaimed mudflats in State C. PP sent two employees to the site. They assessed the situation and decided that it was possible to use the RockMelterBelter to shore up the building. The initial contract between CC and the VP covered only the initial and urgent remedial work, which took three months. When that work was finished, however, CC engaged VP to continue working on both skyscrapers. It was expected that this second phase would take ten months, but it progressed more smoothly than expected and was completed within eight months.

The tax inspector of State C has sent an *ex officio* assessment to VP concerning the year 2006 and 2007, taxing the profits of VP in C as business profits of a permanent establishment. In his assessment, he has allowed the deduction of a small amount of depreciation in the computation of VP profits.

VP protests against the tax claim on the basis of several arguments before the national supreme tax court of state C: (1) there was no permanent establishment in State C, (2) if there was a permanent establishment it was only MP, and not PP, that had a permanent establishment, (3) the machine itself was not a permanent establishment and at best the compensation for the use of the machine was a royalty, and (4) the income from renting equipment should in any event be characterized as rental income and taxed accordingly.

VP furthermore argues that, if there is a permanent establishment, it should be able to deduct a notional rent of € 5,000 per week, the amount of the “unmanned standby charge”. The State C tax
inspector disputes the deduction of the notional rent and argues that, if a deduction for notional rent was the proper method of accounting for the RockMelterBelter machine, VP would have withheld tax of 10% on that amount, as these payments fall within the definition of royalties under the C-M treaty.
The present case involves many juridical questions and topics that can be summarised as follows:

1. **NOTION OF PE**
   1.1. Purpose of the notion
   1.2. Structure of art. 5 OECD-MC
      1.2.1. General definition
      1.2.2. Construction PE
      1.2.3. Agency PE
   1.3. Application of art. 5(3) to the case: a PE exists if a building site lasts more than 12 months
   1.4. In case conditions provided by art. 5(3) are not met, relevance of the general definition

2. **VP’S PRESENCE AND ART. 5(3) CMTT**
   2.1. Determination of the lasting of VP’s presence in state C
      2.1.1. Since the beginning of the work until the conclusion
      2.1.2. Unity, even if several contracts
      2.1.3. Preeminence to effectiveness
   2.2. According to art. 5 (3), a PE does not exist

3. **VP’S PRESENCE AND GENERAL DEFINITION OF PE**
   3.1. PE as fixed place of business through which business is carried on
   3.2. Notion of power of disposition
   3.3. In this case, the foreign partnership has not a place at its disposal: a PE does not exist

4. **BELONGING OF THE HYPOTHETICAL PE**
   4.1. Tax treatment of partnerships under national regulations
      4.1.1. Partnership as taxable entity
      4.1.2. Fiscally transparent partnership
   4.2. Partnership is not defined in CMTT
   4.3. In case of lack of definition, art. 3(2) applies
4.3.1. Reference to domestic regulations
4.3.2. In imposing taxation, the source state has to consider the residence state regulation
4.4. In this case, partnerships are to be considered as fiscally transparent
4.5. VP cannot be the entity which the PE belongs to
4.6. Belonging of the hypothetical PE to MP

5. ATTRIBUTION OF PROFITS TO THE PE
   5.1. Applicant requests
   5.2. Juridical problems at issue

6. THE SEPARATE ENTITY APPROACH
   6.1. Notion and effects
   6.2. Construction of a separate entity: reasons for concluding a leasing contract

7. TESTING THE AMOUNT OF THE RENTAL CHARGES
   7.1. Problems in the application of the arm’s length principle
       7.1.1. No need of adjustment
       7.1.2. A possible analogy: the unmanned standby

8. INCURRED EXPENSES UNDER ART. 7(3)
   8.1. Art. 7(3) as a mandatory rule
   8.2. The inconsistency of State C domestic discipline with the separate entity approach
       8.2.1. Looking for the contracting states intentions
       8.2.2. Internal dealings as incurred expenses under the separate expenses approach

9. A BRIEF ANALYSIS OF THE REVISED COMMENTARY OF ART. 7

10. THE MP TAX RETURN
    10.1. Applying the separate entity approach only to the PE
    10.2. Substance over form in the OECD Commentary
11. LOGICAL INCOMPATIBILITIES BETWEEN POSITION OF THE PE AND QUALIFICATION AS ROYALTY

11.1. Whatever the position of the PE, there is no room for qualification as royalty
   11.1.1. If there is no PE, business income is only taxed in the Residence State
   11.1.2. If there is a PE, and it belongs to VP, OECD recommended separate entity approach discourages such independent royalty qualification
   11.1.3. If there is a PE, and it belongs to MP, the PE can not pay royalty to it is head office

12. PRACTICAL UNSUITABILITY OF ART. 12 (2) C-M Double Tax Convention

12.1. This article, when logically applicable, would not profitably apply to this case
   12.1.1. Evolution of royalty definition put forward within the OECD as an invitation to sharpen the scope of such income
   12.1.2. The States’ need for flexibility in Tax Treaty negotiation –legal certainty and uniformity for taxpayers
   12.1.3. Business judgement rule from corporation law

13. INCONVENIENCY OF CHARACTERIZATION AS ROYALTY

13.1. Unfair juridical double taxation in case royalty qualification prevails
   13.1.1. The Application of the OECD Model Tax Convention to Partnerships issued by the OECD in 1999 offers guidance: Tax Treaty benefits is linked to liability to tax, and this last one to residence
   13.1.2. Per-country limitation and timing difference between assessment of profits in State M and royalty withheld in State C
   13.1.3. Preventive and practical relief from double taxation for taxpayers as object and purpose of a Tax Treaty
1. GENERAL REMARKS ON METHOD

1 The purpose of the present work is to demonstrate that the Tax Administration \(^1\) of State C, in taxing profits of Venture Partnership \(^2\) in State C as business profits generated by a permanent establishment \(^3\), breaches the C-M Tax Treaty \(^4\). It is necessary to stress, from the outset, that a PE does not exist and that, anyway, if a PE is regarded as existing, definitely it does not belong to VP.

2 In order to prove that a PE does not exist, we will first analyse the juridical context which the activity of VP falls under. Reference is to be made to art. 5 CMTT, which provides both for a general definition of PE and a specific definition of PE concerned with construction activities. Neither according to the specific definition, nor according to the general one, a PE exists.

3 Then, in order to prove that the PE, if considered as existing, does not belong to VP, we will start by analysing the notion of partnership and its tax treatment under the national laws. As a matter of fact, the term partnership is not expressly defined in CMTT and, in case of lack of definition, art. 3(2) CMTT provides that residence state regulation has to be considered and therefore, because of its fiscal transparency, VP cannot be considered as the entity which the PE depends on.

4 Eventually, as for concerns the sources of our arguments and conclusions, it should be stressed that, since CMTT follows the current OECD Model Tax Convention on income and on capital \(^5\), a primary role is played by the OECD Commentaries on the Articles of the Model Tax Convention \(^6\).

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\(^1\) Hereinafter: TA.
\(^2\) Hereinafter: VP.
\(^3\) Hereinafter: PE.
\(^4\) Hereinafter: CMTT.
\(^5\) Hereinafter: OECD-MC.
\(^6\) Hereinafter: OECD-Commentary.
2. NOTION OF PE

5 The notion of PE is used in tax treaties in order to allow the source state to impose taxation on activities carried on its territory by a non resident company when its presence is of such a nature that it cannot be considered temporary and the attachment to the territory is strong enough to take advantage of infrastructures, public utilities and market regulations of that State.

6 A PE is not a separate legal entity from its head office. It is, instead, the enterprise itself that rises in the source State to such a permanence and complexity to legitimate its taxing rights on the profits made there.

7 In assessing the existence of a PE, reference has to be made to art. 5 OECD-MC, which enables the interpret to assess whether an enterprise is carrying on a business in a foreign State with such a degree of permanence to legitimate taxation rights there, according to the existing Tax Treaty.

8 Art. 5(1) provides for a general definition of PE, that is a fixed place through which the business of an enterprise is wholly or partly carried on.

9 Art. 5(2) sets forth a non exhaustive list of examples which prima facie can be considered as constituting a PE. According to paragraph 3, which provides a specific rule for a building site, a PE is regarded as existing only if the site lasts more than 12 months.

10 Art. 5(5) and art. 5(6) deal with the conditions for an agent (acting on behalf of an enterprise or independent) to constitute a PE of an enterprise.

11 Coming up to the case, the activity carried on by VP in state C, i.e. the shoring of two skyscrapers by the use of RockMelterBelter machine, is covered by the provision of art. 5(3) OECD-MC, according to which building sites and construction or installation projects are considered as PE only if they last more than twelve months. According to the OECD-Commentary, the term building site or installation project covers also renovation of buildings.

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7 Hereinafter: HO.
8 Hereinafter: RMB.
9 Par. 16 OECD-Commentary on art. 5 (3) OECD-MC.
10 Par. 17 OECD-Commentary on art. 5 (3) OECD-MC; H. PIJL, The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with Special Reference to Dutch Case Law, in Bulletin, 2002, pag. 558; A. CARIDI, Proposed Changes to the OECD Commentary on Article 5: Part. II - The Construction PE Notion, the Negative List and the Agency PE Notion, in European taxation, 2003, pag. 38.
The OECD-Commentary also clarifies that even if the project involves a building site which does not last more than 12 months, it can be considered as a PE if the general conditions laid down by the article are met 11.

In this juridical context, we will now analyze the absence of a PE in the present case firstly with regard to the 12-months rule of art. 5(3) CMTT and, then, according to the general definition of art. 5(1) CMTT.

3. VP’S PRESENCE AND ART. 5(3) CMTT

In order to assess if the conditions of art. 5(3) are met, it is necessary to determine the lasting of the non-resident partnership’s presence in the source state.

Firstly, a site is considered as existing from the date on which the contractor begins his work 12 and it continues to exist until the work is completed or permanently abandoned 13.

Secondly, according to OECD-Commentary, a building site is to be regarded as a single unit even if it is based on several contracts 14. Furthermore, if the contract is concluded by a partnership, the period of time spent by the two partners on site should be aggregated at the partnership level 15.

Thirdly, in determining the exact lasting of a building site, preminence has to be given to the effective presence of the entity, regardless of initial expectations.

Notions as the carrying on of business through a fixed place or the lasting of building sites are clearly pervaded by the preminence of effectiveness over fiction. Moreover, the whole treaty provides for taxation rules which stress the role of effectiveness and substance over fiction and form 16.

When concluding with the juridical context, also the OECD-Commentary calls for an interpretation of treaty provisions based on a factual approach 17.

