



JÖNKÖPING INTERNATIONAL  
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# Permanent Establishment

With respect to attribution of income and the question of documentation  
of internal dealings

Bachelor's Thesis within Commercial and Tax Law

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### Abstract

In 2008 the Committee of Fiscal Affairs of OECD published its report on profit attributable to a permanent establishment. In 2010 article 7 of the OECD model tax convention was reformed, and the report was revised to better conform to the article.

The authorised OECD approach is that a permanent establishment is a separate and independent entity, 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 other parts of the enterprise. The approach is built on a two step analysis, the first is a functional and factual analysis and the second is determining the income of the permanent establishment. The authorised OECD approach is that the Transfer Pricing Guidelines should be applied by analogy in transactions between the permanent establishment and the rest of the enterprise.

The Swedish Income Tax Law has the view that the permanent establishment is a separate and independent entity. The Swedish approach is a two step analysis; the basis is the accountings of the enterprise adjusted for internal dealings, and the second step is a functional analysis. The Swedish law does not allow allocation of “free” capital to a permanent establishment, nor does it allow a permanent establishment to deduct royalty payments to other parts of the enterprise. The Swedish provision regarding documentation of transactions between enterprises with economic interest in each other does not apply to permanent establishments.

For reasons of certainty and predictability, the best thing would be for the legislator to reform the Swedish Income Tax Law. Seeing that a permanent estab-

lishment is obliged to have its own accounting, the burden and cost of obliging it to document internal dealings would not be that big.

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## List of abbreviations

AC	Administrative Court
ACA	Administrative Court of Appeal
AL	Accounting Law
AOA	Authorized OECD Approach
CL	Constitutional Law
ITL	Income Tax Law
LB	Law of Branches
LVAT	Law of Value Added Tax
MoF	Ministry of Finance
OECD	Organization for Economic Co-operation and Development
Prop.	Proposition
RÅ	Regeringsrättens årsbok
SAC	Supreme Administrative Court
SKV M	Skatteverkets meddelanden
SKVFS	Skatteverkets föreskrifter
The 2008 report	2008 OECD report the on attribution of profits to permanent establishments
The 2010 report	2010 OECD report the on attribution of profits to permanent establishments
The Commentaries	Integrated text of the OECD Commentaries of 1977 and 1992
The Committee	Committee on Fiscal Affairs of OECD
TP Guidelines	Transfer Pricing Guidelines
VCLT	Vienna Convention on the Laws of Treaties

# 1 Introduction

## 1.1 Background

The permanent establishment has been a problem when it comes to taxes, due to the fact that it is not a legal entity, and therefore there is a gap between tax law and private law.<sup>1</sup> Different states have different methods attributing income to a permanent establishment.<sup>2</sup> There are the indirect methods, which takes the overall income of the enterprise as a starting point.<sup>3</sup> There are also the direct methods, which require a detailed analysis of every transaction.<sup>4</sup> In the Swedish case, little has been done by the legislator to bring clearance to the area of how to attribute profit and loss to a permanent establishment. Instead it is the Swedish case law that has lead the way, although there has been problems attributing income to a permanent establishment.<sup>5</sup> Sweden is part of a big number of bilateral tax conventions and most of them are based on the Organization for Economic Co-operation and Development (OECD) model tax convention.<sup>6</sup>

In 1994 the Committee on Fiscal Affairs (the Committee) of OECD initiated a report on the issue of attribution of profit or loss to a permanent establishment, which was published in 2008 as a final report (the 2008 report)<sup>7</sup>. The report was intended to bring clearance about how to interpret art. 7 of the model tax convention<sup>8</sup>. Art. 7 of the model tax convention enacts that profit that should be attributed to a permanent establishment is the profit it might be expected to make if it were a separate and independent enterprise. Because of the different interpretations of art. 7 of the model tax convention the Committee wanted to create a greater consensus amongst its member states. The Committee first developed a “Working Hypothesis” to see if the arm’s length principle, as applied between companies

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<sup>1</sup> Reimer, E, Permanent establishment in the OECD Model Tax Convention, Permanent Establishments A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective, 2010/2011, Kluwer Law International, Great Britain 2011, para. 7.

<sup>2</sup> Ibid., para. 21.

<sup>3</sup> Ibid., para. 22.

<sup>4</sup> Ibid., para. 23.

<sup>5</sup> RÅ 1971 ref. 50.

