Journal of Korean Law | Vol. 12, 1-54, December 2012

Apportionment of Profits to a Permanent Establishment: Similarities and Differences in the UK, the US and the Republic of Korea*

Eui Young Lee

Abstract

Apportionment of profits to a permanent establishment is to determine the taxable business profits of a part of a multinational enterprise within the source country. The recent position of the OECD is to apply the separate enterprise approach with the functional and factual analysis. This article focuses on two aspects. The first one is to characterize the activities carried through a permanent establishment when it deals with the head office or the other parts of the same enterprise. The second is the deductibility of expenses which includes the question of notional charges on internal dealings and the issue of indirect expenses incurred by the enterprise as a whole for the common purposes. The UK, the US and Korea have had different tax law to deal with these issues, while they have shared some similarities. The relevant Articles of the current OECD Model Convention and the Commentary will be analysed in advance, as it helps to interpret and understand those different systems and provides a certain guidance to compare them. Several problems contained in the authorized OECD approach and some possible solutions will be discussed at the final part of this article.

Key Words: Permanent establishment, apportionment of profits, OECD Model, internal dealings, indirect expenses, notional charges, separate enterprise approach, formulary apportionment approach

Manuscript received: Nov. 2, 2012; review completed: Nov. 30, 2012; accepted: Dec. 3, 2012.

* This article is the revised paper of the thesis submitted in the course of LL.M. 2011-2012 of the University of Cambridge. I extend my gratitute to Professor John Tiley who supervised the thesis and gave valuable advice. All the mistakes that might be in this article are entirely my fault.

I. Introduction

1. Background

Apportionment of profits to a permanent establishment is to determine the taxable business profits of a part of a multinational enterprise within the source country. This involves allocating taxing rights among different jurisdictions, which is usually decided by a bilateral tax treaty between those countries, while there are some cases where no such treaty exists. Although the specific treaty provisions are made through the negotiations by the two parties, the general principles are provided by Article 7 of the Model Tax Convention of the Organization for Economic Cooperation and Development ('OECD'), since most tax treaties in practices follow this Model. The recent version of the Model clarifies that the OECD adopts the separate enterprise approach on this matter, though there has been a long history of debates with the formulary apportionment approach. [1] From a fiscal point of view, the tax law should be neutral on the decision of an enterprise on whether to operate its worldwide business through a subsidiary or through a permanent establishment, and the methods used in tax treaties for allocating profits should be applied consistently and symmetrically within the entire tax treaty network.

The normal process of profit attribution to a permanent establishment starts with the trading accounts of the permanent establishment, and proceeds to decide whether any adjustment to these figures is needed through identifying the transactions to be attributed to the permanent establishment and quantifying under the arm's length principle. Although the OECD has suggested a way to interpret the provisions in the Model Convention, there has been variation in the actual practices and legislations among countries. The disparities among different jurisdictions have created

---

1) Primarily, under the tax treaty regime, the source country is allowed to tax the business profits of a foreign corporation only if the taxpayer's business is conducted through a permanent establishment, and the taxable profits are limited to those that are attributable to the permanent establishment. For the method of determining the profits attributable, the separate enterprise approach and the formulary approach have had a long debate among countries for decades.

the risk of double taxation or non-taxation.

This article does not intend to cover all tax issues or aspects surrounding the profit allocation to a permanent establishment. Instead, two basic points would be focused on.[2] The first one is to characterize or identify the activities carried through a permanent establishment when it deals with the head office or the other parts of the same enterprise, such as the use or transfer of assets and the provision of funds or services, and to determine the profits attributed to the permanent establishment. As there are no contract terms and no legal obligations in these transactions within an enterprise, whether and when internal dealings are recognized is a very controversial issue. The OECD suggests the hypothetical separate enterprise approach with factual and functional analysis, but it is still abstract and cannot be perfect. How similarly or differently this has been treated in different countries and which problems have been caused will be discussed.

The second point is about the deductibility of expenses which can be divided into two categories. Whether the notional charges on internal dealings are deductible in the calculation of taxable profits of a permanent establishment who has paid these to its head office is closely related to the first issue. Where the deduction of notional interest is allowed, which is usually the case of a bank, the 'free capital' allocation which restricts the deductibility should be also considered. On the other hand, there is the issue of deductibility of indirect expenses incurred by the enterprise as a whole for the common purposes. Whether such expenses are deductible and how to allocate the expenses to a permanent establishment have varied among countries. The OECD left the deductibility of expenses as a matter to be determined by each domestic law as long as there is conformity with the arm's length principle.

The United Kingdom ('UK'), the United States ('US') and the Republic of Korea ('Korea') were chosen as representatives for comparison in this article, since these OECD member countries from different continents have had distinctively different systems with different history.

---

2) Therefore, for example, exploring the various transfer pricing methods used in attributing profits to permanent establishments by analogy, the non-discrimination issue, and the dependent agent problems are out of scope of this article.

2. The Structure of the Article

The chapter II below begins with the relevant Articles of the OECD Model Convention and the Commentary in a context that it helps to interpret and to understand the individual countries' legislation and cases as well as it provides a certain guidance to compare the different systems. The legal status of the Commentary will be also considered as it is one of the important issues before the court in a particular legal dispute. Next, as the representatives of different systems, tax laws of the UK, the US and Korea will be considered one by one in the chapter III. Not only the details of each legislation and rules, but also some principles and important cases before the courts would be discussed regarding the above two issues. At the final section of this chapter, the comparison of these countries will be performed to find out relevant similarities and differences, followed by one table of comparison to help understanding. Also the problems caused by these differences and the limitations in the current OECD approach will be examined from a practical point of view. In the chapter IV, the summary and the suggestions for future study will be made as a conclusion.

3. Examples

Before the start, here are two simple examples to clarify these issues above and to help the development of discussion.

Example 1) Suppose an international drilling company. It has a branch, A, which constitutes a permanent establishment in country X.[3] A uses one of drilling machines which are legally owned by the company as a whole. A has paid and recorded the lease payments made to its head office, H, which is located in country Y.

Example 2) Suppose an international bank. It has a branch, A, in country X, the head office, H, in country Y, and another branch, B, in country Z. A mainly funded its operations by means of loans from unrelated third parties, but also borrowed some money from H and B. A has paid and recorded the interest payments including those made to H and B.

3) The same assumption applies to the Example 2).

II. The OECD Model Tax Convention and the Commentary

1. The Role of the OECD Model Convention and the Commentary

1) In General

The OECD Model Tax Convention ('Model')[4] aims to provide a uniform method for resolution of the commonly occurring problems arising in international juridical double taxation,[5] although taxes are the last topic on which it would be expected for sovereign countries to reach a consensus.[6] Tax treaties in practices entered into by member countries, often including treaties with non-member countries, conform to the OECD Model.[7] Also tax authorities apply the OECD Commentaries on the Articles of Model in interpreting tax treaty provisions, subject to any reservations and observations recorded in the Commentaries.

The Model and the Commentaries have been revised by periodic updates and amendments. In particular, as see below, there were some considerable changes in the Article 7 of the OECD Model in 2010 and the Commentary. This was predicted by the 2008 Commentary which established the authorized OECD approach on the matter of profit allocation to permanent establishments.

When it comes to the appropriate version of the Commentary to be taken into account in a particular case, the opinions are divided. The static approach is to apply only the version of the Commentary in force when a treaty was concluded, on the ground that the subsequent statements made many years later usually do not reflect the intent at the time of ratification. On the other hand, the ambulatory approach is to allow the newly published Commentary to be used unless there is a clear change in the

---

4) The Draft Convention was made in 1963 and the Model Double Taxation Convention on Income and Capital was published in 1977. The title has become shorter ('OECD Model Tax Convention on Income and Capital'), in recognition of the fact that it does not exclusively deal with the elimination of double taxation but also addresses other tax issues.

5) OECD, *Introduction OECD Model 2010*, para. 3 (2010b).

6) Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, Tex. L. Rev. 74, 1303 (1996).

7) *Supra* note 5, at paras. 13-14.

attitude. The latter is based on the fact that the Commentary reflects the agreed interpretation of member states on the Articles of the OECD Model. The US court[8] and the Australian court[9] seemed to adopt the view of the former. If we follow this, where a subsequent Commentary reflects a new interpretation of a treaty provision, such as the 2008 Commentary on the former Article 7, it should not be used to interpret treaties which came into force before it was published.[10] However, there are also some views supporting the ambulatory approach. The argument is that considering the treaty process, the Model convention and Commentaries are to be covered by Article 31 of the Vienna Convention, and subsequent amendments to Commentaries should qualify as subsequent agreements between the parties regarding the interpretation of their treaties.[11]

2) The Legal Status of the OECD Commentaries

Do the OECD Commentaries have the legal effect, or the normative value? Instead of a multilateral tax convention, the OECD Council decided to leave more flexibility to member states by adopting a bilateral Model Convention. The Commentary is the recommended way of interpretation on the Articles of the Model. The legal nature of this recommendation is not defined, but it is generally understood that the recommendations of international organizations are decisions that are not legally binding, even though these are made only by mutual agreement of all members.[12]

The European Court of Justice, in *Grimaldi*[13] stated that, although the

---

8) *See* the first and the second *National Westminster* cases in III.2.C.

9) *Thiel v. Federal Commissioner of Taxation,* 171 CLR 338 (1990). It was held that where a term of a tax treaty is ambiguous the court should consider the OECD Model and the Commentary as supplementary means of interpretation under Article 32 of the Vienna Convention.

10) Michael Kobetsky, International Taxation of Permanent Establishments – Principles and Policy, 177 (2011).

11) Johan Muller, *Attribution of Profits to PE: A Business Perspective*, Weber & van Weeghel, 55-56 (2011); Brian Caster, *After Natwest: How Courts Should Handle OECD Commentary in Double Taxation Treaty Interpretations*, Nw. U. L. Rev. 105, 1321 (2011).

12) Niels Blokker, *Skating on thin ice? On the Law of International Organizations and the Legal Nature of the Commentaries on the OECD Model Tax Convention*, Douma & Engelen, 18 (2008).

13) Case 322/88 *Grimaldi v. Fonds des Maladies Professionnelles* [1989] E.C.R. 4407, at 4421. Under EU law, the recommendations of Commission of European Communities do not have

recommendations of international organizations are not intended to produce binding effects, they cannot be regarded as having no legal effects at all.[14] The national courts of the Member states "are bound to take recommendations into consideration in order to decide disputes submitted to them, in particular when they cast light on the interpretation of national measures adopted in order to implement them or where they are designed to supplement binding Community provisions." Similarly, we can understand that the OECD Commentaries as recommendations of international organizations are not legally binding, but they are not legally irrelevant.

The important question in practices is whether it could be assumed that the two parties, if they decide to copy provisions from the Model in their negotiations for a bilateral tax treaty, have also copied the Commentaries? As there is no basis for such a legal obligation to follow interpretations of the Commentaries, the Commentaries may be used just as authoritative standards, not as law. They have not yet become customary international law since there is no general practice among the OECD members. But some member states, such as Austria, may have included a provision of obligation to follow the Commentaries in their bilateral treaties.[15]

Thirlway shows an interesting approach to this issue by concepts of acquiescence[16] and estoppel[17] in the field of international law. The silence at the time of adoption of the Commentary can be the first acquiescence, and the silence at the time of conclusion of a specific bilateral convention

---

the direct effect.

14) Blokker explains this with an example of the process of freezing water. When a new norm is developing but has not yet reached the stage of a legally binding effect, they may have a legitimizing effect or they may be restated again and again. This is like water which has just been freezing for one night is not sufficiently thick for ice skating. *See* Blokker, *supra* note 12, at 20.

15) Blokker, *supra* note 12, at 26.

16) Acquiescence is a tacit consent to an infringement of rights, either express or implied from conduct. Malcom N. Shaw, International Law, 102, 518-519 (6th ed., 2008).

17) Estoppel is a situation where a person making a representation on the faith of which another party acts will be bound by the representation even if later the factual position is proved different. Hugh Thirlway, *The Role of the International Law Concepts of Acquiescence and Estoppels*, Douma & Engelen, 30-31 (2008).

would be the second acquiescence to make the first acquiescence effective.[18) This argument is based on the fact that two governments could explicitly agree that the bilateral convention should not be interpreted according to the OECD Commentary, if they did not wish to follow it.[19) Of course the existence of acquiescence is rebuttable presumption.[20) If estoppel is to be relied on, mere proof of silence is not enough, but there has to be a significant silence amounting to a representation, and the representation must have been relied on by the other party. However, as both parties knew that the Commentary was not binding, it seems difficult to justify inferring from the silence of the other party that it accepted the binding effect of the Commentary.[21)

Apart from this debate, it is thought desirable that the member countries which copy Model provisions in their bilateral agreements also follow the interpretations given in the Commentaries. [22) This would promote harmonization and reduce potential disputes, while there is no obligation for members to follow such interpretations.