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11 Par. 17 OECD-Commentary on art. 5(3) OECD-MC.
12 Par. 19 OECD-Commentary on art. 5(3) OECD-MC.
14 Par. 18 OECD-Commentary on art. 5(3) OECD-MC.
16 For instance, criterion of permanent home availability (art. 4) or the effective management (art. 4(3)).
17 Par. 6.3 OECD-Commentary on art. 5(1) OECD-MC.
In the present case, attention must be drawn on the effective duration of the activities carried on in State C. VP was called in by Careless Construction Ltd \(^{18}\) in order to shore up two skyscrapers located in state C. The VP-CC project was made up of two different contracts. The performance of the first contract took three months, while the performance of the second contract, which immediately followed the first one, actually took eight months, instead of ten expected. As we are facing with an eleven months activity which does not meet the twelve months requirement stated in art. 5(3) CMTT, RMB does not constitute a PE.

### 4. VP’S PRESENCE AND GENERAL DEFINITION OF PE

Nevertheless, according to the OECD-Commentary, even if the project involves a building site which does not last more than 12 months, it can be considered as a PE if the conditions of the article are met \(^{19}\). Also under this different perspective it is not possible to consider the machine as a PE.

According to art. 5 OECD-MC, a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. The OECD-Commentary explicitly states that the mere fact that an enterprise has at its disposal a certain amount of space which is used for its activity is enough to constitute a place of business. “At its disposal” means that the enterprise has a power of disposition and use of that space. For example, a salesman who regularly visits its customer to take orders and to meet the purchasing director in his office to do so, has not that space at its disposal \(^{20}\).

As for concerns the notion of power of disposition, it is important also to consider the implementing practice followed in some OECD Member States. For instance in a Belgian decision \(^{21}\), an Italian engineering corporation was held not to have a permanent establishment in Belgium merely because it had non-exclusive and limited access to space at the Belgian construction site for the performance of those services. Moreover, a decision of the Canadian

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\(^{18}\) Hereinafter: CC.

\(^{19}\) Par. 17 OECD-Commentary on art. 5(3) OECD-MC.

\(^{20}\) Par. 4.2 OECD-Commentary on art. 5(1) OECD-MC.

Federal Court of Appeal 22 followed the same reasoning in rejecting that an enterprise may have a place of business that is nothing more than a space placed at its disposal, even within the premises of another enterprise.

Hence, in analysing the case, we realize that the company providing the service has not a place at its own disposal: the machine is kept on CC’s site and, although a place of business may exist also in the premises of another enterprise, it is necessary a power of disposition. VP has no power of disposition of the place which the equipment is on.

To sum up, regardless of the provision applying, a PE cannot be considered as existing in State C.

5. BELONGING OF THE HYPOTHETICAL PE

Anyway, in case a PE is regarded as existing, it does not belong to VP and so an attribution of PE profits to VP is in contrast with law applying in this case. Before taking such a conclusion, it is necessary to briefly consider how taxation can be imposed in national regulations on profits generated by a partnership and what the legal context provides for.

From a civil law perspective, a partnership can be considered or not as a legal entity. From a tax law perspective, some states impose taxation on partnership as a separate taxable entity, some regard only the partners as taxable persons23.

As for concerns this case, on the one hand State M considers the partnership as having legal personality but regards the partners as jointly and severally liable for partnership’s debts, hence they are the only taxable persons and the partnership is fiscally transparent. On the other hand, State C regards partnerships as separate taxable entities.

In taxing profits generated by partnerships transnationally active, it is necessary to refer to Tax Treaty Provisions. Unfortunately, OECD-MC and consequently CMTT does not provide for a definition of partnership. In case of lack of definition, art. 3(2) OECD-MC provides that

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23 Par. 19 Partnerships-Report.
the undefined term has to be interpreted according to the law of the state applying the tax treaty, unless the context provide for a different meaning 24.

According to the main understanding of art. 3(2), the state applying the treaty is the source state; however, in applying tax treaty provisions, the source state has to consider as part of the context the domestic law of the residence state of the person claiming for the tax benefits. Hence, for instance, if the residence state considers only the partners as taxable units and the partnership as fiscally transparent and on the other hand the source state considers the partnership as autonomous taxable entity, the source state has to consider the way in which an item of income is treated in the jurisdiction of the person claiming the benefits although partnerships are taxed in a different way. This happens in order to avoid double taxation which is the main aim of tax treaty 25: if an interpretation based on domestic law leaded to cases where the income taxed in the hands of residents of one State could not get the benefits of the convention, this result would be contrary to the object and purpose of the convention and the context of the Convention would require a different interpretation 26.

Furthermore, according to OECD-MC, the convention shall apply to persons which are resident of the Contracting States. As for the notion of residence, the OECD-MC creates a link between such concept and tax liability 27, hence if the partnership is not considered as taxable person in the domestic jurisdiction, the tax treaty does not apply to partnership and only the partners are entitled to claim the benefits deriving from the tax treaty concluded by the state of their residence and the source state 28.

After examining the juridical context, the facts can be simply analysed: State C has to apply the treaty by considering the partnership as fiscally transparent entity. Hence, the PE, if existing, cannot belong to VP and an attribution of profits to VP is not possible. Furthermore, the PE cannot belong to VP also because the partnership is not liable to tax for tax treaty purposes, therefore it is not a resident person. Accordingly, CMTT shall not apply to VP 29.

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25 R. RUSSO - E. PEDRAZZINI, The only way is the way through: Taxation of Partnerships in Italy, in European Taxation, 2005, pag. 142.
26 Par. 62 Partnerships-Report.
27 Art. 4 (1) OECD-MC; par. 40 Partnerships-Report.
28 Par. 43 Partnerships-Report.
29 Par. 42 Partnerships-Report.
Since a PE, if existing, does not depend on VP, it is necessary to determine which company the PE belongs to. People Power\textsuperscript{30} cannot be considered as having a PE in state C, since PP employees are exclusively involved in the operation of RMB and art. 5(5) CMTT expressly states that only persons having the authority to conclude contracts, on behalf of the enterprise, can lead to a PE of such enterprise\textsuperscript{31}. Mud Pressure\textsuperscript{32}, the owner of RMB, which is kept on site all along the performance of the project, will be regarded as having a PE in state C, in case conditions provided by art. 5 CMTT are considered to be met.

6. ATTRIBUTION OF PROFITS TO THE PE

If a PE is considered to be existing, the further question regards the determination of the PE’s profits. Depending on the actual facts and the CMTT, a notional leasing contract is identifiable between MP and its PE concerning the use of the RMB. On this basis MP should be able to deduct a notional rent of 5,000€ per week, except for the first three months of the initial contract where a small amount, reflecting the danger of the situation and the emergency nature of the job, should be added.

This reconstruction raises several juridical questions to analyze: the allocation of the PE taxable income in State C; the consequences on this allocation of the internal dealings concluded between the PE and its HO; the determination of the type of contract stipulated; the deductibility of the relative expenses.

7. THE SEPARATE ENTITY APPROACH AND THE NOTIONAL LEASING CONTRACT

Concerning the determination of the PE taxable income, according to Art. 7(1) of the CMTT, State C is allowed to tax the “profits of the enterprise […] but only so much of them as is attributable to that PE”. The following paragraph 2 defines attributable profits as “profits which [the PE] might be expected to make if it were a distinct and separate enterprise […]

\textsuperscript{30} Hereinafter: PP.

\textsuperscript{31} Par. 32 OECD-Commentary on art. 5(5); H. PIJL, The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with Special Reference to Dutch Case Law, quot., pag. 560; A. DEITMER, I. DORR, A. RUST, Invitational Seminar on Tax Treaty Rules Applicable to Permanent Establishments – in Memoriam of Prof. Dr. Berndt Runge, in Bulletin, 2004, pag. 185.

\textsuperscript{32} Hereinafter: MP.
dealing wholly independently with the enterprise of which it is a PE”. Consequently the core purpose of the first two paragraphs of Art. 7, related with the taxation rights of the source State on business profits produced by a non-resident entity, is to consider the PE as a fictional entity, completely separate and autonomous from its HO. This fictitious new enterprise will be the recipient of the income and expenses related to the business activity that has been carried out in the other State. Moreover, the PE, with the strength of its independence, can also conclude internal dealings with its HO. As a consequence, the profits taxable by the PE-State are determined considering the PE as an independent entity dealing at arm’s length with the enterprise of which it is a part 33. This theory, named “functionally separate entity approach”, is broadly accepted and has been elected as the “authorized OECD approach” by par. 9 of the OECD Report on the attribution of profits to permanent establishment of December 2006 34.

The intent of this approach is to pursue non-discrimination, fair competition and to allow internal dealings at arm’s length without necessarily force an international enterprise to incorporate subsidiaries benefiting of an autonomous legal personality. As a result, the PE must be treated as having an autonomous legal personality and relative costs must be taken into account when determining the taxable income amount in State C.

Then, it is clear that the ratio of Art. 7 OECD-MC is not only to provide the right to tax business profits to the PE-State but also, and especially, to provide the limits of such a right. This reading is supported not only by the wording of Art. 7(1), allowing the taxation of the enterprise’s profits “so much of them as is attributable to that permanent establishment”, but also by the Commentary, which explicitly states that Art. 7 provides “limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State” 35. Moreover, another important limit to the PE-State taxation rights is that not all the business revenues derived in that State are taxable, but only net business profits. For these reasons, it is very important to correctly attribute expenses to the PE, so as to avoid over-taxation by the PE-State. In order to achieve this, considering the lack of legal personality of the PE, a particular attention must be focused on actual facts, circumstances and operations undertaken by the PE itself.

33 K. VAN RAAD, Deemed expenses of a permanent establishment under article 7 of the OECD Model, in Intertax, 2000, p. 253-258.
35 Par. 10.1 OECD-Commentary on art. 7 OECD-MC.
Then, in constructing the fictitious separate enterprise that is necessary in order to attribute expenses to the PE, the most reasonable solution would be for the PE to conclude a leasing contract with MP, rather than purchasing the RMB. In the first place, it must be considered that the RMBs are custom-made and that manufacturers never keep a stock: as a result a considerable length of time is necessary to obtain a new RMB. In the case at issue, considering the urgent nature of the job, the PE was not able to wait such a long time. On the other hand, it must also be considered that there is no market where used units can be purchased. From another point of view, it must not be undervalued the fact that the RMB was needed just for a single job of uncertain duration and that after this job the PE has no future use for the RMB itself. Moreover, it must be kept in mind that also the HO is engaged in the same business, so that it would not be willing to transfer its “monopoly” to an independent contractor but it would have several benefits from a leasing contract. Indeed, in order to earn the profits deriving from the contract with the CC, the PE had an absolute need for the RMB owned by the MP; this situation granted to the HO a strong contractual position. From this perspective it seems clear that there is no real distinction, in terms of profits, for the HO to do the job itself or to rent the necessary equipment to an independent company. Last but not least, such a remunerative contract is also a way, for the HO, to recover the large amount of money invested to purchase the machine. An inoperative RMB is a loss both in terms of costs and lost profits 36.