<sup>6</sup> RÅ 1997 ref. 35.

<sup>7</sup> 2008 OECD report on the attribution of profits to permanents establishment.

<sup>8</sup> OECD model tax convention on income and on capital 2010.

in economic interest with each other in different states, could be applied to permanent establishments as well.<sup>9</sup> Transactions made at an arm's length means that the prices are set as they would be between independent enterprises in similar transactions and under similar conditions.<sup>10</sup> Drafts of the report were subject to reviews by public organs and,<sup>11</sup> like stated above, it was not until 2008 the final report was published. In 2010 a revised version of the report was published (the 2010 report)<sup>12</sup>.

Lenfors and Blom have been saying that the Swedish Income Tax Law (ITL)<sup>13</sup> is not in conformity with the report and thereby creates uncertainty for the taxpayer and the authorities about how to attribute income to a permanent establishment.<sup>14</sup> The constitutional law (CL)<sup>15</sup> of Sweden has the purpose of freedom of good faith and predictability.<sup>16</sup> No tax can be collected unless it has the support by law.<sup>17</sup> From this perspective, since the legislator has not done anything about the uncertainty, it has been the case for the court to decide how to attribute income to a permanent establishment.

The OECD Commentaries (the Commentaries)<sup>18</sup> to the model tax convention and reports of the OECD are not legally binding for the member states of the OECD or states that have used the model convention, but they have had some room in the Swedish case law when interpreting bilateral tax conventions based upon the OECD model tax convention.<sup>19</sup> Existing double tax conventions with other states, according to case law, cannot be inter-

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<sup>9</sup> The 2008 report, para. 3.

<sup>10</sup> Hamaekers, H, Transfer Pricing, IBFD, 2008, p. 3.

<sup>11</sup> The 2008 report, para. 4.

<sup>12</sup> 2010 OECD report the on attribution of profits to permanent establishments.

<sup>13</sup> Inkomstskattelag (1999:1229).

<sup>14</sup> Lenfors, A & Blom, M, Fördelning av vinst till fasta driftställen – problem med de svenska reglerna och hur de bör anpassas, IUR-information, 2007:11, p. 5-9.

<sup>15</sup> Regeringsformen (1974:152).

<sup>16</sup> Pålsson, R, Konstitutionell skatterätt, Iustus förlag, second edition, Västerås 2011, p. 86.

<sup>17</sup> Ibid., p. 86.

<sup>18</sup> Integrated text of the OECD Commentaries of 1977 and 1992 (incorporating the changes of 1994, 1995, 1997, 2000, 2003, 2005, 2008 and 2010).

<sup>19</sup> RÅ 1997 ref. 35, see ch. 6 below.

preted in the light of new materials from the OECD.<sup>20</sup> If the Swedish legislator chooses to do nothing every existing Swedish tax convention has to be remodeled with a clear reference to the 2010 report, since it is in no case part of the Swedish law.

The report states that the considerations in the Transfer Pricing Guidelines (TP Guidelines)<sup>21</sup> also should apply to a permanent establishment and its transactions with the rest of the enterprise.<sup>22</sup> In the preparatory work to the provisions regarding documentation of transactions between enterprises in economic interest with each other, there was a discussion of whether or not the permanent establishment also should be obliged to document transactions with the rest of the enterprise.<sup>23</sup>

## **1.2 Objective and delimitation**

The objective with this thesis is to examine how a permanent establishment is attributed income according to the Swedish income tax law and the OECD model tax convention. The objective is also to compare the two approaches of attribution of income to a permanent establishment, and to examine if the Swedish Income Tax Law need to be reformed to better conform to the 2010 report. The objective is finally to answer the question of whether or not the provisions regarding of transactions between enterprises in economic interest with each other should be reformed to also include permanent establishments.

This thesis will only cover the Swedish law of taxation and documentation, art. 7 of the 2010 OECD model tax convention, the Commentaries to it and the 2010 OECD report for profit attributable to permanent establishments. It will cover how a permanent establishment is subjected to taxation in Sweden. The thesis will cover how the Transfer Pricing Guidelines should be applied by analogy, but not explain the specific transfer pricing methods that should be used for transactions between the permanent establishment and the rest of the enterprise. The thesis will only cover chapter one of the report, which provides general guidelines on how to attribute income to a permanent establishment, and not the chapters specific for banks and insurance. The thesis will not analyze which of the two sources of attributing income to a permanent establishment is the best.