2. *The 2010 OECD Model and the Commentary*

On July 2010, the OECD Council approved an update to the Model which included an entirely new version of Article 7. This can be viewed as the culmination of more than a decade of work the OECD had carried out to reach a clearer international consensus on the way of taxation of a permanent establishment.[23) The wording of current Article 7(2) of the Model is like below;

---

18) *Id.* at 36.

19) But it is not easy to say the consequence of the hypothetical case. There may be no further specific conduct from which acceptance could be inferred. For details, *see* Thirlway, *supra* note 17, at 38-39.

20) Thirlway, *supra* note 17, at 39.

21) *Id.* at 44.

22) There is a "no man's land" between binding and non-binding decisions. Blokker, *supra* note 12, at 27.

23) Mary Bennett, *Article 7 – New OECD Rule for Attributing Profits to Permanent Establishments*, WEBER & VAN WEEGHEL, 21 (2011).

> For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The authorized OECD approach ('AOA') which was provided in the 2010 Report and incorporated in the new Commentary is that a permanent establishment is, hypothetically, treated as a functional separate entity for the purposes of Article 7. In particular, Article 7(2) clarifies that notional transactions between a permanent establishment and other parts of the enterprise are also within the application of the separate entity approach. Also, the formulary approach which has been used in some member states cannot be accepted any more.

In attributing profits to a permanent establishment, all its activities are examined which can be divided into three categories: transactions with independent enterprises, transactions with associated enterprises, and dealings between a permanent establishment and other parts of the enterprise.[24)] The two-step approach is undertaken with these activities. The first step is to undertake a functional and factual analysis to identify the activities of the permanent establishment, and then the transactions and dealings to be attributed to it. The second step, called the arm's length remuneration, is to quantify for tax purposes; this is done by applying the arm's length principle and using the OECD transfer pricing guidelines[25)] by analogy. A detailed part of AOA which is relevant to the two issues of this article will be described below.

---

24) *Supra* note 5, at para. 20.

25) OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995).

1) The Intra-Enterprise Transactions

(1) The Functional and Factual Analysis

In recognizing and determining the nature of internal dealings within an enterprise, the functional and factual analysis should be focused on the significant people functions[26)] which are relevant to either the economic ownership of assets or the assumption of risks.

First, for the transfer of assets within an enterprise, the factual and the functional analysis to determine the economic ownership of the assets used by a permanent establishment are to be performed. A change in place of use of a tangible asset is a strong factor that may trigger a change in the economic ownership of that asset, since the AOA assumes that such property is economically owned by the part of the enterprise that is using it. Where exceptionally the economic ownership of a tangible asset would not be attributed to that part, the transfer could be characterized as a lease and the permanent establishment can be treated as paying an arm's length charge (notional rent).[27)] Alternatively, the factual analysis may show that the permanent establishment and other parts of the enterprise have structured their dealings in a comparable manner to economic co-participants in a cost contribution arrangement-type activity.[28)] In the Example 1) given in the introduction, it is needed to decide who has the economic ownership of the drilling machine used by A.

In the context of intangible assets, more difficult questions arise to decide the economic ownership of it within an enterprise. Where the factual analysis reflects that an intangible property is solely owned in the head office but the permanent establishment has a non-exclusive right to use the intangible sharing with many other parts of the enterprise, there is no room for the notional royalty. On the other hand, the analysis can show that the permanent establishment has obtained a notional right to use the intangible

26) The OECD Report uses the term 'significant people functions' to indicate the significant functions performed by people in the permanent establishment relevant to either the assumption of risks or the economic ownership of assets. OECD, *Report on the Attribution of Profits to Permanent Establishments Part I*, para. 15 et seq. (2010c).

27) But this would not be a big change, since any notional rental payment would represent only an incremental change from the pre-AOA situation, where that part of an enterprise would have been allocated its share of depreciation. Bennett, *supra* note 23, at 33-34.

28) *Supra* note 26, at para. 197.

property analogous to a licensing agreement which might give rise to the arm's length charge (notional royalty). The OECD emphasizes that an internal royalty is only one of possible ways of rewarding intangible property.[29] The focus is to ensure that the intangible owner is attributed an arm's length return, so the recognition of the notional royalty should not be understood to carry wider implication as regards withholding taxes.[30]

Where the economic ownership of the underlying asset is transferred from the head office to a permanent establishment, the fair market value of the asset at the time of transfer would generally provide the basis for computing an allowance for depreciation, subject to the domestic law of the host country.[31] For example, if it is the transfer of machinery that constitutes a fixed asset of the enterprise, the use of the machinery by the permanent establishment will give rise to a claim for depreciation.[32]

Next, regarding the provision of funds, in addition to the prior recognition in its previous Commentaries and Reports of internal interest dealings within the financial sector, the OECD suggests that under the functional and factual analysis there would be also exceptional circumstances where internal dealings within non-financial enterprises could be recognized for the purposes of rewarding a treasury function such as raising funds.[33] But in actual practices, the impact would not be dramatic because it may be a very rare case that one part of a non-financial enterprise performs a real treasury function for the other parts of the enterprise.[34] Also, if the treasury permanent establishment is merely acting as a conduit to borrow funds from a third party, it may be appropriate to reward the treasury function with a reimbursement of any administrative costs incurred.[35] Two important points here are the special treatment for banks and financial instruments, and the adjustment of interest expense deduction in relation with the "free capital" allocation. Both will be

---

29) *Id.* at para. 206.

30) *Id.* at para. 203.

31) *Id.* at para. 196.

32) Peter Harris & David Oliver, International Commercial Tax 165 (2010).

33) *Supra* note 29, at para. 152.

34) Bennett, *supra* note 23, at p. 33.

35) *Supra* note 29, at para. 159.

discussed in the following section about the deductibility of expenses.

Third, the arm's length principle is also applied to determine the reward for performing internal services. It is taken account whether both parties would have contracted for the provision of the service if they were separate enterprises.[36] In some cases, they can be considered as acting as co-participants in a cost contribution arrangement-type activity involving the provision of the services. Most services provided by the head office are mainly similar to those provided by the parent company of a multinational enterprise group.[37] This new notion of internal service dealings may seem somewhat broader, but the notional service charge would largely replace the previous allocation of the external charges for the services.[38]

(2) Greater Scrutiny and Documentation Requirements

The OECD suggests that there should be a need for greater scrutiny of dealings within an enterprise to be recognized for the tax purposes, because there is no legally binding contract between them.[39] The Commentary indicates that intra-entity transactions must have documentation to support purported intra-entity dealings because treating an internal dealing as a real transaction is very unique. The starting point for recognizing a dealing is an international enterprise's accounting records and contemporaneous documents which establish a transfer of economically significant risks, responsibilities and benefits.[40] In the Examples in the introduction, therefore, both branches are required the detailed documentation to prove the existence of their internal dealings.

36) It is necessary to identify whether it is performed as ordinary activities or merely part of the general management. If it is merely part of the general management of the company as a whole, no dealing is recognized, and the costs would be allocated on an actual cost basis to the various parts of the enterprise without any mark-up to represent profit. Harris, *supra* note 32), at 166. Sending an employee to perform specialized staff training, or general supervisory management of the board of directors of a corporation can be the examples of the general management.

37) *Supra* note 29, at para. 219.

38) Bennett, *supra* note 23, at 34.

39) OECD, *Commentary on Article 7 Concerning the Taxation of Business Profits*, para. 25 (2010a).

40) *Id.* at para. 26.

2) The Deductibility of Expenses

(1) The Deletion of Former Paragraph

The former Article 7(3) which was deleted in the 2010 version was providing that "there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere." According to the OECD 2010 Commentary, while the intention of the former Article 7(3) was to require expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account even if these expenses had been incurred outside the country where the permanent establishment is situated, it had been sometimes read as limiting the deduction of indirect expenses to the actual amount of the expenses.[41] The current paragraph 2, however, which clearly establishes the separate entity approach is considered to be opposed to such a limitation on the deductibility of expenses. Therefore the old paragraph 3 was deleted, and the matter has become to be determined by each domestic law so long as it is in accordance with the Article 7(2). Article 7 only serves to allocate revenues and expenses for the purposes of allocating taxing rights, and it does not govern the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law.[42]

The OECD 2010 Commentary prescribes that the deletion does not affect the requirement that all relevant expenses of the enterprise, wherever incurred, be taken into account, and this will be done through the deduction of all or part of the expenses depending on the given circumstances. In the OECD 2008 Commentary, it was mentioned that in some cases it is necessary to estimate by conventional means the amount of expenses to be taken into account.[43] For the methods of this estimation, it suggested a proportionate ratio that the permanent establishment's turnover or gross profit bears to that of the enterprise as a whole. This is still meaningful for

---

41) The OECD 2008 Commentary supported this view that the expenses to be taken into account should be the actual amount incurred for the purposes of the permanent establishment. OECD, *Commentary on Article 7*, para. 27 (2008a).

42) Bennett, *supra* note 23, at 30.

43) *Supra* note 41, at para. 27.

the indirect costs deduction under the current position.

(2) The Principle

The new principle of the OECD is that the deductibility of expense should be in accordance with the separate enterprise approach through the factual and functional analysis given in paragraph 2. It is obvious that once the profits attributable to a permanent establishment have been determined under Article 7(2), whether and how such profits should be taxed is a matter to be determined by the domestic law of each country. In principle, the 2010 view is that Article 7(2) is explicit enough to distinguish cases where an arm's length mark-up is reasonable and cases where only attribution of expenses is appropriate.[44)]

Whether a specific kind of domestic restriction is allowed or is in a violation of the Convention can be an issue. Bennett explains that if the domestic law ignores the recognition of dealings or denies the deduction of common expenses, it would clearly be in violation of Article 7(2). Also she argues that domestic law requiring actual payment would be against Article 7(2), if they do not consider the nature of internal dealings and do not treat them as if they had been made between two different entities.[45)]

Some of indirect expenses may be in relation with the supporting or administrative functions of the head office. Whether they constitute the internal service provision or just trigger proportional costs allocation is to be determined by the factual and functional analysis.

If it is not appropriate to recognize an internal dealing, expenses incurred by an enterprise for the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment. The OECD 2010 Commentary provides an example of the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment. On the other hand, where expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment, an appropriate notional charge will be deducted in determining the profits

44) Hans Pijl, *The 2010 Elimination of Article 7-3*, WEBER & VAN WEEGHEL, 49 (2011).

45) Bennett, *supra* note 23, at 32.

attributable to it.[46] In the Example 1), the depreciation is allowed if the economic ownership of the drilling machine is allocated to A, while the notional lease payment can be deducted in exceptional circumstances where the existence of a lease arrangement is able to be identified.

(3) Attribution of "Free Capital" as the Limitation of Interest Deduction

The OECD 2010 Report clarifies that the separate and independent entity hypothesis requires that an appropriate portion of the enterprise's "free capital," the creditworthiness be attributed to a permanent establishment for tax purposes in order to ensure an arm's length attribution of profits to it.[47] It explains that there is a consensus amongst governments and business on the principle that a permanent establishment should have sufficient capital to support the functions, assets and risks it assumes.

The term "free capital" is defined as an investment which does not give rise to an investment return that is deductible for tax purposes. Under this concept, a permanent establishment is treated as having an appropriate amount of capital in order to cover the assets of which the economic ownership is attributed to it and to support the risks assumed by it. As a result, a permanent establishment would be denied a deduction for interest paid for the fund which is allocated as "free capital," even if it is characterized as an interest through the first analysis. However, the OECD was not able to develop a single internationally accepted approach for attributing "free capital."[48]

There is a view that doubts that this concept of "free capital" is consistent with the idea of allowing deductions for expenses incurred for the permanent establishment, though the former Article 7(3) was deleted from the Model 2010.[49] Also there is a criticism that it does not reflect the economic reality that international enterprises undertake their operations through permanent establishments in order to maximize the flexibility in the allocation of debt and equity capital and that the enterprise as a whole

---

46) *Supra* note 39, at para. 34.