8. ARM’S LENGTH PRINCIPLE AND THE DETERMINATION OF THE RENTAL CHARGES

Particularly on the base of arguments developed above, the amount of the rent, specified in our claim, is consistent with the arm’s length principle as the Commentary requires 37. Art. 9 OECD-MC requires, for the application of the arm’s length adjustment, that the commercial relation “differs from those which would be made between different enterprises”, but this is not the case at issue. Indeed, the market shows that, generally, rental charges are rather high because these machines are so specialized that they are usually in operation for just two or

36 K. VAN RAAD, Deemed expenses of a permanent establishment under article 7 of the OECD Model, in Intertax, 2000, p. 253-258.
37 Par. 11 OECD-Commentary on art. 7 OECD-MC.
three months per year. This market feature is true for much smaller machines and, in the case of the RMB, is greatly accentuated because of its specialization. Moreover, as discussed above, the monopoly and the particular contractual strength of MP must not be forgotten. On the other hand, it must be also noted that, in the adverse case, it would not be possible to apply the “comparable uncontrolled pricing method” suggested by the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration 38, seeing that the uniqueness of the RMB excludes the existence of “a comparable uncontrolled transaction in comparable circumstances” 39. Nevertheless, even if not identical, a situation similar to the leasing one concerning the RMB, is the “unmanned standby”. Here the machine is kept inoperative on the construction site and a special fee is charged. It is not a coincidence that this charge is equal to the leasing charge, both charges being determined by market forces. Moreover, an increased price, in the first three months of the initial contract, simply represents the economical translation of the danger of the situation and the emergency nature of the job.

41 Summarizing, not only the profits deriving from the CC project 40 but also the expenses concerning the notional rent charges and the costs from the smaller pieces of equipment rented from a local company should be allocated to the PE. The latter are pacifically deductible under Art 7(3) OECD-MC.

9. INCURRED EXPENSES UNDER ART. 7(3)

42 Having demonstrated the existence of a notional leasing contract and verified the consistency of the relative charges with the market, the next question is the possibility for the PE to deduct the charges itself. State C TA states that, under its own domestic legislation, deductions are allowed only if expenses are effectively “incurred”, where the latter expression is generally agreed, in that State, to exclude the deduction of notional expenses. Applying its national definition of “incurred expenses” to Art. 7(3) CMTT, the TA denies the deduction of the notional rent charges.

38 Hereinafter: OECD-Guidelines.
39 Para 1.4 of the OECD-Guidelines.
40 € 5,000 per day for the RMB service, with an additional € 1,000 per day in the first three months.
Apart from the wording of Art. 7(3), expressly referring to “deductions”, while usually Art. 7 just deals with the attribution of profits, par. 17 OECD-Commentary on art. 7 OECD-MC, expressly states that: “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”. It results clear not only that Art. 7(3) has a mandatory nature (“must be allowed as deduction”) but also that the profits, attributed to the PE according to the separate entity approach, are “determined in accordance with the rule contained in paragraph 3”. Summarizing, Art. 7(3) is to be interpreted as a mandatory rule in the computation of the profits attributable to the PE and consequently prevailing, in force of the lex specialis principle, on State C domestic law.

Then, the question concerns the definition of “incurred expenses”. Such a definition is not included in the list provided by Art. 3(1) CMTT, then, the following paragraph 2 comes at issue, stating that, for “any term not defined”, reference must be made to the domestic law of the State applying the treaty, “unless the context otherwise requires”. This last condition to be fulfilled is further clarified by Par. 12 OECD-Commentary on art. 7 OECD-MC, stating that the “context” is “determined in particular by the intention of the Contracting States when signing the Convention […]”.

State C domestic law is not applicable because incompatible with the context (rectius, with “the intention of the Contracting States when signing the Convention”). Indeed, the Contracting States’ intention contrasting with that domestic regime, results clear from the Convention itself and especially from the choice of States M and C to include the separate entity approach as the method for business profits taxation. It must not be forgotten that the core of this approach is to consider the PE as “a distinct and separate enterprise [...] dealing wholly independently with the enterprise of which it is a PE” 41. As already explained above in par. 37 this is not a mere fiction but a substantial tax policy choice, that would be seriously infringed if the expenses deriving from internal dealings were not considered to be incurred. The increasing relevance of this approach has raised this taxation method up to the rank of a fundamental principle, as also shown by the evolution of the discipline in this field. Here, it is

41 Art. 7(2) OECD-MC.
enough to underline the high consensus that the recent Profits-Report elected it as the “authorized OECD approach”.

There is no doubt that between two distinct and separate enterprises the charges of this rent would be pacifically deemed to be incurred expenses and deducted accordingly. The main mistake is in undervaluing the separate approach fundamental principle and to consider the rent as a mere notional transaction. If between distinct and separate enterprises the rent charges are incurred then also under the separate entity approach they must be considered to be the same. The interpretation of this approach as a “substantial fiction”, configuring, for any tax purpose, two distinct and separate enterprises, seems also to be supported by the Profits-Report when expressly states that “where a PE is treated as the lessee of a tangible asset, it will typically be entitled to deductions in the nature of rent” 42. Indeed, even not considering the risk of taxation on gross income that could derive from the prevalence of State C domestic law, it would be denied deductions for a transaction that under the separate entity approach is not merely notional, but substantially incurred.

For these reasons, according to Art. 3(2), State C domestic definition of “incurred expenses” cannot be applicable and is in contrast with the definition emerging from the Convention. Consequently the notional rent charges must be deductible under Art. 7(3).

10. THE REVISED COMMENTARY TO ART 7(3)

On April 2007 the OECD Committee on Fiscal Affairs 43 released the discussion draft on a Revised Commentary on Art 7 of the OECD Model tax Convention 44, substantially accepting the principles expressed in the Profits-Report. Par. 26 of OECD-RC affirms that Art. 7(3) “does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law”. This interpretation, at least applied to the actual version of the OECD-MC, seems to be, not only contrary to the wording of Art. 7(3), but even quite unreasonable. Indeed, par. 26 would empty Art. 7(3) of any practical effect, configuring the entire Art. 7 as a system for the allocation of the expenses

42 Profits-Report, pag. 33, par. 104.
43 Hereinafter: CFA.
44 Hereinafter: OECD-RC.
to the PE, which, in the end, does not impose any limit to the taxation rights of the PE-State.

45 The interpretation process is supposed to give meaning to provisions and not to leave them meaningless. It must not be forgotten that the limit established by Art. 7(2) is the net amount of profits attributable to the PE, so Art. 7(3) must be interpreted as requiring the deduction of the expenses attributable to the PE as a result of the “functional separate entity approach”. Considering the application of Art. 7(3) only from the attribution standpoint, consequently excluding the deduction one, means fixing that the only limitation the PE-State taxation rights would suffer from this article regards the amount of the gross revenue attributable to the PE.

11. MP TAX RETURN

49 To conclude, the argument of the TA pointing out that the notional rent is absent in the tax return filed by MP in State M, is not decisive. In fact, symmetrical accounts are not so necessary when the residence State taxes enterprises on a worldwide basis 46, as State M does. Indeed, the starting point is an analysis of the functions and the interactions between Artt. 7 and 23 of the CMTT, that has brought scholars to limit the application of the fiction under Art. 7 only to the PE and not also to the HO.

50 First of all, the effects of the application of Art. 7 must be analyzed in the source State. Here, Art. 7 is aimed at determining when the State can levy taxes on an enterprise carried on by a resident of the other contracting State and then to circumscribe the limits of this taxation right.

51 Secondly, the same analysis has to be conducted from the residence State standpoint. Here, the main objective is to keep the taxpayer safe from double taxation and, limitedly to this purpose, there is an interest in the determination of the profits attributable to the PE, while, on the other hand, the fiction is useless to determine the total taxable income of the enterprise carried on by one of its resident.

52 Indeed, it must be considered that, in force of Art. 23 of the CMTT, State M is obliged to grant tax relief, when one of its residents, “in accordance with the provisions of this Convention, may be taxed in the other Contracting State”, so that it is necessary for the


residence-State to apply the fiction of the “separate entity approach” to determine the credit amount. As principle, if the whole necessarily contains all its parts and there is no need of separate accounts, the part is not the whole so that it needs separate accounts. The most striking consequence of the application of the fiction under Art. 7 only to the PE and not only to the HO is that “when e.g. an asset is temporarily transferred from the head office to its PE and, in an arm’s length situation, the transfer would be characterized as rent, the PE should be allowed to deduct notional rental payments but, in this author’s view, no corresponding profits should be attributed to the head office”.

A wider attention to facts and circumstances prevailing over form can be also detected in par. 14 OECD-Commentary on art. 7 OECD-MC, affirming that the accounts of the PE should be the base for attributing profits to the latter but only “insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed […] and for this purpose the figures to be used will be those prevailing in the open market”.

12. AN APPLICATION OF THE SEPARATE ENTITY APPROACH

Drawing the conclusions of this complex reasoning, we can state the existence of a notional leasing contract between MP and its PE whose terms are perfectly consistent with the market. According to the real facts and circumstances, such a contract has not a deceptive purpose as the TA claims. On the other hand, the related charges must be considered incurred under Art. 7(3) OECD-MC and deducted. Otherwise, there would be a State C over-taxation.

13. JURIDICAL PROBLEMS WITH PROFIT DISTRIBUTION AND STATEMENT OF PURPOSES

47 To better understand this mechanism, an interesting example has been exposed by Prof. Kees van Raad during a lecture given at Leiden University in October 2001 on which see R. RUSSO, Tax Treatment of “Dealings” Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty, in Bulletin for international taxation, 2004, p. 472.

We have dealt with the absence of the PE in State C and argued its belonging, should it exist, to MP rather than to VP. Afterwards, we have shown that profits earned in State C should be firstly qualified as business profits and then attributed to the PE, following the “functionally separate entity approach”. We have then suggested a proper method, in line with OECD recommended approach, to take account of use of RMB in profit computation.

We must now consider whether or not any part of the profit distribution can be characterized as royalty. If we meant as “profit distribution” those payments made by VP to MP and PP under a formal resolution of these last two in relation to their shares in VP, such distribution would seem to fall entirely under State M domestic tax and business law.

We believe instead that the only “profit distribution” that can in theory be characterized as royalty is the notional rent paid with respect to the disposal of RMB. Such characterization appears however logically precluded, whatever the position of the PE, as follows:

- if there is no PE, the business profits earned in State C are taxable only in State M; no resort can be made to different income qualifications, as a PE is a criterion to localize only, and not to qualify, an income;

- if there is a PE and if it belongs to VP, OECD recommended functionally separate entity approach compels to consider the notional rent within the business profits to be attributed to a PE; this fiction has a genuine goal to ensure transparent dealings and fair taxation of foreign enterprises, but it is anyway a fiction, and it can not go so far as to pretend that a real payment is made;

- if there is a PE and if it belongs to MP, such PE would lack the legal personality to pay a royalty to its head office.