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<sup>20</sup> RÅ 1996 ref. 84.

<sup>21</sup> OECD transfer pricing guidelines for multinational enterprises and tax administrations.

<sup>22</sup> The 2010 report, para. 224.

<sup>23</sup> Prop. 2005/06:169, p. 100.

### **1.3 Method and materials**

The methods that have been used for this thesis are the descriptive method<sup>24</sup> and the comparative method<sup>25</sup>. A descriptive method is a method of describing and systematizing the legislation. Describing means identifying legal sources and determine what they contain. Systematizing means integrating all sources into one coherent rule. A comparative method means comparing rules, in their legal and non-legal context, on an objective basis.

The material that has been used for describing the Swedish income tax law is regulations and case law. In the absence of regulations, case law has been given an important role describing the legislation as it is. The 2010 report on profit attributable to a permanent establishment has been the basis when describing how permanent establishments according to OECD should be attributed profit. The commentary to OECD model tax convention has also been a basis for describing the OECD approach on attribution of profit to a permanent establishment.

The materials that have been used for the comparison of the two sources are regulations, case law, literature, and the 2010 report and commentaries from OECD. These sources have been used to compare the two norms on an objective basis. The source of information that has had most impact in this part is the case law and the report.

### **1.4 Disposition**

In the second chapter the definition of a permanent establishment is given. In the third chapter the attribution of profit or losses to a permanent establishment according to the OECD model tax convention and the 2010 report is given. In the fourth chapter the attribution of income to a permanent establishment according to the Swedish ITL is given, and there is also a short introduction to how a permanent establishment is subject to taxation. The chapter also includes a definition of who is obliged to document dealings with other enterprises. The fifth chapter includes a comparison on the two approaches of attributing income to a permanent establishment. The sixth chapter includes an analysis of the legal status of the model tax convention and the 2010 report. In the seventh chapter an

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<sup>24</sup> Van Hoecke, M, *Deep Level Comparative Law, Epistemology and Methodology of Comparative Law*, Hart publishing, Oxford 2004, p.166.

<sup>25</sup> *Ibid.*, p. 167-169.

analysis of whether or not the Swedish ITL and provisions regarding documentation need to be reformed. In the eighth chapter a conclusion is given.

## 2 Definition of a permanent establishment

### 2.1 OECD

According to art. 5.1 of the model tax convention the term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In the Commentaries to the model tax convention, it is enacted that the definition contains the following conditions; the existence of a place of business, the place must be fixed and the business has to be carried out through the fixed place.<sup>26</sup> It is stated that it does not matter if the enterprise owns the fixed place,<sup>27</sup> it could be an illegal occupation of a space.<sup>28</sup> The important prerequisite is that the space is at the disposal of the enterprise at a sufficiently long period of time, which differs from state to state. It is stated that a permanent establishment can only be deemed to exist if the fixed place of business has a certain degree of permanency, meaning that it is not of a temporary nature.<sup>29</sup> According to the Commentaries does a permanent establishment begin to exist as soon as the enterprise commences to carry on its business through the fixed place.<sup>30</sup> The permanent establishment ceases to exist with the disposal of the fixed place or with the cessation of any activity through it.<sup>31</sup>

*Ex. Company A, resident in state B, rents an office in state C. Company A intend to have the office for an unlimited time, but they do not conduct any business from it. The office is thus not a permanent establishment according to the OECD model tax convention since the prerequisite of carried on business is not fulfilled.*

In art. 5.2 of the model tax convention there are fixed places listed that are deemed to be permanent establishments. The list is non-exhaustive, and according to the Commentaries the cases must fulfil the prerequisites in art. 5.1,<sup>32</sup> which are that there is a fixed place of business through which the business of an enterprise is wholly or partly carried on. The

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<sup>26</sup> Commentaries to art. 5, para. 2.

<sup>27</sup> Ibid., para. 4.

<sup>28</sup> Ibid., para. 4.1.

<sup>29</sup> *ibid.*, para. 6.

<sup>30</sup> Ibid., para. 11.

<sup>31</sup> Ibid., para 11.

<sup>32</sup> Ibid., para. 12.

term permanent establishment includes especially; a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

If a building site or construction or installation project lasts more than twelve months it is considered to be a permanent establishment, according to art. 5.3 in the model tax convention. In the Commentaries it is enacted that the twelve month test is applicable to each individual site or project,<sup>33</sup> and a site or project exists from the date on which the contractor starts working in the country where the construction is to be established.<sup>34</sup> The site or project exists until the work is completed or permanently abandoned.