47) *Supra* note 26, at paras. 99, 106.

48) *Id.* at para. 147. Four possible measures to allocate "free capital" are described with advantages and drawbacks of each measure; the capital allocation approach, economic capital allocation approach, thin capitalization approach, and safe harbor-quasi thin capitalization/regulatory minimum capital approach.

49) Harris, *supra* note 32, at 259.

is liable for risks.[50)]

3) The Special Treatment of Banks and Financial Institutions

The feature of International banks and financial institutions lies in the economic reality, that they are a highly integrated business. This has caused a difference in attributing profits to a bank branch among countries. Historically, the US and Japan used the single entity approach, while other majority countries adopted the separate entity approach. The OECD admits the specialty of banks and financial institutions,[51)] and published a special part for this in its Report.

According to the Report, creating of a financial asset and its subsequent management are the key entrepreneurial risk-taking functions. The economic ownership of the financial asset is generally attributed to the location performing those functions, while the supervision of the management of the bank's overall capital and risk exposure would not generally constitute the key function.[52)] The analysis of risks assumed should include several risks, such as credit risk (most important), market interest rate risk, market foreign exchange risk. It is needed to identify all risks including those related to off-balance sheet items.[53)] When there are transfers of risks within a bank, it will be treated as initially assumed by one part of the bank and subsequently borne by another part.[54)]

(1) Recognition of Internal Dealings

Bank branches generally enjoy the same creditworthiness as the enterprise as a whole, which enables them to borrow and on-lend at a profit on the same terms.[55)] So the OECD does not accept the existence of dealings similar to guarantees within a single bank.[56)]

---

50) Kobetsky, *supra* note 10, at 293.

51) OECD, *Report on the Attribution of Profits to Permanent Establishments Part II*, para. 4 (2010d).

52) *Id.* at paras. 8, 10.

53) *Id.* at para. 19.

54) For example, a bank can bear all risks apart from the credit risk by retaining ownership of the financial asset but transferring the majority of the credit risk by executing a credit derivative with another enterprise. *Id.* at para. 21.

55) *Id.* at para. 81.

56) *Id.* at paras. 54, 82.

Traditional banking involved borrowing money from depositors for on-lending to third parties. Interest costs are consequently an intrinsic part of a bank's business, and its trading profits can only properly be determined by deducting such costs, even if they come from internal loans. This is the main difference with other business.[57] In the Example 2) in the introduction, the intra-bank interest dealings of A with H and B in the ordinary course of its business can be identified.

Any dealings purporting to transfer ownership of financial assets to another part of the enterprise would not be recognized as a transfer of economic ownership unless the transfer was accompanied by a transfer of key entrepreneurial risk-taking functions. This evaluation has to be made on a case-by-case basis after a careful analysis of the exact nature of the functions performed and a comparability analysis as to how independent enterprises would structure the dealing in similar circumstances.[58] Where a permanent establishment provides services to the part of the banking enterprise performing the key functions, recognizing an intra-entity dealing is the way to compensate the service provider in accordance with the arm's length principle.[59]

(2) Attribution of "Free Capital"

The OECD suggests that the standardized approaches of risk-weighting assets under the latest version of the Basel Accord can be a reasonable proxy for measuring risks under the arm's length principle and have the advantage of providing an internationally accepted and reasonably consistent way of measuring risk.[60] Given the need for flexibility, it is also suggested that a variety of regulatory based approaches to measure risks may be acceptable, as far as they are consistent with the arm's length principle.[61]

The capital attribution methods accepted by the OECD are 1) capital allocation approaches, where a bank's actual free capital is allocated in accordance with the attribution of financial assets and risks, and 2) thin

57) *Id.* at para. 59.

58) *Id.* at para. 139.

59) *Id.* at para. 68.

60) *Id.* at para. 94.

61) *Id.* at para. 95.

capitalization approaches, under which a permanent establishment would be attributed the same amount of free capital as would an independent banking enterprise carrying on the same or similar activities under the same or similar condition. An alternative approach is quasi thin capitalization/regulatory minimum capital approach, which would require a permanent establishment to have at least the same amount of free capital attributed to it as would be required for regulatory purposes for an independent banking enterprise operating in the host country.[62] In the Example 2 in the introduction, the main issue will be the allocation of "free capital" in order to determine the deductibility of paid interest.

(3) Adjustment of Interest Rates

Funds raised by the bank are from a variety of sources and have varying interest rates. Some funds are free or give rise to very low interest rates, while others give rise to high interest rates, such as subordinated debt. If any internal interest dealings are charged at an appropriately blended rate to reflect the proportions of funding at different interest rates and maturities, there should be no need to make further adjustments.[63]

On the contrary, if internal dealings are priced by reference to market wholesale interbank interest rates, this rate may not be an appropriate comparable without an adjustment to reflect the actual funding mix of the bank of which the permanent establishment is a part. Also the amount of interest expense should not exceed the arm's length amount.[64]

III. Comparative Analysis

1. The United Kingdom

1) Overview

The UK corporation tax has the main rate of 26%.[65] There is no branch profits tax for a permanent establishment of a foreign company which some

62) *Id.* at para. 97.

63) *Id.* at para. 120.

64) *Id.* at para. 121.

65) It is the figure for the financial year 2011. The same will be below.

other countries have. The provisions of double tax treaties entered into by the UK apply in precedence to domestic legislation as provided at Taxation (International and Other Provisions) Act ('TIOPA') 2010, s. 2. If the treaty terms of how income or gains should be attributed to a permanent establishment differ from the UK domestic attribution provisions, then the treaty provisions would take precedence. In practice, however, it is unlikely that a UK treaty would differ materially from domestic legislation, because most UK treaties are written in the same or similar terms to the OECD Model and the domestic legislation also contains mainly the same principle. The UK has concluded around 120 tax treaties.

In the past the UK employed the concept of a 'branch or agency'[66] that brought the non-resident company within UK corporation tax. This led to some confusion as this branch or agency concept did not constitute a permanent establishment in the tax treaties signed by the UK. Effective from 1 January 2003, however, a definition of a permanent establishment was incorporated in the Finance Act ('FA') 2003 s. 148,[67] though it cannot be said having the exactly same meaning with that of the OECD Model.

It is clear under the current domestic law that a company not resident in the UK is within the charge to corporation tax if, and only if, it carries on a trade in the UK through a permanent establishment in the UK.[68] The UK does not have the force of attraction principle.[69] The chargeable profits are divided into two categories. The first type is trading income, income from property or rights, and chargeable gains from assets under the Taxation of Chargeable Gains Act ('TCGA') 1992, s. 10B. The second one is profits attributable to the permanent establishment according to the separate enterprise principle.[70] The main principle for determining the profits attributable to a permanent establishment of a non-resident company under the second category taxation is given by CTA 2009, s. 21, which is similar to the OECD's approach.

---

66) The concept of "branch or agency" has been considered on numerous cases by the courts, but mostly they are old and of limited practical use. Barry Larking, *The United Kingdom*, International Bureau of Fiscal Documentation, 33, 37 (2005).

67) Now the Corporation Tax Act ('CTA'), s. 1141 (2010).

68) *Id.* at ss. 5(2), 19(1).

69) *See* footnote 108 in the US section.

70) *Supra* note 67 at s. 19(2), (3).

The current tax law of the UK clearly adopts the separate enterprise principle to the apportionment of profits to a permanent establishment, applying the arm's length principle to dealings between a permanent establishment and other parts of the enterprise, which is largely influenced by Articles of the OECD Model and Commentaries.[71] Therefore, for the purposes of computation of profits, the permanent establishment is to be considered a distinct enterprise separate from the enterprise as a whole. Internal dealings between a permanent establishment and other parts of the enterprise are treated as taking place on arm's length terms. Also, a permanent establishment is to be regarded as having the same credit rating as the enterprise as a whole, and such equity and loan capital as it could reasonably be expected to have if it were an independent enterprise. Hence any tax deductions would be denied in respect of costs in excess of those that would have been incurred in the assumptions, which will be described with details below.

Not every change in the 2010 OECD updates, however, has been incorporated into the UK's domestic law, so some differences are found. Besides, new tax treaties which were concluded in 2010 by the UK used the old wording of Article 7 based on the OECD Model prior to the 2010 updates. Certainly not too much weight should be given, but it indicates that there will be many years before the new wording will be found in the majority of the UK tax treaties.[72]

On the other hand, UK resident companies are charged corporation tax on their worldwide profits, with relief on any foreign tax paid on the same profits to the extent that it does not exceed the UK corporation tax on those identical profits.[73] Where no treaty applies, the unilateral tax credit [74] is allowed.[75] The new legislation in 2011 allows profits and losses of foreign

---

71) FA 2003 added s. 11AA to the Income and Corporation Taxes Act ('TA') (1988), which reflects the wording of the OECD Model.

72) Philip Baker, *A Note on Recent UK Tax Treaty Developments*, British Tax Review 2, 129 (2011)

73) *Supra* note 67, at s. 5(1).

74) TIOPA (2010), s. 9.

75) Where the treaty expressly grants a credit for foreign tax paid, or where the treaty expressly denies a credit, unilateral relief is not available. *See id*. ats. 11. For the history, *see* John Tiley, Revenue Law, 1215 (6th ed., 2008)

branches of a UK company to be outside the scope of UK corporation tax by exemption provision, if an appropriate election is made.[76] The provisions of CTA 2009 have been amended accordingly, and the new CTA 2009, s. 18A provided that where a UK resident company makes an election, the exemption adjustments will be made for each relevant accounting period. These adjustments are ensuring that those branch profits are left out of account in computing the company's chargeable profits.[77] This is optional, so it has no effect unless a company elects for it to apply, but the election for it to take effect is permanent and affects all the permanent establishments of a company.[78]

2) The Intra-Enterprise Transactions

UK tax law recognizes the internal dealings under certain circumstances and treats them as taking place on such terms as would have been agreed among independent entities.[79]

In terms of the provision of goods or services within a single legal entity, the important point that plays a decisive role is whether the enterprise has also had the same kind of transactions with other separate parties in the ordinary course of its business. If the non-UK resident company provides its permanent establishment in the UK with goods and services which are of a kind that the company supplies to third parties in the ordinary course, the transaction is recognized according to the separate enterprise principle. To the contrary, if the provision cannot be thought as that kind of ordinary transaction, the dealing would not be recognized, and only the expense incurred by the enterprise would be able to be deductible under certain condition.[80]

Admitting the special problems with the international bank business, the UK law has special provisions for the treatment of permanent

---

76) FA (2011), s. 48.

77) *Tolley's Corporation Tax*, 820 (2011).

78) HM Revenue and Customs ('HMRC') Manuals INTM 281010 "Foreign Permanent Establishments of UK Companies: introduction: overview."

79) But the UK has a book value rule for property transfers between related parties in order to prohibit it being abused as a means of crystallizing losses. TCGA (1992), s. 171. For details, *see* LEE CHANG HEE, TAX LAW, 1136-1137 (9th ed., 2008).

80) *Supra* note 67 s. 23 (2), (3).

establishments of banks. In cases of transfer of a loan or other financial asset between a branch of a non-UK resident bank and any other part of the bank, the transfer would be recognized with the application of the separate enterprise principle, only if it would have taken place between independent enterprises.[81] On the contrary, if it cannot reasonably be considered that the transfer is carried out for valid commercial reasons, the intra-bank transfer would not be recognized. To obtain a tax advantage does not constitute a valid commercial reason.[82]

The general principle of deciding the attribution of financial assets and profits is that the loan or other financial assets and profits arising from those assets which can reasonably be regarded as having been generated by the activities of the permanent establishment are to be attributed to the permanent establishment.[83] In determining whether it comes from the activities of the permanent establishment, different factors that should be taken into account and some factors that may be considered are provided in the statute. The former factors, such as getting the offer of new business, estimating the credit of the potential borrower and the risk of the loan, negotiating the terms of the loan agreement, and deciding whether to make or extend the loan under what conditions, are ones that are normally regarded as the key entrepreneurial functions in the banking business, while functions such as concluding the loan agreement, disbursing the proceeds of the loan, administering the loan, and holding and controlling securities are regarded as the supplementary factors that may be taken into account.[84]

When a permanent establishment borrows funds for the purposes of another part of the company and acts only as an agent or intermediary, the profits and the capital attributable to the permanent establishment are to be those appropriate in the case of an agent acting at arm's length, taking into account the risks and costs borne by it.[85]

---

81) *Id.* at s. 26(2).