We secondly believe that, should this qualification be logical, it would not be applicable in practice to this case, due to the evolution reached within OECD in relation to interactions between royalties and business profits and to the preference for the business judgement rule, if no compelling interest otherwise requires.

We thirdly and finally hold that such illogical and inapplicable qualification would also be inconvenient and leading to over-taxation, in light of attribution and fruition in practice of CMTT benefits in State M.

We will deal separately and in detail with every single argument pointed out.
14. LOGICAL INCOMPATIBILITIES BETWEEN POSITIONS OF THE PE AND QUALIFICATION AS ROYALTY

Let us analyse each hypothesis one by one, with respect to this first and logical step.

If we firstly assume that there is no PE, business profits earned in State C would be, by definition, taxed only in the residence State. TA implicitly agrees with this qualification, because of its efforts to ascertain that a PE has existed. Once that an activity is regarded as a business one, it can not be differently characterized only because there is not a PE, since it is a criterion to localize only, and not also to qualify profits as business ones. In this case, any activity carried on is not relevant for tax purposes in the source State. It is left to the residence State to investigate how VP has supplied itself with the machine and how to consider it for tax purposes.

Let us in second instance assume that a PE exists, and that it belongs to VP. In this case, VP should be taxed for that part only of its business profits that is earned in State C through its PE. Once again, and a fortiori, such qualification of profits is accepted by TA, since this scenario is the one represented in its claim. Profits should be attributed to the PE according to OECD’s recommended functionally separate entity approach. TA is supposed to use this approach, as it is not only up to State C domestic law to determine how to take account of supply of production factors, because the taxpayer (VP, in relation to its PE) is not resident there and because CMTT applies, as concluded between two OECD members as contracting partners. Irrespective of how legally VP disposes of RMB, the deduction for having at its disposal should take place within business profit ascertainment and not be independently characterized and taxed. Otherwise, the approach would be deprived of its substance and its purpose.

Let us thirdly regard that, if there is a PE, it belongs to MP only. In this case there can be no payment of royalty, nor of passive income in general, because it would mean to have a legal person, MP, paying to itself. It is not acceptable to imagine that MP’s PE pays a royalty to its HO. A PE is conceived in international tax law as a way of being of an enterprise itself, and its presence, once that art. 5 OECD-MC test is passed, is a limit overcome which a foreign enterprise can be taxed for business profits earned in the source State, pursuant to art. 7(1) OECD-MC.
In conclusion, and whatever the position of the PE, the only possible qualification is the business profits one. This statement is fostered both by the kind of activity carried and by the defendant’s *ex officio* assessment itself, taxing business profits of a PE. It would be discriminatory, an infringement of legal certainty and a manipulation to switch to a different characterization in order only to seize even more tax revenue.

15. PRACTICAL UNSUITABILITY OF ART. 12 (2) CMTT

Any qualification as royalty is logically precluded by the nature of the activities in issue, as confirmed by TA’s search for a PE through which they should have been carried on (and taxed in the Source State). This conclusion, however, shall not impede us to examine the royalty definition included in CMTT. Despite its application is logically precluded, as demonstrated above, it however might be interesting to ensure that it would not in any case affect the case in issue. We hold this point because of OECD evolution with respect to royalty definition and because business judgement rule should always be preferred if no compelling interest, e.g. contrast to abuses of Tax Treaties, or to tax-avoidance or to tax-elusion, otherwise requires.

The provision in comment dates back to the early days of OECD and complies to 1963 OECD Draft Double Taxation Convention on Income and Capital. It is an extensive definition of royalty, including “the use of, or the right to use, industrial, commercial, or scientific equipment”.

The Fourth Report of Fiscal Committee of 1961 is the supplementary instrument of interpretation closer in time to that Draft Convention. The Report is unfortunately quite thin in relation to the definition of royalties, and it says nothing decisive on how to interpret the formula “industrial, commercial or scientific equipment”.

The OECD-Commentary in force instead gives a secure guidance to the interpret. It firstly states that changes to the articles of the MC and to the Commentary should be taken in great account when interpreting older provisions. Afterwards, it outlines the story of the provision in question and reveals that reference to “the use of, or the right to use, industrial,
commercial, or scientific equipment” was deleted from art. 12 in 1977, since CFA found more appropriate to qualify these income as business profits.

What we desire to confirm by this brief historical recognition is both the prevalence of business profits qualification over royalty, with respect to “equipments”, and the sound reasons behind this strategic development within the OECD.

An evolutionary process should always, in fact, be greatly taken in account, despite no binding and enforceable law precludes States to sign in treaties with outdated definitions. The OECD recommends its member to comply as far as possible to the MC and to the Commentary, both when entering in new conventions or revising the existing one and when applying them. It will be impossible, in fact, to avoid double taxation and non-taxation and to prevent their harmful effects on trades and markets, especially in a context of global and increasing complexity and competition, if every single member State, or even groups of Member States, separately keeps on stipulating and interpreting in a divergent sense than the one made clear by OECD, especially on crucial points. This is not to ignore nor to deny a self-evident need for flexibility, that is necessary in order to ensure full agreement of Member States. This is to stress and not to forget also the need for uniformity and, above anything else, legal certainty for and non-discrimination of taxpayers, who are the ultimate addressees of any DTC.

Another argument would impede to apply in practice the provision on royalty definition, when logically suitable. In corporation law, business judgement rule denies directors’ liability for damages when a decision, although taken with care and good faith, proves to be detrimental to the corporation. Room is left therefore to management to perform its tasks in a free market economy. The rule also is aimed to select cases in which judiciary intervention is necessary, as judicial body may feel reluctant or unprepared to set up highly complicated

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50 The Committee on Fiscal Affairs is a body made up of senior officials from all OECD Member governments. Its tasks are to formulate and update OECD tax policies, models and commentaries. It also sets the OECD Work programme in the tax area and provides a forum for exchanging views on tax policy and administrative issues. The detailed work of the Committee on Fiscal Affairs is carried out by a number of subsidiary groups of experts in particular areas, drawn from Member governments, and in certain cases, non-member economies. Consultation with representatives of business and trade unions and co-operation with other international and regional tax organisations is becoming more and more frequent in a view to enhance the Committee’s work. Established on 1st May 1971, it continues the duties formerly undertaken by the Fiscal Committee (Source OECD website).

51 Par. 59 of OECD-Commentary on art. 7(7) OECD-MC and par. 9 on art. 12 (2).

52 Par. 34 of Introduction to OECD-Commentary.

53 On what OECD exists for par. 1-3 of the Introduction to the OECD-Commentary.

corporative lawsuits. This rule is probably not be transplanted as such into tax law for many reasons, but primarily because every TA is willing, and legally compelled, to monitor an exact fulfilment of tax obligations and because tax elusion and avoidance can never be justified. Anyway, we hold that this rule raises up issues that should be considered in a tax litigation as well. The core rule is that management and entrepreneurial risk involve choices. TA should refrain from re-qualifying tax implications of such choices if they, as in this case, not only taken according to OECD patterns, but also determined by the uniqueness of the RMB machine highlighted above.

Conclusively, application of art. 12(2) CMTT, even assumed (which is not the case) that royalty characterization would be possible, would be the same undesirable, both because of the evolution within OECD and to freedom that should be left to corporations to organize themselves, provided that no law, and no tax law, is violated. We are therefore convinced that these payments, originating from equipments, at best fall in a “grey area” between royalty and deduction from business profits. Evaluated and taken in due care every argument, this last qualification seems more accurate and prudent.

16. CHARACTERIZATION AS ROYALTY AND ITS INCONVENIENCY

We desire to analyse what consequences would have in practice on the taxpayer in State M a characterization as royalty, should it be logically available and should art. 12(2) CMTT apply to this case a 10% withholding tax on the gross payment. We hold that an unfair juridical double taxation would derive from such characterization, as neither VP nor MP would be credited the tax levied in State C.

Allocation of tax treaty benefits must be considered in this respect. OECD 1999 Report on application of the MC to partnerships offers a guidance for this and must be taken in account. Par. 12 of the report fixes the general rule: “where income is derived by an entity organised under the laws of another jurisdiction...the entity will have to be classified for purposes of the application of the tax laws of the country where the income is derived, regardless of whether

or not that classification is compatible with the civil or commercial law system of the jurisdiction from which the entity derives its legal status”.

76 It also stated, at par. 34, that “if the State in which a partnership has been organized treats the partnership as fiscally transparent, then the partnership is not ‘liable to tax’ in that State within the meaning of Article 4, and so cannot be a resident for the purposes of the Convention”. Resort is then made in par. 34 to par. 3 of OECD-Commentary on art. 1 OECD-MC and so to the entitlement of partners, “with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership’s income is allocated to them for the purposes of taxation in their State of residence”.

77 The Report, at par. 47, states that “where the partnership as such does not qualify as a resident under the principles developed in the preceding section, the Committee agrees that the partners should be entitled to the benefits provided by the Conventions entered into by the countries of which they are residents to the extent that they are liable to tax on their share of the partnership income in those countries”.

78 Finally, and with reference to a scenario that is not dissimilar to the case in dispute, par. 81 concludes that “in any event, if an interpretation based on domestic law would lead to cases where the income taxed in the hands of the residents of one State would not get the benefits of the Convention, a result that would be contrary to the object and purpose of the Convention, the context of the Convention would require a different interpretation”.

79 Once we assume that approach outlined by the Report is correct, tax treaty benefits should in general be granted not to VP, which is transparent for tax purposes in its domestic law, but to MP as, in State M, it is the only person liable to tax. It is clear that residence, for the purposes of the Treaty, is attached to tax liability.

80 The application of this approach alone can not, however, prevent juridical double taxation if the notional rent is qualified as royalty. Hurdles would derive in fact by timing difference between assessment of profits in State M and tax withheld in State C, not to mention per-country limitation to tax credit in State M. Double taxation would continue, therefore, to be the practical consequence under this reconstruction.

81 We believe that CMTT was signed not only in order to avoid double non-taxation and tax avoidance, but also and primarily to prevent in practice double taxation. The final result for the taxpayer should never be the failure in practice to achieve the last mentioned goal. That is
instead what might happen should qualification as royalty prevail and due to per country limitation and timing difference in granting a tax credit in State M.

OECD-Commentary on art. 7(2) OECD-MC suggests at par. 21 that “where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise’s head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or — in the event that it is wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of over-taxation”.

Double taxation is to be prevented, as its prevention is the purpose of any DTC. Characterisation as a royalty would determine instead an unfair taxation. The applicant would have to take steps in State M in order to find a solution once over-taxation has incurred, e.g. by asking State M-TA to enter in a mutual agreement procedure with their counterparts in State C. Notably, it is possible pursuant to art. 25(1) CMTT to start the procedure even before that excessive taxation takes place, if such result is certain due to a given ascertainment and/or qualification. Economy would preferably require not to make resort to heavy and lengthy procedures, if not strictly necessary. Legal certainty besides suggests not to levy a tax, and sanctions, under an uncertain, contested and disputable qualification.