In art. 5.4 of the model tax convention there are some activities for fixed places listed, that should not make the place deemed to be a permanent establishment. According to the Commentaries the common thing to all of these fixed places is that the activities that the fixed place perform is either preparatory or auxiliary.<sup>35</sup> The decisive prerequisite for an activity to fall under the exception is, as enacted in the Commentaries, whether or not the activity of the fixed place forms an essential and significant part of the activity of the enterprise as a whole.<sup>36</sup> It is enacted that the fixed place can be combining two activities in the list and still fall under the exception of not being a permanent establishment, but that is only if the combined activity is merely preparatory or auxiliary.<sup>37</sup> If, on the other hand, the fixed place combines activities which fall under the exception and other activities that do not, the fixed place shall be deemed to be a permanent establishment.<sup>38</sup>

*Ex. Company A, resident in state B, has a warehouse in state C. There is no business being conducted from the warehouse. The only activities are auxiliary. After a while company A starts renting out space in the warehouse to other companies in state C. The warehouse shall then be deemed to be a permanent establishment.*

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<sup>33</sup> Ibid., para. 18.

<sup>34</sup> Ibid., para. 19.

<sup>35</sup> Ibid., para. 21.

<sup>36</sup> Ibid., para. 24.

<sup>37</sup> Ibid., para. 27.

<sup>38</sup> Ibid., para. 30.

According to art. 5.5 of the model tax convention should a person that is acting on behalf of an enterprise and has, in a contracting state, an authority to conclude contracts in the name of the enterprise be deemed to constitute a permanent establishment. This is for all activities that the person undertakes for the enterprise, unless the activities fall under the exception in art. 5.4. In the Commentaries it is enacted that the term permanent establishment in this case presupposes that the person can make use of the authority repeatedly and not merely in isolated cases.<sup>39</sup>

Art. 5.6 covers the situation where an enterprise carries on business in a state through a broker, general commission agent or any other agent of independent status. If said person is acting in the ordinary course of the persons business, the enterprise should not be deemed to have a permanent establishment in that state.

Art. 5.7 cover the situation where a company resident in one contracting state controls a company which is resident in the other contracting state. According to the article this does not mean that the subsidiary constitutes a permanent establishment for the controlling company. The concept of the article is that a subsidiary is an independent legal entity, as enacted in the Commentaries.<sup>40</sup> This being the case, the controlling company might still have a permanent establishment in the other contracting state if the subsidiary has as space which is at the controlling company's disposal.<sup>41</sup>

## **2.2 Sweden**

In Sweden, the definition of a permanent establishment is given in ch. 2 art. 29 I TL. A permanent establishment is a of fixed place of business through which the business of an enterprise is wholly or partly carried on.<sup>42</sup> There is a non-exhaustive list of what is deemed to be a permanent establishment; a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, quarry or other place of extraction of natural resources, a building site, construction or installation project and a property that is a current assets in business.<sup>43</sup> One difference between the Swedish law and the model tax convention

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<sup>39</sup> Ibid., para. 32.

<sup>40</sup> Ibid., para. 41.

<sup>41</sup> Ibid., para. 41.

<sup>42</sup> Ch. 2 art. 29 para.1 I TL.

<sup>43</sup> Ibid., para. 2.

is that the Swedish law does not require a building site or construction project to last for at least twelve months. Another difference is that the Swedish law does not have any exceptions as they are enacted in art. 5.4 in the model tax convention. According to ch. 6 art. 11 para. 2 ITL, revenues in the form of royalty or periodical cost for material or intellectual property should be seen as revenues derived by a permanent establishment if the revenues are derived from another enterprise with a permanent establishment in Sweden.