82) *Id.* at s. 26(3), (4).

83) *Id.* at s. 27(2).

84) *Id.* at s. 27(3), (4).

85) *Id.* at s. 28(2).

3) Deductibility of Expenses

Generally, expenses incurred for the purposes of the permanent establishment including executive and administrative expenses can be deductible irrespective of whether the expenses are incurred or reimbursed by the permanent establishment. This applies whether or not the expenses are incurred by the UK permanent establishment itself or by another part of the non-resident company in another territory, but the expenses must actually have been incurred as a real cost by the non-resident company.[86)]

For example, no deduction could be allowed to a permanent establishment for rent hypothetically charged to it by the rest of the entity as a whole. Rent could only be allowed as a deduction in calculating the permanent establishment's profits if the entity as a whole paid rent to another party for premises that were used in the permanent establishment operations, i.e. a real cost had been incurred and it was attributable to the permanent establishment.[87)] This attitude has not been changed after the OECD 2010 updates which implies the recognition of notional rents in certain circumstances.

As to the dual purpose expenditure which is incurred both for the purposes of the head office and the permanent establishment, such as central administration expenses and similar costs, the deduction was thought as being denied under the UK tax law.[88)] This is due to the wholly and exclusively rule.[89)] The key point of this test is the purpose of the expenditure. The expenditure incurred with a dual purpose, part of which is not to benefit the business of the taxpayer, is not deductible. Generally, it is understood that the dissection of expenditure is allowed, while the apportionment is not guaranteed.[90)] In practices, however, where an identifiable part or proportion of an expense was incurred wholly and exclusively for the purposes of the

---

86) *Id.* at s. 29.

87) This example is provided in HMRC Manual INTM 267100 "Allocation of expenses in the attribution exercise."

88) Harris, *supra* note 32, at 161.

89) TA (1988), s. 74(1)(a). Now, CTA (2009), s. 54(1).

90) The expenditure which had the incidental effect of furthering other business remained deductible. *See Robinson v Scott Bader Company Limited*, [1981] STC 436. For details of this rule, *see* Keith M. Gordon, Ximena Montes Manzano & John Tiley, *Tiley and Collison's UK Tax Guide 2011-2012*, 681-687 (29th ed., 2011).

trade, HMRC did not disallow the deduction.[91) CPA 2009, s. 54(2) provides that a deduction for any identifiable part or identifiable proportion of the expense is not prohibited. Now, HMRC clarifies that, where expenditure is incurred for other purposes apart from those of the UK permanent establishment alone, "a reasonable apportionment could be made to calculate the expense attributable to the UK permanent establishment."[92) An example given by HMRC is a payment for marketing services. If the Swiss head office paid a monthly fee to a marketing consultant for services provided to permanent establishments in various countries including the UK, the monthly fee could be apportioned on any reasonable basis. This can be by reference to a proportionate part of the expense based on relative turnover being attributed to each part of the entity whose operations received marketing services. It is also explained that the expenses attributable may include a proportionate part of general administrative costs of the entity as a whole. Any reasonable method of apportionment can be adopted, e.g. relative turnovers or gross profits of the different parts of the enterprise. This seems to follow the view of 2008 OECD Commentary.[93) Care should be taken to eliminate expenditure that would not be allowable under UK domestic law, e.g. capital costs or business entertaining.

For interest expense on internal loans, the UK tax law generally prohibits a permanent establishment of a non-resident company from claiming the deduction of such interest.[94) According to HMRC, the circumstances when payments of interest or other financing costs can be considered for deduction in calculating the profits of a non-financial business permanent establishment are where the entity as a whole has incurred such a payment to an external party and the payment was wholly or partly in respect of the business of the permanent establishment. For example, if a non-resident company pays interest under a loan agreement in respect of funds used to purchase plant and machinery that is employed in the business carried out through the UK permanent establishment, the permanent establishment can claim interest deduction. The new change in

91) *Supra* note 77, at 1811.

92) *Supra* note 87.

93) *Supra* note 41, at para. 27.

94) CTA 2009, s. 32.

the OECD 2010 Report has not been reflected.

However, regulated banks or other financial businesses can be allowed the deduction of interest expense on internal loans.[95] When a permanent establishment borrows the fund in the ordinary course of a financial business carried on by it, the interest paid by the permanent establishment to other parts of the enterprise is deductible. But, there is an important restriction on this interest deduction, i.e. "free capital." The permanent establishment is treated as having such equity and loan capital as it could reasonably be expected to have if it were a distinct and separate enterprise.[96] This requires that a bank branch should maintain the equity capital that a domestic bank would have to hold for prudential purposes. Prior to 2003, a permanent establishment was free to borrow the whole of the funds used in its business. This had often resulted in higher funding costs and in lower profitability for the permanent establishment. It was quite possible for a foreign bank that was profitable overall to make a substantial loss in its UK permanent establishment, even if the terms on which the bank as a whole and the permanent establishment do business were broadly the same. To respond to this problem, TA 1988, s. 11AA(3)[97] introduced the requirement of capital attribution to a permanent establishment. When it was first enacted, the UK Inland Revenue made it clear that a treaty would only override the rules of legislation if it has specific provisions on capital attribution that either prohibit this statutory approach or have a different effect on it.[98] Now, this has been adopted by the OECD later as being seen above.

The process of capital attribution under the UK law can be broken down into five steps.[99] It seems to use the thin capitalization approach.[100] It is

95) *Id.* at s. 32(2).

96) *Id.* at s. 21(2)(b).

97) Inserted by FA (2003), s. 149(2). Now CTA (2009), ss. 21(2), 30.

98) There is a view that questions whether this position of the Revenue is contrary to UK treaty obligations that predate FA (2003) since the new rules mark a significant change to the past UK position. Arun Birla, *The Attribution of Profits – Fact or Fiction?*, British Tax Review, 125-131 (2005).

99) For the detailed explanation of each step, *see* HMRC Manual INTM 267707, 267710, 267760, 267770, and 267780.

100) HMRC Manual INTM 267120 "Attribution of capital to the permanent establishment

useful to see an example[101] provided by HMRC for capital attribution to a banking permanent establishment. Suppose a UK branch of a foreign bank is funded by its head office with 1) short terms loans of £800m at an interest cost of 5%, 2) a ten year loan of £25m at an interest cost of 7%, and 3) an interest-free allotment of capital of £75m. Also assume that 1) under the current legislation it is required that the branch to have equity capital of £150m and loan capital of £50m, 2) the appropriate interest rate for attributed loan capital is agreed at 6%, and 3) the funding to be displaced by the attributed equity and loan capital is agreed as the £75m allotted equity, £25m ten-year loan and £100m of the short-term loans. The interest costs to the displaced funding is £6.75m (= £75m × 0% + £25m × 7% + £100m × 5%), while the total interest costs after the attribution is £3.0m (= £150m × 0% + £50m × 6%). As a result, the costs to be disallowed under the capital attribution tax adjustment would be £3.75m (= £6.75m – £3.0m).

Importantly, no deduction is allowed for royalties paid by the permanent establishment to any other part of the enterprise in respect of the use of intangible assets held by the company.[102] Only the costs of creation of an intangible asset contributed by the permanent establishment can be deducted.[103] This is different from AOA which admits the possibility of recognition of notional royalty in the computation of taxable profits of a permanent establishment. HMRC explains that where a payment for the use of intangible assets can be allowed to the permanent establishment is only where the entity as a whole has incurred a payment for the use of intangible assets to an external party and the payment was wholly or partly in respect of the permanent establishment's business.[104] A typical example given is the non-resident company who pays royalties under a license agreement to use particular software that is employed in the business carried out through the UK permanent establishment.

– companies only: FA2003 domestic legislation – an overview."

101) HMRC Manual INTM 267782 "The attribution of capital to foreign banking permanent establishments in the UK: The approach in determining an adjustment to funding costs - STEP 5: Determining the capital attribution tax adjustment: Disallowance of interest and other costs on funding equivalent to attributed equity - an example."

102) CTA, s. 31(1).

103) *Id.* at s. 31(2).

104) HMRC Manual INTM 267100 "Allocation of expenses in the attribution exercise."

2. The United States of America

1) Overview

The US has the corporate tax at the progressive rates from 15% to 35%[105] for the federal taxation. Also a foreign corporation operating in the US through permanent establishment is subject to the branch profits tax.[106] The US domestic tax law does not use the term 'permanent establishment', but uses the permanent establishment concept in its tax treaties. On top of that, the two approaches of domestic law and tax treaty regime are so different that, unlike the UK, whether to fall under the treaty umbrella makes a big difference.[107] The US has concluded 60 tax treaties approximately. This gap between treaty regime and non-treaty regime may result in problems of disparity and unfairness.

Under the domestic law, US source taxable income generated by non US corporations[108] can be categorized into two classes: income effectively connected with the conduct of a trade or business within the US ('ECI') and

---

105) Internal Revenue Code ('IRC') 1986, s. 11(b).

106) *Id.* at s. 884(a). For the history and the problems of the branch tax, *see* AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW – AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 92-96 (2007). The branch tax is imposed at a rate of 30% and applies to the extent that amounts remitted by the US branch to its home office are deemed equivalent to a dividend. Most tax treaties mitigate the rate and some of them waive it entirely.

107) Irene J.J. Burgers, *The New OECD Approach on Profit Allocation: A Step Forward Towards Neutral Treatment of Permanent Establishments and Subsidiaries*, FLORIDA TAX REVIEW, 52-53 (2009).

108) Prior to 1966, the US applied the "force of attraction" principle to tax US source income of non-residents, under which all of a foreign person or corporation's US-source income would be subject to US tax if the foreigner was engaged in a US trade or business. Since 1966 the force of attraction principle has been largely replaced by the "effectively connected" concept. *See* H. David Rosenbloom, David K. Sutherland & Diane M. Ring, *The United States*, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, 51 (2005); Avi-Yonah, *supra* note 106, at 79-81.

Still a limited force of attraction principle is applied under section 864(c)(3) of IRC 1986, but treaties contain the identical language of Article 7(2) of the OECD Model which is regarded as reversing the limited force of attraction policy and limiting US taxation of the PE to the income earned directly through the business activities of the permanent establishment. Joseph Andrus & Daniel Rinke, *The United States*, REIMER, URBAN & SCHMID, 18 (2011).

income not effectively connected.[109] The former, income from an active trade or business in the United States is taxed on a net basis at standard corporate tax rates.[110] In determining the effective connectedness, most US source income is effectively connected, and most foreign source income is not.[111] Income that is passive in nature, such as dividends, interest, rents and royalties[112] is taxed generally at a flat 30% rate based on the gross amount of payment without any deductions.[113] But if passive income is attributable to the business of a permanent establishment, i.e., it is effectively connected with business in the US, it is also taxed on a net basis along with other business income with the normal rates.[114]

For the apportionment of profits to permanent establishments, the general treaty policy of the US is to apply the separate entity approach and the arm's length principle in a manner consistent with the OECD Model. Recent treaties with the United Kingdom, Japan, Canada and Germany explicitly apply the separate entity approach. However, some formulary methods are found in the domestic tax law.[115] Treasury Regulation s. 1.882-5 uses the formulary approach in allocating interest expenses and IRC 1986 s. 842(b) requires foreign insurers to allocate investment income to their permanent establishment on a formulary basis. It seems apparent that this is not consistent with the arm's length standard because it relies on the different assumption.[116] Consequently, each of these formulary methods to

---

109) *Supra* note 105 s. 882(b).

110) *Id*. at s. 882(a)(1).

111) Kirsch (2010), 1000.

112) They are often called "investment income."

113) *Id.* at at ss. 871(a), 881(a), 1441.

114) While the 30 percent gross tax rate in passive income has remained unchanged since the 1940s, the net tax rates have been changing very largely. As a result, there were also changes in whether it is beneficial to apply the flat rate or the net rate. In many situations it is not difficult to choose between the two categories, because making passive income being connected with business in the US is not so hard. Avi-Yonah, *supra* note 106, at 64-65, 80.

115) Also the US states have had operating their own formulary systems for the taxation of multi-state entities. For the explanation of these formulary methods, *see* Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, TAX L. REV. 61, 198-219 (2008).