It should be always remembered that a DTC is finally aimed at applying to taxpayers. A contracting State is expected to comply with a signed tax treaty, and not only (and of course) in light of its own interests, but also in a view to encounter legitimate expectations of taxpayers, be they resident or not.

Legal certainty, competition, dealing at arm’s length are great achievements, and all parties concerned to the application of a treaty can benefit from them, especially when interpretation is not limited only to a narrow perspective to seize more and more tax revenue, irrespective of the complex entrepreneurial organization and risk management in which tax phenomena often take place. This complexity, when not an instrument of abuse or avoidance, should never be treated *tamquam non esset*. 
We hold that qualification as royalty, should it be logically suitable and should art. 12(2) apply, would however laid upon MP an unfair and excessive taxation, as MP, in theory entitled to the treaty benefits, would not be able to take advantage of them in this situation, due to a number of hurdles. This final result would be contrary to the object and purpose of CMTT to prevent double taxation, and it should therefore be rejected.
### V. LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CC</td>
<td>Careless Construction Ltd</td>
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<td>CFA</td>
<td>OECD Committee of Fiscal Affairs</td>
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<td>CMTT</td>
<td>C-M Tax Treaty</td>
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<td>i.e.</td>
<td>id est</td>
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<td>HO</td>
<td>Head Office</td>
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<td>MP</td>
<td>Mud Pressure</td>
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<td>OECD-MC</td>
<td>2005 OECD Tax Model Convention</td>
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<td>OECD-Commentary</td>
<td>2005 OECD Commentaries on the Articles of the Model Convention</td>
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<td>OECD-Guidelines</td>
<td>1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration</td>
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<td>OECD-RC</td>
<td>2007 Revised Commentary on Art 7 of the OECD Model tax Convention</td>
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<td>PE</td>
<td>Permanent establishment</td>
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<td>PP</td>
<td>People Power</td>
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<td>RMB</td>
<td>RockMelterBelter Machine</td>
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<td>TA</td>
<td>Tax Administration of State C</td>
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<td>VP</td>
<td>Venture Partnership</td>
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European Tax Moot Court Competition 2007/2008

MEMORANDUM FOR THE DEFENDANT

Registration number: G/001
I. LIST OF SOURCES

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*Model Convention with respect to Taxes on Income and Capital*, Paris, 2005;

Mud Pressure (MP) and People Power (PP) are two companies that provide services for the construction industry. MP is the owner of an unique construction machine, called RockMelterBelter, and PP provides the employees servicing the machine. In order to provide the RockMelterBelter service, MP and PP have formed a Venture Partnership (VP) in State M. The profits of VP are evenly split between MP and PP. MP and PP are both 100% subsidiaries of a holding company called Mud Pressure People (MPP), and are both resident in State M.

VP was called in by Careless Construction Ltd (CC), a company that was in the process of building a couple of skyscrapers on some reclaimed mudflats in State C. PP sent two employees to the site. They assessed the situation and decided that it was possible to use the RockMelterBelter to shore up the building. The initial contract between CC and the VP covered only the initial and urgent remedial work, which took three months. When that work was finished, however, CC engaged VP to continue working on both skyscrapers. It was expected that this second phase would take ten months, but it progressed more smoothly than expected and was completed within eight months.

The tax inspector of State C has sent an *ex officio* assessment to VP concerning the year 2006 and 2007, taxing the profits of VP in C as business profits of a permanent establishment. In his assessment, he has allowed the deduction of a small amount of depreciation in the computation of VP profits.

VP protests against the tax claim on the basis of several arguments before the national supreme tax court of State C: (1) there was no permanent establishment in State C, (2) if there was a permanent establishment it was only MP, and not PP, that had a permanent establishment, (3) the machine itself was not a permanent establishment and at best the compensation for the use of the machine was a royalty, and (4) the income from renting equipment should in any event be characterized as rental income and taxed accordingly.

**II. STATEMENT OF FACTS**
VP furthermore argues that, if there is a permanent establishment, it should be able to deduct a notional rent of €5,000 per week, the amount of the “unmanned standby charge”. The State C tax inspector disputes the deduction of the notional rent and argues that, if a deduction for notional rent was the proper method of accounting for the RockMelterBelter machine, VP would have withheld tax of 10% on that amount, as these payments fall within the definition of royalties under the C-M treaty.
III. ISSUES

1. NOTION OF PE
   1.1. Purpose of the notion
   1.2. Structure of art. 5 OECD-MC
       1.2.1. General definition
       1.2.2. Construction PE
       1.2.3. Agency PE
   1.3. Application of art. 5(3) to the case: a PE exists if a building site lasts more than 12 months
   1.4. In case conditions provided by art. 5(3) are not met, relevance of the general definition

2. ACCORDING TO ART. 5 (3), A PE EXISTS
   2.1. Determination of the lasting of VP’s presence in state C
       2.1.1. Unity, even if several contracts
       2.1.2. Preminence to the initial planning and to the intention of creating a fixed place of business
       2.1.3. 3.2 According to art. 5 (3), a PE does not exist

3. ACCORDING TO THE GENERAL DEFINITION, A PE EXISTS
   3.1.1. 4.1 PE as fixed place of business through which business is carried on
   3.1.2. 4.2 All the conditions laid down by the general definition are met: a PE exists

4. BELONGING OF THE PE TO VP
   4.1. Tax treatment of partnerships under national regulations
       4.1.1. Partnership as taxable entity
       4.1.2. Fiscally transparent partnership
   4.2. Partnership is not defined in CMTT
   4.3. In case of lack of definition, art. 3(2) applies
       4.3.1. Problems of double taxation
       4.3.2. Reference to domestic regulations
4.3.3. In imposing taxation, an exclusive jurisdiction in the qualification of terms not defined is attributed to the source state

4.4. Partnerships are to be considered as autonomous taxable entities

4.5. VP is the entity to which the PE belongs to

5. INADMISSIBILITY OF THE APPLICANT REQUEST
   5.1. Inadmissibility of the applicant request consisting of the request of deduction an hypothetic “notional rent” paid by PE to VP for the use of RMB in computing the profits

6. THE IMPOSSIBILITY TO DEDUCT THE “NOTIONAL RENT”
   6.1. Art. 7(2) and art. 7(3) and “expenses incurred”
   6.2. The Profits-Report about art.7(3): among the expenses attributable to a PE, the domestic state tax legislation determines which of these are deductible

7. THE DEALINGS BETWEEN THE PE AND VP
   7.1. The importance of the dealings between VP and PE and the documentation showing them on attributing profits to the PE

8. THE NATURE OF THE ACTIVITY OF THE PE AND VP
   8.1. The nature of the activities of both VP and PE as service companies, showing the inconsistency of the possibility of the rent thesis

9. THE AMOUNT OF MONEY ASKED FOR THE RENT IS NOT APPROPRIATE
   9.1. The amount of money request as not appropriate

    10.1. The TA thesis: PE as economic owner of RMB.

11. THE ECONOMIC SIGNIFICANCE OF THE “ECONOMIC OWNERSHIP”
    11.1. The economic significance of the “economic ownership”: a possible cost-sharing agreement between PE and VP
12. CONCLUSIONS ON PROFITS ATTRIBUTION
   12.1. Conclusions on profits attribution: in terms of computing the industrial and commercial 
   profits from its PE in state C, VP no “notional expenses” can be deducted, including the 
   ”notional rent”

13. THE ROYALTIES TOPIC: THE TAX ADMINISTRATION OPINION
   13.1. Introduction to the dispute

14. APPLICABLE TAX REGIME
   14.1. Applicability of a withholding tax to the paid consideration - exclusion of any kind of 
   expenses deduction

15. THE INCOME QUALIFICATION
   15.1. Qualification of the income as a royalty (Art.12 OECD 1963 Draft Convention) 
   15.2. Presence of a Permanent Establishment, its function of income localization. No relevance 
   of the Permanent Establishment over the qualification of income

16. BENEFICIAL OWNERSHIP
   16.1. Beneficial ownership of VP’s partners on the profit distribution related to the use of the 
   machinery

17. CLAIMANCE OF THE TAX CREDIT
   17.1. Claimance of the tax credit: Source State has no room for action 
   17.2. Interpretation of the tax treaties: Application of the Art.31(1) Vienna Convention on the 
   Law of the Treaties, the “objectivistc” criterion.

18. CONCLUSIONS
   18.1. Summary on the issue
1. GENERAL REMARKS ON METHOD

1. The purpose of the present paper is to demonstrate that Venture Partnership 56 has a permanent establishment 57 in state C and PE profits must be attributed to VP, since, according to the domestic law of the source state, VP is a legal person and an autonomous taxable entity.

2. In order to demonstrate the existence of a PE, we will first deal with the notion of PE. Then, in order to determine the existence of a PE, we will analyse the relevant legal provision of article 5 C-M Tax Treaty 58, which provides for a general definition of PE applicable to all kinds of activities and, in the third paragraph, for a specific definition concerning building sites. According to both the general and the specific definition, it is possible to regard a PE as existing.

3. In order to determine the entity which the PE depends on, it is important to analyse the tax treatment applying to partnerships. Since the term partnership is not defined in CMTT, pursuant to art. 3(2) CMTT, it has to be interpreted according to the domestic regulation of the source state. Hence, VP has legal personality and is considered as an autonomous unit for tax purposes. PE profits are to be attributed to VP and VP is also the entity which the PE belongs to.

4. After having showed this very first starting point, this paper is going to focus on the total inconsistency of the applicant request concerning its will to deduct the so called “notional rent” in computing the profits of the PE. According to the applicant, in fact, the PE would have paid to the HO itself the just cited “notional rent” for using the “RMB” during its permanence in state C, and for these reasons it feels itself entitled to operate the deduction. The TA of state C, instead, believes that the correct way to focus the dealings between the PE and the head office is to hypothesise that the PE has the economic ownership of the machine during its entire existence. Later in this paper all the reasons which give consistence to this thesis as much as the all its consequences are going to be illustrated and proved in details.

56 Hereinafter: VP.
57 Hereinafter: PE.
58 Hereinafter: CMTT.
5 We are moreover of the opinion that income has to be taxed as a royalty, according to the relevant CMTT provisions. Besides the PE does not change the nature of the income, but makes it taxable in the State of the source. In response to VP’s partners assertions, C is not to be held responsible for any mismatch in tax credit claimance before M’s Tax Authorities.

6 Finally, as for what concerns the interpretation of treaty provisions, since CMTT follows the current OECD Model Tax Convention on income and capital 59, a leading position is held by the OECD Commentaries of the Articles of the Model Tax Convention 60.