### **3 Attribution of income to a permanent establishment according to OECD materials**

#### **3.1 Taxation according to the 2010 OECD model tax convention and the Commentaries**

Art. 7.1 of the model tax convention enacts that the profits or losses of an enterprise of a contracting state shall be taxable only in that state, unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. The profits or losses attributable to the permanent establishment in accordance with art. 7.2 may be taxed in that state. According to the Commentaries, there are two principles underlying the article. One is that until an enterprise has a permanent establishment in another state, it should not be regarded as participating in the economic life of the other state to the extent that the other state may tax the enterprise.<sup>44</sup> The second principle is that the other state may not tax income which are not attributable to the permanent establishment.<sup>45</sup>

Art. 7.2 enacts that the permanent establishment shall be seen as a separate and independent enterprise in particular in dealings with other parts of the enterprise, when the permanent establishment is 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. It is the profits or losses the permanent establishment might be expected to make that are important. In the Commentaries it is stated that this article is based upon the separate entity principle and the arm's length principle.<sup>46</sup>

A new version of the article was adopted 2010, which also was the time when a revised version of the report was published to better harmonise with the article.<sup>47</sup> According to the Commentaries the article reflects the approach developed in the report, and therefore must be interpreted in the light of guidance of it.<sup>48</sup> The article does not seek to allocate the overall income of the whole enterprise to the permanent establishment, instead it requires the

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<sup>44</sup> Commentaries to art. 7, para. 11.

<sup>45</sup> Ibid., para. 12.

<sup>46</sup> Ibid., para. 3.

<sup>47</sup> Ibid., para. 8.

<sup>48</sup> Ibid., para. 9 and para. 19.

profits or losses attributable to the permanent establishment to be calculated as if it was a separate enterprise.<sup>49</sup> Income may thus be attributed to a permanent establishment even though the enterprise has not made any profits and the other way around.

In the Commentaries, it is enacted that a two step approach needs to be taken to attribute income to a permanent establishment. Since it is stated in the Commentaries that the approach is greater explained in the report,<sup>50</sup> the approach will not be described here but in ch. 4.2 below.

It is also enacted that art. 7.2 only determine the income that is attributable to a permanent establishment. It is up to both states' domestic law to decide how to tax the income and what expenses are deductible for the enterprise as a whole, as long as there is conformity with the article. To clarify, as long as the permanent establishment is treated as a separate entity there is no violation of the article.<sup>51</sup> A permanent establishment shall have the right to under the same conditions as enterprises of the host state deduct expenses incurred, either directly or indirectly.<sup>52</sup>

According to art. 7.3, when a contracting state adjusts the income attributable to a permanent establishment and taxes income that have been subject to tax in the other contracting state, the other state shall make an appropriate adjustment to eliminate double taxation. As it is stated in the Commentaries, this is an important mechanism for eliminating double taxation of income.<sup>53</sup> The state which does not do the adjustment to the income of the permanent establishment is only obliged to make an adjustment if it considers that the other state has correctly implemented art. 7.2.<sup>54</sup>

According to art. 11.4, concerning interest, enacts that interest the enterprise receives shall be taxable in the contracting state where the interest arises and a state shall have the right to tax the interest if the debt claim in respect of which the interest is paid is effectively

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<sup>49</sup> Ibid., para. 17.

<sup>50</sup> Ibid., para. 20-22.

<sup>51</sup> Ibid., para. 30-31.

<sup>52</sup> Ibid., para. 33-34.

<sup>53</sup> Ibid., para. 44.

<sup>54</sup> Ibid., para. 59.

connected with the permanent establishment. The same goes for royalties according to art. 12.3 and gains from the alienation of movable property forming part of the business property according to art. 13.2.

## **3.2 The 2010 report**

### **3.2.1 Introduction**

The focus of the report is on formulating the most preferable approach to attribute profits (or losses) to a permanent establishment under art. 7.2 of the model tax convention in a modern way of the business trades of today.<sup>55</sup> The report is based upon an analogy to the TP Guidelines, so to the extent the TP Guidelines are modified, the report should be applied with account taken to the modifications.<sup>56</sup> The new and revised report is a product of the reformulated art. 7 of the model tax convention and does not change the conclusion of the 2008 report, but was published simply to avoid difficulties in the interpretation of the article.<sup>57</sup> The authorised OECD approach (AOA) is to apply the TP Guidelines by analogy and not directly, the report discusses how to adapt and supplement the guidance given in the TP Guidelines.<sup>58</sup>

The basic premise of AOA is that it only sets a limit on the amount of attributable profit that may be taxed in the host country of the permanent establishment. The profit of the permanent establishment is the profit attributable to it according to the arm's length principle, in particular in dealings with other parts of the enterprise, as if it was 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 other parts of the enterprise.<sup>59</sup>

According to the AOA a two-step analysis is required. Step one consists of a functional and factual analysis, which must identify the economically significant activities and responsibili-

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<sup>55</sup> The 2010 report, preface, para.4.