116) The formulary method begins with the assumption that the multinational group is a single entity, as opposed to the separate entity approach. It first determines the net income for the group as a whole and the proportion of the business conducted in the US (normally by

permanent establishments has been held by the courts to violate the treaty provisions. In *North West Life Assurance Company*,[117)] the provision of IRC s. 842(b) applying the formulas testing the average asset to liability ratios and the average investment yields either of the domestic insurance industry or of the taxpayer's global operations was held inconsistent with Article 7(2) of the United States – Canada tax treaty. As to the interest expense allocation, three *Natwest* cases will be discussed later in the following section. But importantly, the formulary methods have been considered valid for the cases where a treaty does not exist.

The US was an active participant in the OECD discussions leading to AOA and has clearly changed its treaty negotiating policy, but it has not yet updated its regulations or changed statutory law to reflect the OECD principles. As a result, some of them still include the formulary methods which are not consistent with the notion of the separate entity approach adopted by the OECD as an authorized method.

On the other hand, the US law taxes income of its residents on a worldwide basis, but even where no tax treaty applies, it provides a foreign tax credit for taxes paid to the jurisdiction where the permanent establishment operates.[118)] Recent US treaties contain a provision to limit the treaty relief to the relief granted under US domestic foreign tax credit principles.[119)]

2) The Intra-Enterprise Transactions

The recent treaties applying the separate entity approach apparently closely mirror the OECD's authorized approach, including identifying the key entrepreneurial functions, allocation of risks based on those key

---

averaging percentages of assets, payroll, and sales) and then simply multiply them.

117) *North West Life Assurance Company of Canada v. Commissioner of Internal Revenue* (1996) 107 TC 363. The court indicated that the amount of investment income of the taxpayer subject to tax in the US should be determined by reference to the assets on the books of the permanent establishment and the investment yields achieved by it than by applying the statutory formula, since it was essential, under the tax treaty, to look to the actual operations of the permanent establishment rather than a generalized formula.

118) *Supra* note 105, s. 901. Generally, the provisions of tax treaties override the previously enacted US Tax Law. Shelton (2004), 270-271.

119) For example, US-Germany Tax Treaty, art. 23. Rosenbloom, *supra* note 108, at 65.

functions, and allocation of assets based on location of risks. It is yet uncertain how the US will implement the AOA in terms of the recognition of internal dealings within an enterprise, for example, a notion that a permanent establishment should pay for home office services on an arm's length basis in certain circumstances.[120)] Where no treaty applies, the effectively connected income principles of domestic statutory law still apply along with the formulary apportionment principles applicable to insurance company investment income, bank capital and interest expense.

General rule in the US is that transactions occurring within the same legal entity are not recognized for tax purposes.[121)] In other words, intra-entity dealings were disregarded under the US tax law. Even most US treaties include the provision of the separate enterprise principle which is similar to the previous version of the OECD Model, The Internal Revenue Service ('IRS') generally has interpreted them not to allow recognition of internal transactions.[122)]

Consequently, a transfer of assets or functions between a permanent establishment and its home office has not been recognized under prevailing US law.[123)] Also when a branch of a company manufactures goods in one country and another branch of the same company sells those goods in the US, income has been apportioned between a manufacturing branch and a US sales branch through a formula that attributes one half of the income to the place of sale and the other half to the place where the production assets are located.[124)]

The exception to this general rule of non-recognition of intra-entity transaction may be that the proposed regulations relating to global dealings in financial products permit to recognize the intra-entity dealings.[125)]

The IRS has not provided any further guidance on how it intends to implement suggestions in the new OECD Report that, for treaty purposes, internal dealings be respected for income attribution purposes.

---

120) Andrus, *supra* note 108, at 20.

121) *Id.* at 22.

122) Rosenbloom, *supra* 60.

123) Andrus, *supra* note 108, at 22.

124) Brian J. Arnold & Michael J. McIntyre, International Tax Primer 73-74 (2nd ed., 2002).

125) Andrus, *supra* note 123.

3) Deductibility of Expenses

Generally non-resident corporations subject to net basis taxation on business profits are entitled to deduct expenses that are effectively connected or attributable to the operations of the US trade or business.[126) The detailed rules of the apportionment and allocation of the deductions are provided in Treasury Regulations.[127) The itemized deductions are governed by IRC 1986, s. 162 and etc.

Where there are treaties, a permanent establishment is allowed to deduct expenses incurred for the purposes of furthering its business, regardless of where the liability is actually booked. It includes interests, research and development expenses, and a reasonable portion of expenses of its head office such as general executive and administrative expenses that are related to the management of the US permanent establishment.[128)

In the past, it was clear that deductions were limited to an allocable share of actual expenses and did not involve a profit element because no internal dealings were recognized.[129) Now the US seems to have changed its treaty policy, but it has not established a new provision to reflect the change.

A formulary method is found in determining the interest deduction of a bank branch. It is the Treasury Regulation s. 1.882-5 that provides the exclusive rules for this.[130) Initially it always applied regardless of tax treaty, but it was amended to provide US branches of a foreign corporation with the option to use the treaty method.[131)

The main process is through the three steps. First, the total value of the US assets of a foreign corporation is determined. Next, the amount of US connected liabilities is determined. The amount of US connected liabilities equals the total value of US assets multiplied by the actual ratio or by the

---

126) *Supra* note 105 s. 882(c)(1)(A).

127) For the general rules, *see* Treasury Regulation, s. 1.882-4.

128) Some tax treaties contain a clear notion of this. For example, *see* US-Germany Income Tax Treaty, Article 7(3); US-Italy Income Tax Treaty, Article 7(3).

129) Andrus, *supra* note 108, at 20.

130) Treasury Regulation, s. 1.882-5(a)(1)(i).

131) Now, unless expressly excluded, the provisions apply to tax treaty situations as well. *Id.* at s. 1.882-5(a)(2).

fixed ratio if the taxpayer has made an election.[132] The actual ratio is the total amount of its worldwide liabilities divided by the total value of its worldwide assets.[133] The elective fixed ratio is 95 percent for a bank, and 50 percent for a taxpayer who is neither a bank nor an insurance company.[134] Finally the amount of interest paid or accrued on US booked liabilities is adjusted for interest expense attributable to the difference between US connected liabilities and US booked liabilities. For this purpose, a transaction of any type between separate offices or branches of the same taxpayer does not create a US asset or a liability.[135] Under this provision, a US branch would be deemed to have liabilities either in an amount equal to its assets multiplied by the ratio of the international bank's world-wide liabilities to assets, or, at its election, in an amount equal to assets multiplied by a fixed ratio of 95 percent. A branch of a foreign bank is entitled to an interest expense deduction on liabilities booked to third parties at the booked interest rates, and to the extent that its deemed liabilities exceed booked third party liabilities, it is also able to deduct interest expense on such excess liabilities at the average rate paid by the bank on liabilities outside the US.

Regarding this formulary rule, there were three cases of *National Westminster Bank plc*. In the first case, whether the formulary method could be used to determine the interest deduction of the US branch was the main issue.[136] Like many other banks, NatWest conducts most of its international operations through branches. During the years at issue, the US branch funded its operations not only by loans from unrelated third parties but also by internal loans from its head office and other branches, paying

---

132) *Id.* at s. 1.882-5(c)(1).

133) The total amount of worldwide liabilities is the average of the sums of the amounts of the taxpayer's worldwide liabilities. *See id.* at s. 1.882-5(c)(2).

134) *Id.* at s. 1.882-5(c)(4).

135) *Id.* at s. 1.882-5(b)(1)(iv), (c)(2)(viii), (d)(2)(viii).

136) *National Westminster Bank PLC v. United States* 44 Fed Cl 120 (1999). Although the OECD material used as an interpretive aid in this case was the 1963 OECD Model and Commentary which was the version applicable at the time the 1980 US-UK treaty was concluded, it provides case law on the deductibility of interest on intra-bank loans. Kobetsky, *supra* note 10, at 253. The US Court of Appeals for the Federal Circuit in *National Westminster Bank PLC v. United States* 512 F 3d 1347 (2008) affirmed the decisions by the trial court.

interest on such loans and reflecting these amounts in its branch books of account. The US branch claimed deductions for all the interest expenses shown in its books, including interest expense attributable to the internal loans. IRS asserted that the US branch was required to compute its interest expense in accordance with a formula set forth in the Treasury Regulation. Under this formula, the US branch would have been allowed an interest deduction, but not to the full extent of the booked interest on internal loans. The court held that the formulary method conflicted with the separate entity method prescribed in the 1980 US-UK treaty and the treaty prevailed over the Treasury Regulation.[137)]

The issue of the second litigation was which method should be used to determine the interest deduction under Article 7.[138)] The court concluded that a foreign bank branch's profits must be based on the branch's books, and they may only be adjusted if they do not correctly reflect intra-bank loans or where the branch's intra-bank interest expense exceeds arm's length rates. Also the court rejected the IRS's argument of attribution of equity capital on the ground that there was no such understanding between two countries when the 1980 US-UK treaty was negotiated.

In the third case, one of the issues was whether NatWest's six US branch offices should be treated as a single permanent establishment or six different ones.[139)] The court held that NatWest had one US permanent establishment and to aggregate the records of the six branches was appropriate.

Most newly entered US tax treaties allow the contracting parties to treat a permanent establishment as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. This is similar to the OECD's "free capital" concept. To the extent that a permanent establishment lacks sufficient capital which may be attributed to the permanent establishment by operation of US tax regulations, interest deductions may be denied. A permanent establishment will have to have capital allocated to

---

137) *National Westminster* (1999), 130-131.

138) *National Westminster Bank PLC v. United States* 58 Fed Cl 491 (2003). This was also affirmed by the Court of Appeals.

139) *National Westminster Bank PLC v. United States* 69 Fed Cl 128 (2005).

it based on the amount of risk represented by the business activities conducted there.

However, there are difficulties in weighing the risks and the US regulatory rules which are heavily formulaic might not adequately address the allocation of capital based on a risk-based model. More recent treaties as well as the 2006 US Model explanation recognize the potential conflicts between treaties and the regulations and allow taxpayers to apply a more flexible approach regarding the allocation of capital to take into account the risks inherent to a business. Since the domestic tax regulation at issue is not flexible enough to account for the varying degrees of risk in a given business enterprise, the US Model Technical explanation provides that taxpayers may adopt a modified version of the more complicated rules or may choose the risk-weighing method for purposes of allocating capital.[140)]

3. The Republic of Korea

1) Overview

Korea has the corporation tax with the progressive rates from 10% to 22%.[141)] Also a foreign corporation operating in Korea through permanent establishment is subject to the branch profits tax with the rate of 20%,[142)] which can be mitigated or waived by a tax treaty.

Korean domestic tax law uses the term of "domestic place of business" as the almost same meaning of the permanent establishment in the OECD Model. The tax base and the classification of the income sources are provided in CTA, Arts. 91, 93. The calculation of taxable income of a permanent establishment of a foreign corporation starts from the total amount of income generated from its sources in Korea and proceed to deduct its expenses.[143)] The profits attributed to and substantially connected with a permanent establishment are taxed at a normal tax rate.[144)] The

140) Andrus, *supra* note 108, at 20-21.

141) The Corporate Tax Act ('CTA'), Art. 55(1).

142) *Id.* Arts. 96, 98. It can be mitigated or waived by a tax treaty.

143) *Id.* Arts. 91(1), 92(1).

144) Korean domestic law uses both terms of attribution and substantial connectedness without distinction. It will be desirable that it be amended to be consistent with the treaty provisions. *See* Ahn Chang Nam & Oh Kwang Tae, *A Study on the Necessity of Re-establishment*

profits which are not substantially connected with or not attributable to a permanent establishment are taxed by means of withholding tax with a fixed rate.[145)] The meaning of 'substantially connected with' here has been interpreted as almost same as the meaning of 'effectively connected with' in treaty provisions.[146)] Korean source income of a foreign corporation who does not have a permanent establishment in Korea is taxed at respective fixed rates if the income falls in one of certain types of sources provided in the CTA, Art. 93.[147)] Under the tax treaty regime, however, there is no tax on business profits where there is no permanent establishment. In such cases, only investment income such as dividend, interest, or royalty is taxed according to the treaty provisions.

Most tax treaties entered into by Korea follow the attribution principle and the hypothetical separate enterprise approach which was proposed by the OECD Model. Korea has entered into around 77 tax treaties. The National Tax Service ('NTS') has followed the interpretation of the OECD Commentary, and the Korean courts have looked to the OECD Commentary as an important supplementary material in interpreting a tax treaty.[148)] In general, the provisions of a tax treaty override the domestic tax law.[149)]

On the other hand, Korean resident companies are subject to corporate tax on their worldwide income, but the foreign tax credit is allowed. Unilateral foreign tax credit is available where no tax treaty applies.[150)]

---

of the Attribution of Profits to the Dependent Agent Permanent establishments in Korea – under the Authorized OECD Approach, 26 TAX LAW JOURNALS 1, 304-306 (2010).