2. NOTION OF PE

7 The notion of PE is used in tax treaties in order to allow the source state to impose taxation on activities carried on its territory by a non resident company when its presence is of such a nature that it cannot be considered temporary and the attachment to the territory is strong enough to take advantage of infrastructures, public utilities and market regulations of that State61.

8 A PE is not a separate legal entity from its head office62. It is, instead, the enterprise itself that rises in the source State to such a permanence and complexity to legitimate its taxing rights on the profits made there.

9 In assessing the existence of a PE, reference has to be made to art. 5 OECD-MC, which enables the interpret to verify when an enterprise is carrying on a business in a foreign State with such a degree of permanence to legitimate taxation rights there.

10 Briefly, art. 5(1) provides for a general definition of PE, that is a fixed place through which the business of an enterprise is wholly or partly carried on. Art. 5(2) sets forth a non exhaustive list of examples which prima facie can be considered as constituting a PE63. According to paragraph 3, which provides a specific rule for a building site, a PE is regarded as existing only if the site lasts more than 12 months. The fourth paragraph lists a series of activities which are exceptions to the general rule and which cannot constitute a PE, even if

59 Hereinafter: OECD-MC.
60 Hereinafter: OECD-Commentary.
62 Hereinafter: HO.
63 Par. 12 OECD-Commentary on art. 5(2) OECD-MC.
all the other conditions are met. A PE does not exist in case of auxiliary and preparatory activities.

11 Art. 5(5) and art. 5(6) deal with the conditions for an agent (acting on behalf of an enterprise or independent) to constitute a PE of an enterprise.

12 Coming up to the case, in order to assess the existence of a PE, it is necessary firstly to determine the applicable provisions. The activity carried on by VP in state C, that is the shoring of two skyscrapers by the use of RockMelterBelter machine 64, is covered by the provision of article 5(3) OECD-MC, according to which building sites and construction or installation projects are considered as PE only if they last more than twelve months 65. According to the OECD-Commentary, the term building site or installation project covers also renovation of buildings (involving more than the mere maintenance or redecoration) 66.

13 The OECD-Commentary also clarifies that even if the project involves a building site which does not last more than 12 months, it can be considered as a PE if the general conditions laid down by the article are met 67.

14 In this juridical context, we will now analyze the existence of a PE in the present case firstly with regard to the 12-months rule of art. 5(3) CMTT and, then, according to the general definition of art. 5(1) CMTT.

3. ACCORDING TO ART. 5(3), A PE EXISTS

15 In order to determine whether the conditions laid down by art. 5(3) are met, it is necessary to determine the lasting of the presence of the non-resident partnership in the source state.

16 As for the facts of this case, the VP-Careless Construction Ltd 68 project was made up of two different contracts. The performance of the first contract took three months and the performance of the second contract, which immediately followed the first one, actually took eight months, instead of ten expected.

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64 Hereinafter: RMB.
65 Par.16 OECD-Commentary on art. 5 (3) OECD-MC.
66 Par.17 OECD-Commentary on art. 5 (3) OECD-MC; H. PIJL, The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with Special Reference to Dutch Case Law, in Bulletin, 2002, pag. 558; A.CARIDI, Proposed Changes to the OECD Commentary on Article 5: Part. II - The Construction PE Notion, the Negative List and the Agency PE Notion, in European taxation, 2003, pag. 38.
67 Par. 17 OECD-Commentary on art. 5(3) OECD-MC.
68 Hereinafter: CC.
According to the OECD-Commentary, a building site is to be regarded as a single unit, even if it is based on several contracts; the OECD-Commentary stresses the prominence of the commercial coherence of activities carried out. Well, in determining whether the 12 months requirement has been met, the point is whether the lasting of the presence expected at the outset (13 months) or the effective presence (11 months) is to be considered.

In determining that, we have to remind that the tax treaty notion of PE is provided for allowing the source state to tax activities carried on its territory by a non resident company. Along with the effective presence, preminence should be given to the intention of creating a permanent structure in the source state. In the present case, it is important to underline that, according to the contractual agreements, it was supposed that VP would have been present in state C for 13 months. Contractual Agreements are the only elements available to TA. It does not matter that the effective presence in state C lasted only 11 months, because the incredible capacity of RMB influenced the performance of the contract. Also the OECD-Commentary states that a place of business may constitute a PE if, designed at the outset to be fixed, existed for a short period of time, as a consequence of special circumstances which lead to a premature liquidation.

It should also be added that it is not possible for the Tax Administration to know whether the project actually did not last as long as expected and therefore, in imposing taxation, it has to rely on formal elements, such as the literal wording of VP-CC contracts.

Hence, prominence should be given to the initial setting of activities instead of the effective presence that follows. Therefore, on the basis of the initial projects, which provides for a 13-months activity in state C, the 12-months test laid down by art. 5(3) is passed and a PE may be considered as existing.

4. ACCORDING TO THE GENERAL DEFINITION, A PE EXISTS

Nevertheless, also in the case conditions laid down by art. 5(3) are considered as not satisfied, the same building can be regarded as a PE according to the general definition provided for art. 5 CMTT. Coming to the single elements of this general notion, we can realize that:

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70 Par. 6.3 OECD-Commentary on art. 5(1) OECD-MC.
71 Hereinafter: TA.
a. **Place of business:** RMB can be regarded as an equipment, an installation and, accordingly, as a place of business\(^{73}\). As the OECD-Commentary states, the mere fact that an enterprise has a certain amount of place at its disposal which is used for business activities is sufficient to constitute a place of business\(^{74}\), no formal legal right to use the place of business is required\(^{75}\).

b. **Fixed place:** in general, a certain degree of permanence is required in order to regard an activity carried on through a place of business as a PE and the practices followed by many Member States show a six months term for assessing the existence of a PE. RMB is always kept on site for 11 months\(^{76}\).

c. **Business carried on:** a business should be carried on through this place of business. In this case, VP carries out its business through the ground which RMB is on and through RMB machine itself. It should be stressed that, according to the OECD-Commentary, a PE may exist even if the activity is carried on mainly through automatic equipment, the activity of the personnel being restricted to controlling and maintaining such an equipment\(^{77}\).

22 As before said, art. 5(4) enlists a series of business activities which are exceptions to the general definition provided by paragraph 1 and which do not constitute a PE. This kind of activities have an auxiliary and preparatory nature. In the present case, the activity carried on by VP in state C is not covered by this negative definition\(^{78}\), since it is clearly an essential and significant part of the activity of the partnership as a whole. So, the exception stated in art. 5(4) is not applicable.

23 In conclusion, VP carries on its business in State C through a PE, according to the general definition laid down in article 5 CMTT.

### 5. BELONGING OF THE PE TO VP

\(^{72}\) Par. 16 OECD-Commentary on art. 5(3) OECD-MC.
\(^{73}\) Par. 2 OECD-Commentary on art. 5(1) OECD-MC; par. 10 OECD-Commentary on art. 5 (1) OECD-MC.
\(^{74}\) Par. 4.1 OECD-Commentary on art. 5(1) OECD-MC.
\(^{75}\) J. LUDICKE, Recent Commentary Changes concerning the definition of Permanent Establishment, quot., p. 190.
\(^{76}\) Par. 6 OECD-Commentary on art. 5(1) OECD-MC.
\(^{77}\) Par. 10 OECD-Commentary on art. 5(1) OECD-MC; A.CARIDI, Proposed Changes to the OECD Commentary on Article 5: Part. II - The Construction PE Notion, the Negative List and the Agency PE Notion, quot., pag. 38.
\(^{78}\) Par. 24 OECD-Commentary on art. 5 (4) OECD-MC.
Having determined the existence of a PE, it comes naturally from the facts that the PE belongs to VP. In order to explain such a conclusion, it is necessary first to underline that the term partnership is not expressly defined in CMTT and that, according to art. 3(2) CMTT, in case of lack of definition, reference has to be made to national regulations. Therefore, we will first consider how taxation can be imposed in national regulations on profits generated by a partnership and then analyse the treatment of partnerships at treaty level.

From a civil law perspective, a partnership can be considered or not as a legal entity. From a tax law perspective, some states impose taxation on partnership as a separate taxable entity, some considers only the partners as taxable persons.

As said, the term partnership is not expressly defined in CMTT. In such a case, art. 3(2) states that the term shall, unless the context otherwise requires, have the meaning that it has under the law of the state applying the treaty.

Since this provision calls for a reference to the national regulations of the contracting states, it comes naturally that, in attributing PE profits to a partnership (in this case VP), problems of double taxation may arise because states involved (i.e., State M and C) provide for different regulations concerning partnerships. In this case, for instance, whilst on the one hand the VP residence state does not impose taxation on partnerships and profits are taxed in the hands of partners, on the other hand, according to the source state national law, partnerships are considered as autonomous taxable entity. The result would be an economic double taxation, as the same income would be taxed in the hands of two taxpayers, who could not get tax relief because they are not the same person. Hence, in determining how to impose taxation on profits generated by the PE, it is necessary to determine which national regulation has to be applied in order to avoid double taxation, that is the main aim of CMTT.

The answer comes naturally from the literal meaning of art. 3(2), as reference must be made to the domestic law of the state applying the treaty and the word “application” makes clear that the applying state is the source state. According to art. 3(2), an exclusive jurisdiction in the qualification of terms not defined is attributed to the source state, therefore neither a

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79 See par. 8.
81 R. RUSSO - E. PEDRAZZINI, The only way is the way through: Taxation of Partnerships in Italy, in European Taxation, 2005, pag. 142.
82 Par. 19 Partnerships-Report.
contrast between legislations nor a problem of qualification exists. Accordingly, the term “partnership” has to be interpreted according to the national law of the source state; in this case VP has to be considered as an autonomous taxable entity and, more specifically, the entity which the PE belongs to.

It should be also underlined that the OECD-Commentary, in dealing with problems concerning the application of exemption and credit method, shows the OECD approach to the matter: the residence state has to respect the definition of income provided by source state regulations.

Moreover, also the facts of the case, that are to be interpreted according to the source state law, lead to consider VP as an autonomous entity. It is important to underline that the presence of VP in State C is due to a specific commitment that VP has undertaken as an autonomous entity, by signing two different contracts; because of its legal personality, it is able to become party of a contract. On the basis of this contract, VP and (not the partners) is obliged to provide as a whole a service including the machine and the employees trained at an university level; as a matter of fact, the shoring up of buildings is carried on not only through the personnel hired for the operation of the machine.

Considering all these both juridical and factual aspects, it comes naturally to conclude that the PE belongs to VP, which therefore is the legal person, which the PE depends on, and the taxable entity, which PE profits are to be attributed to.