<sup>56</sup> *ibid.*, preface, para. 10.

<sup>57</sup> *Ibid.*, part 1, para. 5.

<sup>58</sup> *Ibid.*, para. 55.

<sup>59</sup> *Ibid.*, para. 9.

ties undertaken by the permanent establishment. Step two consists of applying the transfer pricing tools in art. 9 of the model tax convention applied by analogy to dealings between the permanent establishment and the rest of the enterprise, by reference to functions performed, assets used and risks assumed. The end result of this two-step analysis is to allow the calculation of profits (or losses) of the permanent establishment from all its activities.<sup>60</sup>

### **3.2.2 Step one**

#### **3.2.2.1 General**

The first step of the AOA is to hypothesise the permanent establishment as 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 other parts of the enterprise.<sup>61</sup> Some of the conditions of the permanent establishment will be derived from a functional and factual analysis of the internal attributes of the enterprise itself, while other will be derived from a functional and factual analysis of the external environment in which the functions of the permanent establishment are performed.<sup>62</sup>

#### **3.2.2.2 Activities**

In order to determine the activities of the permanent establishment the functional analysis will initially be applied for the hypothesis, as mentioned above, that the permanent establishment is a separate and independent enterprise. The functional analysis must determine which activities and responsibilities that is associated with the permanent establishment, and to what extent. Where the permanent establishment is created through a fixed place of business, according to art. 5.1 of the model tax convention, the determination of which activities and responsibilities that are associated with the permanent establishment should be done from the fixed place and the functions performed there.<sup>63</sup>

The functional and factual analysis of the first step takes account of the functions performed by the personnel (the people functions) of the enterprise as a whole and assesses what significance they have in generating profit. The people functions can be either of an-

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<sup>60</sup> Ibid., para. 10.

<sup>61</sup> Ibid., para. 57.

<sup>62</sup> Ibid., para. 58.

<sup>63</sup> Ibid., para. 60.

cillary or support functions to significant relevant functions to the attribution of economic ownership of assets and the assumption of risk.<sup>64</sup>

According to the AOA, care should be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent the conditions are relevant to the performance of the functions of the permanent establishment. Conditions that might require to be taken care of are contractual terms, business strategies, characteristics of property and other economic circumstances.<sup>65</sup> It is important to include all activities performed on behalf of the permanent establishment by other parts of the enterprise and the other way around when applying the functional and factual analysis.<sup>66</sup>

### **3.2.2.3 Risks**

In order to attribute risks to the permanent establishment the permanent establishment should, according to AOA, be considered as assuming any risk for which the significant people function relevant to the assumption of risk is performed by personnel of the permanent establishment at the location of the permanent establishment.<sup>67</sup> The division of risks and responsibilities will have to be deduced from the parties conduct and economic principles that generally governs relationship between independent enterprises.<sup>68</sup>

### **3.2.2.4 Assets**

When it comes to the attribution of assets, it is important to understand that it is the economic rather than the legal conditions that are the most important since the permanent establishment is not a legal entity but just a part of the whole enterprise. First of all, it is necessary to examine the facts and circumstances in order to determine the extent to which the assets of the enterprise are economically owned by and/or used in the functions performed by the permanent establishment.<sup>69</sup>

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<sup>64</sup> Ibid., para. 62.

<sup>65</sup> Ibid., para. 63.

<sup>66</sup> Ibid., para. 65.

<sup>67</sup> Ibid., para. 68.

<sup>68</sup> Ibid., para. 69.

<sup>69</sup> Ibid., para. 72.

When it comes to tangible assets, the place of use is the relevant criterion for attribution of the asset to the permanent establishment.<sup>70</sup>

For internally developed trade intangibles (intangibles such as patent etc.), the economic owner is the part that performs the significant people functions relevant to determine the economic owner.<sup>71</sup> The significant people function is active decision making with regard to where the related risk is undertaken.<sup>72</sup> The same goes for acquired trade intangibles, the economic owner is the part performing the significant people functions.<sup>73</sup> The significant people function is yet again active decision making with regard to where the related risk is undertaken.<sup>74</sup> The things that has been said about trade intangibles also goes for marketing intangibles (ex. trade marks).<sup>75</sup>

### **3.2.2.5 Capital**

The AOA requires that an appropriate portion of the enterprise's "free" capital is to be attributed to the permanent establishment for purposes of tax and creditworthiness.<sup>76</sup> The term "free" capital is defined as an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes.<sup>77</sup>

According to the AOA, the permanent establishment should have an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. The process of attributing the permanent establishment "free" capital involves two stages; the first involves a measurement of the risks and valuation of the assets attributed to the permanent establishment, and the second is to determine the "free" capital the permanent establishment needs to support these risks and assets.<sup>78</sup>

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<sup>70</sup> Ibid., para. 75.