145) *Supra* note 141 Arts. 91(3), 98(1).

146) Kim Jaeseung, *Taxation of Permanent Establishment of a Foreign Corporation – A case Study of a Foreign Corporation with Passive Income Effectively Connected With Its Permanent Establishment*, 29 JEONNAM NATIONAL UNIVERSITY LAW REVIEWS 1, 256-257 (2009). The tests adopted here are the asset-use test and the business-activities test, which is similar to the US law. See the NTS's General Ruling on the CTA, N. 93-132-18.

147) *Supra* note 141 Art. 91(2).

148) For example, Seoul Administration Court decision 2009. 2. 16. Held 2007 *GuHap* 37650.

149) Seo Kiseok, *The Taxation on the Foreign Corporation – focusing on the cases of the Supreme Court*, STUDY OF SPECIAL LAWS 5, 430 (1997).

150) *Supra* note 141, Art. 57(1).

2) The Intra-Enterprise Transactions

Under the tax treaty regime, since most tax treaties concluded by Korea adopt the separate enterprise approach, the intra-enterprise dealings between a permanent establishment of a foreign company and other parts of the same enterprise are, in general, treated as if they were the transactions between separate enterprises, provided they pass the threshold for the recognition. A mere purchase of goods for the head office has not had a tax effect. This provision is included in most treaties, copying the previous version of the Article 7(5) in the Model.

The way of determining the arm's length price of an intra-entity transaction is mainly the same as that of transfer pricing of related corporations.[151] NTS, however, has been allowed to use the formulary method in calculating the profits attributable to a permanent establishment in exceptional circumstances where an arm's length price is not available.[152] These are the cases where there are not sufficient accounting records and documents.

In practices, internal loans, lease or license agreements within an enterprise were seldom recognized in the computation of profits. However, as Korean government negotiates its treaty provisions based on the OECD Model and generally follow the interpretation of the Commentary, the AOA's functional and factual analysis on internal dealings is expected to affect Korean treaty policies.

On the other hand, under the domestic law, CTA does not provide a clear standard to determine the profits attributable to a permanent establishment. As a result, there is no precise provision on where the internal dealings are recognized for the purposes of the computation of taxable income of a permanent establishment.[153] The current CTA only contains a provision that permits a deduction of notional interest payments by a bank branch made to its head office or other part of the bank, subject to

---

151) Adjustment of International Taxes Act ('AITA'), Arts. 4, 5.

152) Enforcement Decree of CTA ('ED CTA'), Art. 131(3). This exceptional formulary method has been accepted by the courts. Supreme Court [S. Ct.], 91*Nu*8852, June 23, 1992 (S. Kor).

153) To insert an explicit provision of the separate enterprise approach into CTA is being demanded by commentators.

the deemed capital requirement.[154] If a limited interpretation is employed, it may be read that except internal loans within a bank, other types of internal dealings are not recognized under non-treaty situations. However, as see above, AITA includes the permanent establishment of a foreign corporation in the application of the arm's length principle. NTS states that the intra-enterprise transactions are subject to the application of the transfer pricing rule by analogy.[155] Also, some commentators argue that the separate enterprise approach is implicitly adopted by the Korean domestic law. Therefore it can be interpreted that there are possibilities for other types of internal dealings to be identified, though it is hard to meet the threshold.

In the past, the Korean courts interpreted that the intra-bank loan dealings were not recognized at all for the purposes of tax. The Supreme Court decision 1985. 11. 12. Held 83 Nu 40 is the representative of the old cases. In this case, a Korean branch of an international bank paid some interests to its head office in terms of L/C sales dealings and etc. The branch claimed the deduction for those interests, which were denied by the tax authority. The court was in favour of the tax authority on the ground that internal loans were not real transactions that gave rise to a tax effect since the branch and its head office were legally and economically belonging to the same enterprise.

However, NTS made a new ruling about the deductibility of interest paid by a bank branch to its foreign head office in 1987[156] in order to reflect the international practices, followed by the amendment of CTA to the current position. The principle of this rule is that interest which could be determined to be paid to its debt not to its capital would be deductible, as see below. This is based on the assumption that the internal interest dealing between a branch of an international bank and other parts of the bank could be recognized.

Korean domestic law does not provide further provisions regarding internal transactions. But most tax treaties which Korea has concluded have

---

154) ED CTA, Art. 129-3.

155) NTS (2011), 145.

156) NTS 1987. 3. 11. Ruling N. 87-11. It was partly amended by NTS 1999. 9. 1. Ruling N. 99-29.

the same provisions as the former Articles of the OECD Model, and the domestic tax law has been amended to reflect the international tendency. Since the 2010 OECD updates extended the separate enterprise approach to the inter-enterprise dealings, there may be a reform of the domestic law in the near future.

3) Deductibility of Expenses

The general principle of Korean tax law about the deductibility of expenses is that expenses are deductible only if they are reasonably connected with the Korean source income.[157)] As a result, the expenditure which is incurred by the Korean permanent establishment but not connected with the Korean source income shall not be deducted.[158)] The cost for the mere purchase of goods for the head office by a permanent establishment is one of those that are denied the connection with the Korean source income.[159)]

For the provision of funds from head office or other parts of an international bank to the permanent establishment, there is a limitation according to the "deemed capital" requirement.[160)] A branch of an international bank is required to have a certain amount of capital attributed to it, which is called "deemed capital." There are two ways to calculate the deemed capital. The first one is to multiply the value of total assets attributable to the permanent establishment by the ratio of equity capital to the value of the bank's worldwide assets. The other one is to allocate the deemed capital of a permanent establishment based on the functions performed, assets owned and risks assumed by the permanent establishment. This provision only applies to a branch of a bank.[161)]

The deemed capital is required for the credibility of the bank branch, and the provision of funds from the head office or other parts of the bank is not recognized if it violates the assumption of deemed capital. As a result,

---

157) ED CTA, Art. 129(1).

158) *Id.* Art. 129(2).

159) Enforcement Regulation of CTA ('ER CTA'), Art. 63.

160) There is a separate provision to limit the deductibility of paid interest based on thin capitalism. AITA, Art. 14; Enforcement Decree of AITA ('ED AITA'), Art. 24. The total amount of paid interest that is not deductible is adjusted to avoid the double counting.

161) *Supra* note 158 Art. 63-2(2).

the interest paid on the deemed capital is not deductible.

The common expenses of the head office and other related branches of the enterprise managing over the permanent establishment could be deducted from the profits of the permanent establishment, if they have a reasonable connection with the generation of income in Korea obtained by the permanent establishment.[162] Expenses for the exclusive performance of the head office such as audit, issuing stocks or publishing financial statements, costs for a specific branch or head office, and investment expenses in other corporations do not have a reasonable connection.[163]

The costs incurred outside Korea also can be considered, provided the allocation of the costs was reasonable. The principle was declared in 85 Nu 883 of the Supreme Court[164] which was the case of a Korean branch of a German bank. The court held that the direct expenses by the head office for the purposes of the branch are obviously accepted as losses deductible from the profits of the branch, and a reasonable portion of indirect expenses such as operation and general administrative costs which were incurred as common expenses for the enterprise as a whole is to be also recognized regardless of the actual place of incurring, subject to the domestic tax law as long as it does not violate the treaty provisions.

The method of allocation of common expenses is required to be reasonable,[165] and to the extent the method is reasonable, the expenses can be allocated not only by the respective allocation approach of each item, but also by the overall profit proportion of the permanent establishment over the worldwide profits of the enterprise as a whole.[166] The methods provided in the NTS's ruling are not definitive, and as a result, other methods are acceptable so long as they are reasonable.[167]

162) ED CTA, Art. 130(1).

163) These examples are given in ER CTA, Art. 64(1).

164) Supreme Court [S. Ct.], 85*Nu*883, January 31, 1989 (S. Kor).

165) CTA, Art. 92(1), ED CTA Art. 130(1), (2), ER CTA Art. 64(1).

166) ER CTA Art. 64(2). The overall proportionate method was confirmed by the Supreme Court. *See supra* note 164. .

167) Supreme Court [S. Ct.], 89*Nu*7320, March. 23, 1990 (S. Kor). In this case, a branch of an international bank claimed a deduction of a part of expenses incurred by its head office. NTS denied it because the way of allocation didn't follow the specific way provided in the NTS's rule. However, the Supreme Court declared that the method used by the bank was also

The allocated expenses do not need to be actually repaid by the permanent establishment to the head office. In practices, a branch often decides to remit the money allocated for the common expenses, but this has no relevance. The cancellation of its decision to send back the money does not affect the deductibility.[168)]

In a recent case,[169)] the deduction of notional royalties was not allowed by the Supreme Court on the ground that the arm's length principle does not necessarily require the recognition of notional royalties and that the updated OECD's view does not apply to the cases of the former Article because it was not reflected in the intent of the treaty parties at the time of conclusion,[170)] which seems to follow the static approach in regard to the appropriate version of the Commentary to be considered.[171)]

4. Review

1) Comparison

As see above, these three OECD member countries have different tax law to deal with the identification of transactions of a permanent establishment with other parts of the enterprise and the deductibility of internal expenses and indirect costs.

The UK law is in a position following the attitude of the OECD in most parts to adopt the separate enterprise approach both in the treaty provisions and the domestic tax law. There is a general provision in the statutory law to declare this principle. It has updated its domestic law to adopt the

---

reasonable and acceptable. After this decision the tax authorities amended their rule to follow this principle.

168) Supreme Court [S. Ct.], 2006 *Du* 5175, June 11, 2009 (S. Kor). The head office of a French bank allocated the common expenses to its permanent establishments in various countries including Korea. The permanent establishment in Korea recorded the allocated expenditure, and, at first, decided to remit the allocated money to its head office, but cancelled its resolution later.

169) Supreme Court [S. Ct.], 2007 *Du* 21587, February 24, 2011 (S. Kor). It was a case of a foreign branch of a Korean media company with the issue of foreign tax credit.

170) Cho Yoonhee, *The deductibility of notional royalties in calculating the foreign source income of a corporation for the purpose of foreign tax credit*, COMMENTARIES ON SUPREME COURT DECISION 87, 753-761

171) *See* II. 1. A

functional and factual analysis on the assets used, risks assumed and functions performed by the permanent establishment. For the deductibility of indirect expenses, it has begun to allow the allocation of general administrative costs and other expenses for common purposes. Its requirement of "free capital" as the limitation to the interest deduction is similar to the AOA as well. However, it still remains against to deduction of other notional expenses from internal dealings, while the 2010 OECD Report suggests some possibilities of the recognition of those notional payments. The new tax treaties recently entered into by the UK are not using the new wording of the OECD Model, which might imply its reluctance to accept the new recommendations of the OECD.

The US situation is very unique. The US domestic law doesn't have the concept of a permanent establishment or similar, while most countries are using the concept both in tax treaties and in their domestic law. It has a long history of the formulary methods with the background of federalism. Also, there is a strong tradition of ignoring the internal dealings in the context of anti-avoidance of tax. It is quite unfamiliar for the US law to evaluate assets and risks of a part of a corporation for the purposes of calculation of taxable income. On the other hand, tax treaties entered into by the US include provisions containing the separate enterprise approach following the OECD Model provisions. The formulary method used in the determination of interest deduction was held inconsistent with the treaty provisions, but it is still valid for non-treaty situations. The US has introduced a risk weighing method for capital allocation to a permanent establishment under tax treaties, giving an option to choose between this and a new formulary method. It is hard to find that the existence of internal dealings has been accepted even under treaty situations, save the internal loans of an international banking business. Also, it is uncertain how the US will make a change in this area to reflect the OECD's new recommendation. Indirect expenses are deductible if it is incurred for the purposes of the permanent establishment.

Korea has a general provision to clarify that the arm's length principle applies to the internal dealings of an international corporation. However, a clear notion of the separate enterprise approach is not found in the domestic law, whilst most tax treaties concluded by Korea have such a provision. Under its domestic law, therefore, how to identify internal dealings is not clear. There is only one individual provision based on the presumption to allow the interest payment by a branch of an international bank to its head office or other parts of the bank. For the other types of inter-enterprise dealings, such as the provision of services or the transfer of financial or intangible assets. There are not many cases before the court, but notional royalties were not allowed to be deducted in a recent case. Any reasonable method of allocating indirect expenses for common purposes has been allowed, regardless of the place of actual payment. Korean domestic law has the concept of "deemed capital" as a similar meaning to "free capital." But it is different from the AOA in a sense that it allows a choice between the formulary method and the capital attribution method.