6. INADMISSIBILITY OF THE APPLICANT REQUEST

In calculating the profits of the PE located in state C of VP, after having done a examination of the case and, obviously, after having taken into consideration the expenses incurred to the PE itself deductible in state C, the TA of state C firmly believes that the request of VP is absolutely unacceptable. In this latter request, the HO pretends the deduction, in computing the PE profits, of a “notional rent” that the PE would have paid to the HO itself for using the “RMB” during its permanence in state C. The TA of state C, instead, believes that the just cited “machine” is not to be considered as if the HO has leased it to the PE, but it argues that the correct way to focus the dealings between the PE and the HO is to hypothesise that the PE

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84 Par. 32.1-32.7 OECD-Commentary on artt. 23A and 23B OECD-MC.
has the economic ownership of the machine during its entire existence. All of this means that the machine legally belongs to the HO during all the eleven-months period in which the machine is situated in State C but, since it is totally used in the PE, this last becomes the economic owner of the machine during all this time period.

This statement is proved under many circumstances that are going to be illustrated hereinafter.

7. THE IMPOSSIBILITY TO DEDUCT THE “NOTIONAL RENT”

First of all we are going to illustrate the inconsistency of the “rent thesis” as it has been formulated by the applicant part in its request of deduction of the “notional rent”.

According to art. 7(2) of OECD-MC, the profits attributable to a PE should be those which it might be expected to make if “…it were a distinct and separate enterprise engaged in the same of similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which the PE is a part…”. This is, obviously, a mere fiction useful for the only purpose of attributing the profits to the PE. Then, art. 7(3) of the OECD-MC, that relates to the expenses attributable to PEs, seems, at a first glance, to be mandatory towards the contracting states of the convention while it states that “there shall be allowed as deductions expenses which are incurred for the purpose of the permanent establishment…”. However, the generally accepted interpretation of this latter paragraph of art. 7 believes that the article actually does not determine any duty to the contracting states to recognise as deductions those expenses which are not considered so by the domestic law of the source state. This latter interpretation has also been confirmed by the authorised OECD approach (given by the Report on the attribution of profits to permanent establishments approved by the OECD’s Committee on Fiscal Affairs in 2006), which argues that art. 7(3) is to be interpreted as only determining which expenses should be attributed to the PE but not determining which of these expenses are deductible while computing the profits of the PE. This latter determination, in fact, according to the Profits-Report, will be done by the domestic law of the source country. As following this fundamental rule, that the State C TA can not absolutely allow the deduction of the “notional rent” as it has been requested by the applicant part, since State C legislation only allows the deduction of “expenses that are

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86 OECD Profits-Report, p. 22, par. 54.
incurred” and, as it is generally accepted within state C, the notional rent is not to be included among those series of expenses. We can, then, not forget that the same art. 7(3), in exposing which expenses should be deductible, refers explicitly to “expenses which are incurred”. Therefore, besides all the various interpretations elaborated by the Profits-Report or the majority of the scholars, if we make a strict interpretation of the words used by the article itself (“expenses… incurred”), and we take consequently into consideration this latter as the category of expenses to be considered as deductible by the OECD-Model, we will conclude again with the inconsistency of the applicant request since the notional rent for no reasons can be included in such a category.

8. THE DEALINGS BETWEEN THE PE AND VP

For these reasons, the only argument that could give consistency to the applicant thesis would be based on the fact that a real payment has incurred between the PE and the HO. Unfortunately for the applicant, any economic transaction, though, is absolutely absent and this is showed by the fact that there is no trace of obligation to pay any rent and no payment incurred between the HO and the PE concerning this hypothetic notional rent.

It is also true that, even though art. 7(2) of the OECD Model states that the PE is to be considered as “…if it were a distinct and separate enterprise…”, a PE has no legal personality and the dealings between the PE and the HO have no legal effects between these two. As a consequence, all these dealings do not take the form of legally binding contracts. But this can not be an argument used to justify the absence of any trace of the payment. In fact, the functional and factual analysis of the Profits-Report, in this circumstances suggests, taking firmly into account the lack of legal personality of the PE and its consequences, to take into consideration the documentation, such as accounting records and informal contracts, showing the dealings of economic significance between the PE and the HO 87. According to the Profits-Report, these dealings can be accepted as equivalent to the transactions that normally takes place between independent enterprises acting at arm’s length. It is also added, as underlining the importance of such a consideration, that the scrutiny of this documentation should be the very starting point of the analysis for the purpose of attributing profits.

87 OECD Profits-Report, p. 18, par. 36-39.
In our concrete case, there is relevant and significant proof in the matter of documentation that must be taken into account. We are referring to the tax return of the year in which the PE was settled, filed by MP in state M, which does not include any rent as income of the HO. It is evident, then, that nobody, including the PE, has paid to the HO any rent and, consequently, that the request of the deduction of the notional rent in state C by the PE is totally baseless.

But the thesis, according to which the PE has rented the RMB, shows its weakness also under other points of view.


First of all, the fact that the VP in state M, as much as the PE in state C, is not a renting enterprise, rather it is a service company. If, at a first glance, this particular might seem irrelevant, hereinafter we will show the reasons why, instead, it gets crucial in these particular circumstances. In fact, both the HO and the PE, besides the use of the specific “machine”, so unique and expensive, provide for any service that comes out to be required for the appropriate use of the “machine” itself, including the necessary number of employees which are going to manage the RMB. It seems useful to remind that the just cited “machine” is so sophisticated that requires employees trained at university level to operate it. As a consequence of this, the PE is required to have a specific equipment to meet the needs of CC, and we can also state that the reason why the PE obtained the contract is because a company which actually is in the same business sector (i.e., CC) did not have the equipment to get its job done efficiently. Consequently, we can definitely conclude that the PE would not have obtained the contract with CC unless it owned the required equipment. This is showed by the fact that, if the all deal was only a matter of renting, and not the real need of a complex nexus of services, CC would have rented directly the machine from the VP, avoiding one more transaction with the PE, that would represent higher costs for it.

10. THE AMOUNT OF MONEY ASKED FOR THE RENT IS NOT APPROPRIATE

Secondly, even though documentation would exist and the thesis of the rent would in this case get consistent, we would also like to underline that the amount that the PE pretends to deduct
as notional rent, would, anyway, be definitely not appropriate since it is too high. In fact the total amount of money requested by the VP for the eleven months rent would almost represent the 25% of the capital cost of the machine, that is clearly too exaggerate. This would, in concrete, mean that a subject hypothetically interested in a long term lease, in only four years would pay an amount of money equal to the entire capital cost of the machine. This is clearly not convenient and uneconomic for anyone. The amount of money hypothetically requested for this “notional rent” recalls, instead, the circumstance of a sale with payment by instalments that seems to be more appropriate in this case.


After the exposure of the reasons which shows why the thesis formulated by the applicant is absolutely not acceptable, now on, TA of state C is going to illustrate the thesis that believes to be the most adherent to the concrete situation under examination.

The TA strongly believes that the PE has the economic ownership of the RMB machine. This means that, even though, legally, the assets belongs to the enterprise as a whole, and there are no legal transaction between the PE and the HO 88, the only correct way to focus on the reasons and explanation on why the PE has the availability of the “machine”, is to refer to the functional and factual analysis of the authorised OECD approach. This latter states that (it) “…attributes to the permanent establishment economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the permanent establishment…” 89. The just cited Profits-Report specifies that as economic ownership of assets, it is meant “the equivalent of ownership for income purposes by a separate enterprise with the attendant benefits and burdens” 90. So, the Profits-Report suggests to make use of a fiction once again, consisting on as if the PE would have purchased the machine from the head office at fair market value at the time it entered in State C and sold it back once the project was over. In our concrete case, it is evident that the people in the PE are the only one who operate with the machine during the period of existence of the PE and,
consequently, the previous cited “significant functions relevant to the economic ownership of assets” must be performed by those employees. Economically, the assets throughout this period can be owned only by the PE itself since no one else besides the people that work there is even in a close contact with the “machine”.

12. THE ECONOMIC SIGNIFICANCE OF THE “ECONOMIC OWNERSHIP”

Besides the fiction, some questions here would come as a consequence since more than once we reminded that we consider the PE and the HO as two independent enterprises. First of all, anyone will wonder why independent enterprise would transfer for no consideration such an asset. In fact, it may seem, at a first glance, uneconomic. These comprehensible questions are answered by the OECD-Commentary on art. 7. The very first problem the Commentary deals with is whether “...The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm’s length price, i.e. by normally including in the sale price an appropriate profit” 91. That seems to mean that only in very particular situations an enterprise will accept, in a business relationship, to not charge an arm’s length price to a third party. Then, in the very next paragraph, the OECD-Commentary goes on arguing that: “One the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales”. With the last sentence, the Commentary seems to refer to nothing else than the rationale underlying a cost-sharing agreement between independent enterprises, i.e. to those contracts among independent parties aiming at reducing costs and, thereby, increasing profits. This could definitely fit in our concrete case, since VP in state M has much interest on making its machine and its employees

91 Commentary par. 17(1).
working, due to its incredibly high capital cost. Then, the OECD-Commentary dedicates one more paragraph (par. 17.3) specifically to the transfer of assets stating that: “...where goods are not supplied for resale but for temporary use in the trade... 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 e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts ...” This paragraph underlines again the same principle but this time applied to the specific case of transfer of assets instead of referring again to dealings in general, making our thesis even more adherent to our concrete case.

45 We may also add, then, that in similar circumstances, the PE would have the right to depreciate the assets whether during the existence of it, the value of the machine would get lower. But this is not the case, since it is absolutely clear in this particular situation that, if the RMB is properly maintained, it lasts in principle indefinitely and no depreciation right get consistence.

13. CONCLUSIONS ON PROFITS ATTRIBUTION

46 As a conclusion, the TA, under the interpretation of the OECD-MC, strongly reaffirms the inconsistency of the request of the applicant part (VP) due to all the arguments precisely listed above and believes that the correct way to focus on the transfer of assets between PE and HO is to hypothesise that the PE owns the economic ownership of the RMB machine. In terms of computing the industrial and commercial profits from its PE in state C, VP is then allowed to include all amounts billed to CC. It may, then, as a consequence, deduct from income expenses as all direct labour costs, insurance and similar costs, transportation costs, certain additional labour costs and a portion of its general overhead expenses, but as it comes obvious once the arguments we just mentioned above are scrupulous analysed, no “notional expenses” can be deducted, including the insofar often mentioned “notional rent”

14. THE ROYALTIES TOPIC: THE TAX ADMINISTRATION OPINION
In the litigation between State C and the VP concerning the use of the RMB, another important matter of law arose: how to qualify the consideration paid and the consequent profit distribution from VP to the partners MP and People Power. The aim of this memorandum is to demonstrate that such income constitutes an income according to the applicable tax treaty, has to be taxed only in C by mean of a withholding tax levied on the gross income, such qualification is related not only to the consideration, but also to the profit distribution. It has been prospected by this TA that the consideration for the exploitation of the machinery has to be qualified as a royalty; so as to be taxed with a 10% withholding tax levied on gross income, under the relevant provision of the CMTT. Moreover, in the opinion of the TA, the machinery exploited constitutes for sure a PE, as underlined above.