<sup>71</sup> Ibid., para. 87-88.

<sup>72</sup> Ibid., para. 91.

<sup>73</sup> Ibid., para. 92.

<sup>74</sup> Ibid., para. 94.

<sup>75</sup> Ibid., para. 97.

<sup>76</sup> Ibid., para. 99.

<sup>77</sup> Ibid., para. 105.

<sup>78</sup> Ibid., para. 107.

When it comes to the valuation of assets in the non-financial sector, there are several options. One option is to use the accounting value of the assets, another is to use the market value of the assets and a third is to use the purchase price or cost. When it comes to the measurement of risks, there are problems. In the report it is enacted that it might be possible to use the enterprise's own measurement tools as a starting point.<sup>79</sup>

The attribution of "free" capital to the permanent establishment needs to be done on an arm's length basis. The attribution of "free" capital should be done in accordance with where the assets and associated risks have been attributed and should take into account the specific functions, assets and risks of the permanent establishment relative to the functions, assets and risks of the enterprise as a whole.<sup>80</sup>

The AOA have several approaches for the determination of "free" capital. Where one produce a result which is not in accordance with the arm's length principle should, another should be used.<sup>81</sup> Under the capital allocation approach, "free" capital is allocated on the basis of the proportion of assets and risks attributed to the permanent establishment.<sup>82</sup> The problem with the approach is that there could be different market conditions, different business activities or that the enterprise itself is thinly capitalised.<sup>83</sup> Under the economic capital allocation approach, "free" capital is allocated on the basis of the measurement of the risks. The problem with the approach is that non-financial enterprises do not have developed systems for measurement of risks.<sup>84</sup> Under the capitalisation approach, "free" capital is allocated on the basis of debt-to-equity ratios of independent enterprises in the host country of the permanent establishment, carrying on the same or similar activities under the same or similar conditions.<sup>85</sup> The problem with the approach is that it might be hard to apply it outside the financial sector.<sup>86</sup> Where two contracting states have interpreted the ar-

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<sup>79</sup> Ibid., para. 109-113.

<sup>80</sup> Ibid., para. 116-117.

<sup>81</sup> Ibid., para. 118.

<sup>82</sup> Ibid., para. 121.

<sup>83</sup> Ibid., para. 124-125.

<sup>84</sup> Ibid., para. 128.

<sup>85</sup> Ibid., para. 129.

<sup>86</sup> Ibid., para. 132-133.

ticle correct, but used different approaches attributing “free” capital to the permanent establishment, art. 7.3 of the model tax convention should be applied.<sup>87</sup>

### **3.2.2.6 Funding**

The AOA acknowledges that the permanent establishment needs funding, made up of both “free” capital and interest-bearing debts. Once the amount of funding required is established, the foregoing discussion on “free” capital is applied.<sup>88</sup> When it comes to the attribution of funding costs to the permanent establishment, the AOA focus is the determination of an allowable interest deduction for the permanent establishment. The objective is to establish an arm’s length amount of interest to the permanent establishment.<sup>89</sup>

According to AOA there are two approaches to determine an allowable interest deduction for the permanent establishment. These are the tracing approach; where the interest rate on the funds provided to the permanent establishment are determined to be the same as the actual interest of the third party provider of the funds and the fungibility approach; where the permanent establishment is allocated a portion of the whole enterprise’s actual interest rate paid to a third party.<sup>90</sup>

When the attributed “free” capital is less than it would be under the arm’s length principle, an adjustment should be made by the host country. Where the interest-bearing debt attributed to the permanent establishment covers parts of the arm’s length amount of “free” capital attributable to the permanent establishment, any interest covering that amount will not be deductible for tax purposes. The same goes for the other way around, i.e. when the permanent establishment has been attributed to much “free” capital.<sup>91</sup>

### **3.2.2.7 Internal dealings**

Art. 7.2 of the model tax convention requires that the profit attributed to the permanent establishment must be based on the hypothetical separate and independent enterprise acting as such in its dealing with other parts of the enterprise. It is thus necessary to identify

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<sup>87</sup> Ibid., para. 149.