These major differences may have originated from the different history of foreign investments and the different measures used to tax their profits. The UK has concluded a number of tax treaties with many foreign countries and actively amended its domestic law in accordance with its treaty policy. The big proportion of financial industry in its economy seems to have had an important role in recognizing internal loans within a bank.[172)] Also the "free capital" concept which was invented by its domestic law was accepted by the OECD Commentary.[173)] The US has taken actions to maximize its tax revenue and have focused on prohibiting the US tax avoidance making use of the form of internal transactions.[174)] Also the difficulties in assessing the value of assets used, risks taken and functions performed by a part of an international enterprise have discouraged it to adopt the separate enterprise approach. On the contrary, Korea was in the situation of a capital importing country for decades, and its tax authorities did not have an aggressive position toward foreign investors. The courts, on the other hand, have had an inflexible view to accept the form of

172) The US branches of the UK banks have challenged the US tax law which did not recognize the internal dealings.

173) In general, however, the UK's influence on the OECD Model has not been so great. John F. Avery Jones, *The United Kingdom's Influence on the OECD Model Tax Convention*, British Tax Review 6, 653 (2011).

174) It is still the main concern of the US tax law regarding international transactions. *See* Allison S. Garner & Daniel C. Murphy, Corporate and International Taxation – Analyses and Reforms 80-85 (2011).

corporate entity almost absolutely.[175)] Consequently there have been a few discussions about this issue. Recently, however, it has realized the importance of this matter with the growth of economy and slowly started to update its law since joining the OECD.[176)]

Despite the divergence in degrees, domestic laws of all three countries still have a negative position as to the deductibility of notional payments from internal dealings, save the cases of paid interest on internal loans in banking businesses. In particular, as see above, the UK tax authority clearly announces that the payments of notional rents by a permanent establishment to the enterprise as a whole for the use of premise owned by the enterprise is not deductible, on the ground that there should be a real payment incurred by the foreign company. This tendency is probably due to the fear for tax avoidance which has been concerned since early 20th century when the League of Nations first discussed this matter. However, such a strict prohibition might be against the separate enterprise approach, because there might be an exceptional case where the economic ownership of a tangible asset is reasonably attributed to other part of the company rather than to a permanent establishment using it.

Here is the table of comparison.

Country	Treaty		Domestic law			
	Separate enterprise approach	Use of formulary method	Separate enterprise approach	Deduction of notional charges	Capital allocation	Deduction of common purpose expense
UK	Yes	No	Yes	No, exception of bank	Free capital	Yes (No in the past)
US	Yes	Partly Yes (choice is given)	No	No, exception of bank	No (choice is given to a bank under treaties)	Yes

175) It is very rare to see that the Korean courts deny the form of corporate entity, though there is a principle of 'substance over form'.

176) International taxation issues including transfer pricing started to be discussed since late 1980's.

Country	Treaty		Domestic law			
	Separate enterprise approach	Use of formulary method	Separate enterprise approach	Deduction of notional charges	Capital allocation	Deduction of common purpose expense
Korea	Yes	exceptional use	Not clear	Not clear (but, interest within a bank is clearly allowed)	Only for bank (choice between a formula and capital attribution)	Yes (reasonable method of allocation)

2) Problems of the Disparities

The disparities that are to be found in the above three countries have hindered the consistent and symmetrical operation of the tax treaty network. This imbalance or the lack of unitary application had been triggering a problem of double taxation.

Suppose, in the Example 1) in the introduction, source country X allocates the economic ownership of the drilling machine to A, resulting in depreciation and allocation of debt financing for acquiring the machine, although A wants the recognition of internal leasing. Home country Y, on the other hand, may respect the company's accounting records. This will cause the double taxation for the difference between the depreciation and the notional lease payments. On the contrary, if X admits the lease payments, but Y does not include it in the computation of H's taxable profits, then there is no taxation over the amount equivalent to lease payments.

Also assume that X and Y in the Example 2) in the introduction have a different law about the recognition of internal interest dealings and the deductibility of paid interest. If interest paid to H by A is not deducted partly or entirely in the computation of profits of A under the X's law, but the interest received by H constitutes taxable income under the Y's law, there will be double taxation by both countries because the amount of interest payment is counted twice.[177] Similarly, when X allows the full

177) When comparing this result with a situation of a subsidiary instead of permanent establishment, the problem becomes worse. Suppose the subsidiary is allowed to deduct its

deduction of the paid interest while Y does not recognize the internal dealing, then there will be no taxation on the amount.

Even if both X and Y, in the above two examples, admit that the threshold for recognizing the internal dealings has been passed, the differences in the methods used to reflect those dealings in the computation of profits or in the limits of deduction, in particular, in relation with the allocation of "free capital" may also cause the problems of double taxation or non-taxation.

On top of that, given the recent change in the OECD Model and its Commentary of several points, this problem would be getting worse, if the countries have the different views on the version of the OECD Commentary which is relevant to a certain tax treaty. As see above, there are divided opinions about this; the static approach v the ambulatory approach.[178] If one country adopts the former and the other partner country has the latter view, the risk of double taxation would become greater.

3) The Limitation of the OECD's Authorized Approach

Does the OECD's current approach give a perfect solution to these problems? The answer cannot be affirmative, as there are several flaws or limitations in the OECD's separate enterprise approach.

(1) Inconsistency with the Economic Reality

The basic criticism is that the separate enterprise hypothesis ignores the reality of international business through branches and its nature of high integrity. What is often described as a transfer of assets is, in reality, merely a change in the use of the property owned by that company as a whole. This leads to the argument that there is no objective or perfect method for allocating revenue and costs within an international enterprise because of the integrated nature of their business operation. Any attribution of profits can be artificial.[179]

---

interest payment to parent corporation under the X's law, the denial of internal interest in cases of permanent establishments may cause the distortion of an international enterprise's decision in choosing its form of operating its business in X. This is against the neutrality of tax law.

178) *See* II.1.A.

179) Kobetsky, *supra* note 10, at 187; Lee Chang Hee, *Taxation on a Permanent Establishment*, 13 Seoul Tax Law Review 2, 250 (2007).

In particular, with regard to the issue of deductibility of notional charges, Lee argues that the separate enterprise approach cannot give a proper answer, and that the core point is only to distinguish capital from indebtedness.[180] Interest on funds that are attributable to equity capital should not be deductible, so the issue of internal loans may be viewed from the perspective of thin capitalism.[181] As the opportunity costs of equity capital should not be deductible, where a company has purchased a machine and then its branch used it, the notional rents should not be recognized. It is not necessary to assume whether the branch as a hypothetical independent enterprise would need to buy the machine or can rent it.[182]

When it comes to the allocation of "free capital," Kobetsky argues that it ignores the differences between domestic and international banks and the fact that the branch is merely an integrated part of an international bank which meets the regulatory requirement for adequate capital.[183] It is the enterprise as a whole that is legally responsible for the liabilities to third parties.

Although the OECD emphasizes that the separate enterprise hypothesis is only a hypothesis and does not intend to treat permanent establishments as subsidiaries, the recent change may be viewed as taking a step forward towards more similar treatment of the two forms of business operation.[184]

(2) The Possibility of Different Results of Application

Another practical problem is that there may be different outcomes of applying the separate enterprise approach, since any particular facts and circumstances are to give rise to a range of arm's length results, not a single figure.[185] Also, the risk of double taxation in this field is inevitable, because basically the deductibility of expenses is left to the domestic law of each

---

180) Lee, *supra* note 176, at 254-255.

181) *Id.* Lee analyzed *National Westminster* (1999), arguing the court missed this point. pp. 253-254.

182) *Cudd Pressure Control Inc. v, Canada* [1995] TCJ 495 was viewed from this aspect. The conclusion of the court that the notional rent charges for the snubbing units were not deductible was supported. Lee, *supra* note 177.

183) Kobetsky, *supra* note 10, at 273.

184) Burgers, *supra* note 107, at 53.

185) *Supra* note 26, at paras. 52, 125.

country. In particular, as to the computation of "free capital," the OECD admits that there are a range of methods for the attribution of capital instead of a single method, as being described above. The effectiveness of Article 7(3) of the new Model which aims to prevent the double taxation is not clear.

Moreover, there are different possible interpretations of the separate enterprise theory.[186] They differ mainly in whether to recognize internal dealings or not.[187] The OECD seems to adopt the broad functional approach, while the UK is closer to the narrow functional approach, the US takes the legalistic functional approach with a limited exception of financial institutions, and Korea seems to be somewhere between the broad functional approach and the narrow functional approach.

(3) Uncertainty

Also uncertainty is a big problem. In the Example 1) of the introduction, whether the economic ownership of the drilling machine is allocated to the permanent establishment or the internal leasing dealing is recognized may be depending on the facts and circumstances.

In a system where the choice between ownership and leasing is determined by the factual and functional analysis, the outcome may be very uncertain, especially if there is no prior case similar to that. In such a situation, the international company would in most cases have to incorporate a new subsidiary to which it would lease the machine in order to ensure the deduction.[188] This may break the neutrality of tax law by distorting the decision of enterprises on whether they operate their business in branches or subsidiaries.

---

186) *Supra* note 107, at 55.

187) The legalistic functional approach does not take into account internal transactions. The narrow functional approach accepts internal dealings only in so far as identical or similar activities are rendered between third parties. The broad functional approach allows in general all internal transactions to be remunerated at arm's length price. The narrow territorial approach deals with a permanent establishment exactly as if it were a subsidiary. The broad territorial approach treats a permanent establishment as a completely separate enterprise. Burgers, *supra* note 107, at 55-56. There were five ways of interpretation which were adopted by four different countries (Germany, the Netherlands, the UK and the US) at the time of 1991.

188) Johan Muller, *Attribution of Profits to PE: A Business Perspective*, WEBER & VAN WEEGHEL, 60-61 (2011).

(4) Reliance on the Accounting Book and Documentation

As deciding a proper price for an internal dealing is very difficult, the OECD's approach is eventually to start with the accounting books of the taxpayer and to proceed to make ad hoc adjustments to those books when the results appear to be inconsistent with the arm's length standard. This is a big difference with the situation of associated corporations.[189] This reliance on the taxpayer's books of account may not correctly represent an arm's length price because the financial accounting may differ. [190] Also the accounting books might be manipulated by the company as a whole.

The higher requirement of documentation for the internal transactions, in principle, is right. It is reasonable for tax authorities to require such strict documentation between a permanent establishment and the other parts of the same enterprise, because there is no legally binding contract for the internal dealings. However, it is also important to remember that the existence of documentation is not sufficient to prove the real existence of internal dealings. Too much weight on the record or documentation has a potential risk that the substance may be ignored by the formality or by the manipulated records.

4) Reasons to Retain the Separate Entity Approach

Given the economic reality of multinationals, one might think that the unitary worldwide formulary apportionment is preferable. This has been insisted by not a few people.[191] There would be no complicated application of the transfer pricing and no problem of disparity, if it is established. It is often argued that the recognition of internal dealings under the separate enterprise hypothesis might allow for an international enterprise to swift its worldwide profits easily to a country with lower tax rate. Also an aggressive source country could increase the taxable income of a permanent establishment in that country by adjusting its income to reflect the

189) While Article 9 starts by looking at contracts and then tests the significant functions and risks to confirm that the contracts are in line with reality, Article 7 starts with identifying the allocation of significant functions, assets and risks to a permanent establishment and then extracts the likely contractual terms from that. *Id.* at 53.

190) Arnold, *supra* note 124, at 75.

191) Kobetsky, *supra* note 10, at 393-429; Roin, *supra* note 115, at 198-221.

payments of notional charges from all other branches. The AOA has been rejected by the UN in 2009.[192] The UN Model Article 7 is still based on the former version of Article 7 of the OECD Model. Furthermore the EU is studying proposals to develop a multinational tax system for the taxation of corporate profits in the EU by adopting formulary apportionment allocation rather than the arm's length method.