15. APPLICABLE TAX REGIME

First of all the TA wants to remark that, given the contrast between the domestic provision (stating a 20% withholding tax on rents and royalties) and the treaty provision (which states a limitation up to 10% on withholdings levied on royalties, taking into account the gross income), the latter provision should prevail, because of the undisputable qualification of the treaty provision as lex specialis derogating to the general domestic rule. The application of a tax levied on gross income means that, obviously, no deduction can be allowed. This lead to the conclusion that if a deduction for effective expenses borne by the taxpayer are to be denied by such TA, a fortiori no calling for deductions of notional expenses has to admitted.

The last arguments leads to another controversial topic of all the litigation, concerning the law which has to be preferred in terms of interpretation of the treaty provisions. In this case, most of the issue is about the “expenses” notion. According to the TA opinion, such a meaning is to be researched under the domestic taxation law. In fact, art. 3(2) OECD-MC provides that “as regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State”. In this controversy, State C, which is the taxing State applying the treaty, is making reference to its domestic law in order to qualify a

92 Hereinafter “PP”. 
term not defined by the treaty. Moreover; nothing, neither as to the law, nor as to the facts, prevents such a qualification because of a particular context. Finally, the definition of “expenses” is provided by the State C’s tax law and not from other laws of the State. Given that, all the requirements imposed by the provision are met. The lawfulness of the TA activity is clearly evident and adverse theories have to be rejected.

16. THE INCOME QUALIFICATION

The qualification of such item of income as a royalty cannot be disputed, given that the CMTT, following the royalty definition provided by the 1963 OECD Draft Convention (Art. 12(2)), includes the considerations paid “for the use of, or the right to use industrial (...) equipment”. Given the facts, such provision fits undoubtedly with the contract concluded between VP and CC. Anyway, against this opinion, it has been pointed out that Art. 12(3) makes applicable, in the case of the presence of a PE, the regulation of Art. 7, i.e. a reclassification of the income at stake from the ontological category into the class of business profit. Given that, VP, even if it is not admitting to deem the machinery to be a PE, calls for a net taxation, i.e. for the deduction of the expenses incurred for the production of such income, given the nature of business profits as a net-taxable income (see Art. 7 (3)). The TA disagree on this point.

The TA, in order to determine the applicable tax law to an economical phenomenon, takes firstly into account the localization of the phenomenon; secondly, the correct qualification of such a phenomenon (i.e., which kind of income we are dealing with) and, thirdly, given the foregoing, the applicable tax. This because, in the TA opinion, it is more logical to ascertain firstly whether or not the economical phenomenon has any kind of link with the territory of the State. Without this preliminary ascertainment, the second step would become a futile operation, given the institutional aims of the TA.

Given that, the TA is of the opinion that the PE notion cannot be deemed to provoke a requalification of items of income that, in this case, are more than merely “effectively connected” with it, because this income constitutes the reason for the installation of the PE in the territory of the State. In order to support such an argumentation, the TA would like to remember that par. 20 OECD-Commentary on Art. 12 OECD-MC states that “the paragraph

93 See par. 20 OECD-Commentary on Art.12 OECD-MC.
(i.e., art. 12(3)) merely provides that in the State of the source the royalties are taxable as part of the profits of the PE there owned by the beneficiary (...), if they are paid in respect of rights or property forming part of the PE or otherwise effectively connected with that establishment”. The TA strongly holds that such a statement of the Commentary is to be interpreted in the meaning that the PE notion has to be exploited only to localizing the income in the State of source, but not to the extent of imposing a new classification of the income as business profit. In fact, it states that other items of income have to be considered as revenues included in the PE taxable base, but it does not oblige to attribute them to the PE in a particular way. The PE, in such an interpretation, provokes a widening of the income taxable by the source State, but in a different way in comparison to the one realized by the so-called force of attraction rule. While according to the last mentioned rule income not generated through the activities of the PE is reconducted to it; in the present case, the TA, because of the presence of a PE, localizes in the territory of the State income that; given the relevant provisions of the tax treaty, would not be taxable by C, State of the source. In fact, Art.12(1) expressly provides that “royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State”. In our case, it means that royalties are taxable only in State M, but the presence of a sufficient localization criterion such as a PE makes such royalties taxable also in State C. In other words, the TA believes that royalties are taxable in State C because of the presence of the PE, but not as business profits. They follow the tax regime applicable to their ontological category of income.

Someone may argue that the elimination from the present royalty definition of the income arising from the rent (or any other title conceding the right to use) of industrial equipment may lead to the exclusion of the income at stake from the royalty category. Often, such an interpretation is supported through the following explanatory statement of par. 9 OECD-Commentary on Art. 12 OECD-MC: “given the nature of income from industrial (...) equipment, (...) the Committee on Fiscal Affairs decided to exclude income from such leasing from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits, as defined in Articles 5 and 7”. In the opinion of the TA, any change in the OECD-Commentary, that is not legally binding, but has to be taken into the greatest account for understanding treaty provisions, cannot be deemed to have any influence on an existing and
effective treaty. It is commonly known that only a new agreement between the Contracting States can modify an already existing treaty. Moreover, the treaty was signed in 1997, when OECD already modified the MC in the actual way. Given that, the TA is of the opinion that this circumstance leads to the conclusion that State M and State C wanted to be obliged by such a definition of the royalty notion as the one embodied in the 1963 OECD Draft Convention.

17. BENEFICIAL OWNERSHIP

54 The matter of law that we are now taking into account is not concerning just the consideration, but involves also the so-called profit distribution from VP to the partners MP and PP. The TA opinion on the topic is that such “distribution” must be intended not referring to the formal sense; i.e. a distribution of dividends to the partners paid in accordance with their investment in the partnership, but more generally to any cash-flow generated by VP for the benefit of the partners. Even if MP and PP refer to a “profit distribution”, nothing demonstrates such a qualification of the payment, neither the formal resolution of VP’s administrative board nor the one of any other partnership legal body required under State M civil law. In the TA opinion, we are not facing with two different incomes (i.e., the remuneration for the use of RMB from CC to VP and the profit distribution from VP to the partners), but with the same income formally owned by VP and beneficially owned by its partners. In fact, the traditional notion of “beneficial ownership” refers to a splitting of the right of property, in which together with a formal owner coexists another owner, who receives the economical utilities arisen from the allocation of the right to use the good. In this case, even if VP is entitled to a generic power of disposition over the machinery, MP is the owner of the good. Moreover, this good cannot work without exploiting the know-how of PP’s workers. Besides, because of the tax regime applicable in M to partnerships, MP and PP are the subjects liable to be taxed in the event of the incomes arisen from VP’s activities. Given the foregoing, TA concludes that the income, even if beneficially owned by other subjects in State M, has still to be taxed in C in accordance with the conclusions of the previous paragraphs.
18. CLAIMANCE OF THE TAX CREDIT

The VP’s partners, i.e. MP and PP are complaining that the qualification prospected by the TA can result in a double taxation, because of the impossibility to obtain a tax credit for the tax withheld in the State C caused by timing differences. It is very unfair, in the TA opinion, to attribute any responsibility for such hurdles to State C, as the problem arises by virtue of the failing of the domestic tax legislation of State M to protect their taxpayers by a well-known issue of international taxation. Such a problem is produced not by the legitimate classification of the income as a royalty and the consequent taxing modality (in the present case, a withholding on the gross income) provided under both the concluded tax treaty and State C domestic legislation, but because of the limitations imposed by State M tax law to the traditional relief method of the tax credit. The correct solution is, in the TA opinion, to be found in State M legal system. The traditional rule that protect state sovereignty in the taxation subject-matter cannot lead to an actual violation of both domestic law and tax treaty obligations to compensate foreign taxpayers for the failings of their residence state to protect them against double taxation. Moreover, this matter can be solved only by a sovereign action of the other State (e.g. a statute), so no room for intervention of branches of the other States is left.

Someone may argue that, according to the Vienna Convention on the Law of the Treaties that obliges States to interpret treaties “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”94, State C may be deemed to be obliged to renounce to the prospected qualification because it derives from an interpretation of the tax treaty that does not lead to the elimination of double taxation, which is the fundamental purpose of tax conventions. The TA is of the opinion that such a wide interpretation cannot be accepted, because it is against the literal definitions of the income categories used in the treaty (i.e. in the case at issue, the royalties definition). Moreover, scholars95 are of the opinion that the quoted provision obliges States to interpret treaties in an “objectivistic” way, so as to consider the principal mean of interpretation to be the common sense of the used expressions, and only subsequently any other argument related to the willing of the States party. In the end, the TA strongly holds the lawfulness of its

94 Art. 31(1) of the Vienna Convention on the Law of the Treaties.
interpretation, supported by the *communis opinio* among international scholars and stresses that the solution must be found only in a possible modification of State M domestic tax law. Given that, State C and any body of its government are not entitled to intervene.

### 19. CONCLUSIONS

When concluding, the TA would like now to summarize its conclusions for the reader’s sake. Given the facts object of the litigation, it considers that the machinery constitutes a PE under the relevant provisions of the tax treaty concluded between M (residence State of VP, the partnership providing the service, and of MP and PP, partners of the aforementioned joint-venture) and C. The consideration paid has to be qualified as a royalty, according to the definition embodied in Art. 12(2) CMTT. Given that, State C taxing powers may be lawfully exercised. Notwithstanding the adverse opinion, and given the aforementioned arguments, the TA qualifies the PE only as relevant in terms of localization of the income produced, but denies any mutation of its nature. The royalties, even received by a PE, are still royalties and they have to be taxed accordingly. It means that, in accordance with the relevant provisions of the tax treaty, a withholding tax of 10% on gross amount has to be levied. The TA believes that the royalties are beneficially owned by VP’s partners, i.e. MP and PP, but this circumstance, even if leads to the conclusion that no real “profit distribution” had happened, does not influence the conclusion reached in this pleading.
V. LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CC</td>
<td>Careless Construction Ltd</td>
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<tr>
<td>CMTT</td>
<td>C-M Tax Treaty</td>
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<td>HO</td>
<td>Head Office</td>
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<td>i.e.</td>
<td>id est</td>
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<td>MP</td>
<td>Mud Pressure</td>
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<tr>
<td>OECD-MC</td>
<td>2005 OECD Tax Model Convention</td>
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<tr>
<td>OECD-Commentary</td>
<td>2005 OECD Commentaries on the Articles of the Model Convention</td>
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<tr>
<td>PE</td>
<td>Permanent establishment</td>
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<td>PP</td>
<td>People Power</td>
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<td>RMB</td>
<td>RockMelterBelter Machine</td>
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<td>TA</td>
<td>Tax Administration of State C</td>
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<td>VP</td>
<td>Venture Partnership</td>
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