However, the worldwide unitary formulary taxation cannot be established easily. Above all, there is a big difficulty to establish a common definition of income and other terms among countries. A difficult question would arise in deciding the appropriate formula as well.[193] In practices usually separate accounts are kept for branches, so it is hard for a tax authority of a small country to examine the value of worldwide assets of an international company. The separate enterprise method is a way to reflect the profits attributable to a permanent establishment without the troublesome need for a foreign corporation's worldwide data.[194] Also, the separate enterprise approach is more consistent with the arm's length principle, because it does not impose any limitation on the profits attributable. [195] Moreover, considering the taxation on businesses through subsidiaries, the separate enterprise approach is the method to minimize the tax impact on the investment decisions.[196] Finally, most countries except the US do not have any experience with the operation of the formulary taxation system which is not suitable to harmonize different laws used in different countries.

Therefore, it is more practical to find a way to improve the current separate enterprise approach including the amendments to the OECD

---

192) United Nations, Report of Experts on International Tax Cooperation in Tax Matters (2009), p. 9, para. 31. Recitation from Kobetsky, *supra* note 10, at 357. *See supra* note 20.

193) Sol Picciotto, International Business Taxation 247 (1992).

194) Fred B Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, Tax L. Rev. 29, 206 (1993). He viewed the 'effectively connected' rules in the US as the first step of reform and supported the future adoption of separate enterprise method rather than the formulary method.

195) The OECD consensus was mainly made on these two points. Burgers, *supra* note 107, at 59.

196) World economic welfare is maximized by a system that applies the same tax burden to prospective marginal profits from different investments so that taxes do not distort investment decisions.

Report and the individual reform of each country's law. In particular, the above four drawbacks of the current AOA should be taken into account in the future discussion. Each country can get information and materials needed for their legislative reform from other countries.[197] The new legislation of the UK which allows the foreign permanent establishment of a UK company to be outside the UK taxation can be a good solution to eliminate double taxation. Also, it is necessary to make efforts to harmonize the existing different systems. As new Article 7(3) of the Model provides, the mutual consulting of each tax authority can be one of the ways to reduce the problems caused by the disparity, although it cannot be done easily in practices. Obviously, more comparative law works and more international discussions, including on the version of Commentary which can be read by the court, will be helpful to minimize the disputes.

IV. Conclusion

The recent position of the OECD is to apply the separate enterprise approach with the functional and factual analysis to these internal dealings consistently. It generally looks to significant people functions and the key entrepreneurial risk-taking functions of financial institutions. It allows the recognition of notional charges in the computation of profits attributable to a permanent establishment, if the functional and factual analysis shows the existence of those internal dealings. On the other hand, it requires the allocation of "free capital" to a permanent establishment, which is a main restriction on the interest deduction in calculating its taxable profits. The allocation of indirect costs is to be allowed where no internal dealings are recognized, while the direct deduction of notional charges is to be done if internal dealings are established. However, it is notable that the final decision of deductibility is left to each domestic law.

The UK, the US and Korea have had different tax law to deal with these issues, while they have shared some similarities. The current UK law adopts the separate enterprise approach. The functional and factual

---

197) For example, the detailed provisions of the UK legislation must be useful as a reference to other countries which prepare the reform.

analysis may be done both in treaty and non-treaty situations. However, the deduction of notional expenses is not allowed, save the cases of paid interest deduction of financial institutions. For the deductibility of indirect expenses, it has begun to allow the allocation of a portion of common expenses incurred by the enterprise. It requires the allocation of "free capital" as the limitation to the interest deduction. The US has not been familiar with the hypothetical analysis, though most tax treaties include provisions containing the separate enterprise approach. It has ignored dealings within an enterprise, and only focused on the effective connection with the US source income or the allocation of common expenses incurred by the enterprise as a whole. As to the internal loans within an international bank, it has used the formulary method in determining the deductibility of the interest, which was decided by the courts as violating treaty provisions. In Korea the arm's length principle applies to the internal dealings within an international corporation. While most treaties adopt the separate enterprise approach, the domestic law does not have the explicit provision. Internal loans of a bank are recognized but with the restriction of "deemed capital" which can be calculated either on a formulary basis or on a capital allocation basis. For the other types of inter-enterprise transactions, there is no clear provision. Indirect expenses that reasonably allocated to the permanent establishment can be deducted.

The differences have the risk of double taxation or non-taxation. The divided opinions on the version of Commentary would make things worse. Basically, the authorized approach of the OECD contains several problems which cannot be solved simply. The hypothetical analysis is not easily consistent with the nature of international businesses through permanent establishments. There are different measures employed under the separate enterprise approach. The functional and factual analysis does not give certainty to taxpayers, at least before the accumulation of precedents. The reliance on the documentation can be excessive sometimes. However, it is not desirable neither realistic to adopt an alternative approach, such as the formulary method. Rather, it is needed to make efforts to improve current tax systems. The ideal tax regime is the one that is logically sound, applies consistently reducing disparities, and respects different laws in different countries. International discussions across continents including more comparative law works may reach this more closely.

Bibliography

Ahn, Chang Nam & Oh, Kwang Tae (2010), "A Study on the Necessity of Re-establishment of the Attribution of Profits to the Dependent Agent Permanent Establishments in Korea – under the Authorized OECD Approach –, Tax Law Journals, **26**, 1, pp. 277-310.

Andrus, Joseph & Rinke, Daniel (2011), "The United States," in Reimer, Urban & Schmid (eds), pp. 1-26.

Arnold, Brian J. & McIntyre, Michael J. (2002), *International Tax Primer*, 2nd edition (The Hague: Kluwer Law International).

Avery Jones, John F. (2011), "The United Kingdom's influence on the OECD Model Tax Convention," British Tax Review, 6, pp. 653-683.

Avi-Yonah, Reuven S. (1996), "The Structure of International Taxation: A Proposal for Simplification," Texas Law Review, **74**, pp. 1301-1359.

______ (2007), *International Tax as International Law – An Analysis of the International Tax Regime –*, Cambridge Tax Law Series (Cambridge: Cambridge University Press).

Baker, Philip (2011), "A note on recent UK tax treaty developments," British Tax Review, 2, pp. 125-131.

Bennett, Mary (2011), "Article 7 – New OECD Rules for Attributing Profits to Permanent Establishments," in Weber & van Weeghel (eds), pp. 21-36.

Birla, Arun (2005), "The attribution of profits – fact or fiction?," British Tax Review, 2, pp. 207-221.

Blokker, Niels (2008), "Skating on thin ice? On the law of international organizations and the legal nature of the Commentaries on the OECD Model Tax Convention," in Douma & Engelen (eds), pp. 13-27.

Brown, Fred B. (1993), "Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?," Tax Law Review (New York University), **49**, pp. 133-207.

Burgers, Irene J.J. (2009), "The New OECD Approach on Profit Allocation: A Step Forward Towards Neutral Treatment of Permanent Establishments and Subsidiaries," Florida Tax Review, **10**, pp. 51-76.

Caster, Brian (2011), "After Natwest: How Courts Should Handle OECD Commentary in Double Taxation Treaty Interpretations," Northwestern University Law Review, **105**, pp. 1317-1346.

Cho, Yoonhee (2011), "The deductibility of notional royalties in calculating the foreign source income of a corporation for the purpose of foreign tax credit," Commentaries on Supreme Court Decision, 87, pp. 716-761.

Choi, Seonjip (2010), "The method of allocation of expenses incurred by the head office," The National Tax, **522**, pp. 45-51.

Douma, Sjoerd & Engelen, Frank (eds) (2008), *The Legal Status of the OECD Commentaries,* Conflict of Norms in International Tax Law Series (Amsterdam: IBFD).

Garner, Allison S. & Murphy, Daniel C. (eds) (2011), *Corporate and International Taxation -Analyses and Reforms-* (New York: Nova Science Publishers).

Gordon, Keith M., Manzano, Ximena Montes & Tiley, John (ed) (2011), *Tiley and Collison's UK Tax Guide 2011-2012*, 29th edition (London: LexisNexis).

Groff, Alfred C. & Hoch, James F. (1988), "Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks," University of Illinois Law Review, pp. 343-369.

Harris, Peter & Oliver, David (2010), *International Commercial Tax*, Cambridge Tax Law Series (New York: Cambridge University Press).

International Bureau of Fiscal Documentation (2005), *The Taxation of Permanent Establishments*, Binder 3 (Amsterdam: IBFD Publications).

Kane, Mitchell & Hartwell, Olga (2000), "Case Comment: National Westminster Bank Plc v Internal Revenue Commissioner (US)," British Taw Review, pp. 44-54.

Kim, Jaeseung (2009), "Taxation of Permanent Establishment of a Foreign Corporation – A case Study of a Foreign Corporation with Passive Income Effectively Connected With Its Permanent Establishment-, Law Reviews (Jeonnam National University), **29**, 1, pp. 241-265.

Kirsch, Michael S. (2010), "The Role of Physical Presence in the Taxation of Cross-border Personal Services," Boston College Law Review, **51**, pp. 993-1080.

Kobetsky, Michael (2011), *International Taxation of Permanent Establishments – Principles and Policy –*, Cambridge Tax Law Series (New York: Cambridge University Press).

Krever, Richard (ed) (1997), *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate* (London: Kluwer Law International).

Lang, Michael (ed) (2003), *Avoidance of Double Non-Taxation* (Wien: Linde Verlag).

Larking, Barry (2005), "The United Kingdom," in International Bureau of Fiscal Documentation, pp. 1-92.

Lee, Chang Hee (2007), "Taxation on a permanent establishment," Seoul Tax Law Review, **13**, 2, pp. 216-259.

______ (2011), *Tax Law*, 9th edition (Seoul: Pakyoungsa).

Lee, Natalie (ed) (2008), *Revenue Law – Principles and Practice*, 26th edition (West Sussex: Tottel Publishing).

Muller, Johan (2011), "Attribution of Profits to PE: A Business Perspective," in Weber & van Weeghel (eds), pp. 51-62.

OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.*

______ (2008a), *Commentary on Article 7.*

______ (2008b), *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD).

______ (2010a), *Commentary on Article 7 Concerning the Taxation of Business Profits.*
______ (2010b), *Introduction OECD Model 2010.*
______ (2010c), *Report on the Attribution of Profits to Permanent Establishments* Part I (Paris: OECD).
______ (2010d), *Report on the Attribution of Profits to Permanent Establishments* Part II (Paris: OECD).
Picciotto, Sol (1992), *International Business Taxation* (London: George Weidenfeld and Nicolson).
Pijl, Hans (2011), "The 2010 Elimination of Article 7-3 (1963)," in Weber & van Weeghel (eds), pp. 37-49.
Pires, Manuel (ed) (1989), *International Juridical Double Taxation of Income,* Series on International Taxation (Deventer: Kluwer Law and Taxation Publishers).
van Raad, Kees (ed) (2011), *Materials on International & EU Tax Law,* 11th edition, Vol. I (Leiden: International Tax Center Leiden).
Reimer, Ekkehart, Urban, Nathalie & Schmid, Stefan (eds) (2011), *Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (Alphen aan den Rijn: Kluwer Law International).
Ring, Diane M. (2007), "International Tax Relations: Theory and Implications," Tax Law Review (New York University), **60**, pp. 439-485.
Roin, Julie (2008), "Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment," Tax Law Review (New York University), **61**, pp. 169-240.
Rosenbloom, H. David, Sutherland, David K. & Ring, Diane M. (2005), "The United States," in International Bureau of Fiscal Documentation, pp. 1-92.
Sandler, Daniel (1998), *Tax Treaties and Controlled Foreign Company Legislation*, 2nd edition (London: Kluwer Law International).
Seo, Kiseok (1997), "The taxation on the foreign corporation -focusing on the cases of the Supreme Court-", Study of Special Law, **5**, pp. 429-471.
Shaw, Malcolm N. (2008), *International Law*, 6th edition (Cambridge: Cambridge University Press).
Shelton, Ned (2004), *Interpretation and Application of Tax Treaties* (London: LexisNexis).
Tiley, John (2008), *Revenue Law*, 6th edition (Oxford: Hart Publishing).
Thirlway, Hugh (2008), "The role of the international law concepts of acquiescence and estoppels," in Douma & Engelen (eds), pp. 29-49.
Tolley's Corporation Tax 2011-2012 (2011), (London: LexisNexis).
Weber, Dennis & van Weeghel, Stef (eds) (2011), *The 2010 OECD Updates – Model Tax Convention & Transfer Pricing Guidelines, A Critical Review –*, Series on International Taxation (Alphen aan den Rijn: Kluwer Law International).