<sup>88</sup> Ibid., para. 150.

<sup>89</sup> Ibid., para. 152.

<sup>90</sup> Ibid., para. 154.

<sup>91</sup> Ibid., para. 162-166.

and determine the nature of the internal dealings by applying the arm's length principle. The dealings with other parts of the enterprise will affect the attribution of profits to the extent those dealings are relevant to the functions performed by the permanent establishment and other parts of the enterprise, taking account to assets used and risks assumed.<sup>92</sup>

The permanent establishment is not a legal entity and dealings between a permanent establishment and the rest of the enterprise has no legal consequences. Therefore a greater scrutiny of internal dealings is required, and also a greater scrutiny of documentation. The greater scrutiny means that there is a threshold which needs to be passed for a transaction to be conducted on an arm's length basis.<sup>93</sup>

Ultimately, when recognising internal dealings, it is the functional and factual analysis that will determine whether or not dealings have taken place, and not the accounting records or internal documentation. But according to the AOA, they are still the starting point for the evaluation of potential dealings. The functional and factual analysis will require a determination of whether or not there has been any economically significant transfer of risks, responsibilities and benefits as a result of the dealings.<sup>94</sup> Once a dealing has passed the threshold and been recognised as existing, the AOA applies the guidance at para. 1.48-1.54 and 1.64-1.69 of the TP Guidelines by analogy.<sup>95</sup>

### **3.2.3 Step two**

When it comes to the determination of profits of the separate and independent enterprise, the AOA is to undertake a comparison of dealings between the permanent establishment and the rest of the enterprise, with transactions between independent enterprises. The comparison should be made by an analogue application of the comparability analysis in the TP Guidelines. Comparability in the context of the permanent establishment means either that none of the differences between the dealing and transaction between independent enterprises materially affects the measure used to attribute profit to the permanent establishment or that reasonable adjustment could be made to eliminate the material effect of such differences. When it comes to which transfer pricing method to select when determining

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<sup>92</sup> Ibid., para. 172-173.

<sup>93</sup> Ibid., para. 175-176.

<sup>94</sup> Ibid., para. 177-178.

<sup>95</sup> Ibid., para. 182.

the arm's length remuneration of dealings, the most appropriate method due to the circumstances should be used.<sup>96</sup>

When deciding on which method to apply, it is important to undertake a functional and factual analysis to determine which functions are performed, assets used and risks assumed by the permanent establishment.<sup>97</sup>

When applying the comparability analysis of the TP Guidelines by analogy, the following factors should, according to the AOA, be identified; characteristics of property and services, functional analysis, contractual terms, economic circumstances and business strategies. When there is a transaction between the permanent establishment and another part of the enterprise that is comparable to a transaction between independent enterprises, the parties should be remunerated at an arm's length.<sup>98</sup>

### **3.2.4 Documentation**

According to the AOA, the guidance on the transfer pricing documentation in chapter V of the TP Guidelines should be applied by analogy. The same standards should be applied to the documentation of the arm's length nature of profit determination relating to internal dealings as currently apply to the documentation of transactions between associated enterprises. The summary of recommendations at para. 5.28 and 5.29 of the TP Guidelines should be followed. The tax authorities should have the right to obtain the documentation as means of verifying compliance with the arm's length principle.<sup>99</sup>

The TP Guidelines does not provide specific provisions that states should implement, but they are rather guidelines for states when developing rules on documentation.<sup>100</sup> In the Guidelines it is said that the tax authorities should take great care to balance the need for documents against the cost and administrative burden to the taxpayer of creating or obtaining the documents.<sup>101</sup>

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<sup>96</sup> Ibid., para. 183-184.

<sup>97</sup> Ibid., para. 185-188.

<sup>98</sup> Ibid., para. 190-191.

<sup>99</sup> Ibid., para. 224.

<sup>100</sup> TP Guidelines, para. 5.1.

<sup>101</sup> *ibid.*, para. 5.6.

## **4 Attribution of income according to Swedish law**

### **4.1 Taxation of a permanent establishment**

According to ch. 6 art. 7 and 11 IITL, a foreign enterprise is liable to tax on income derived from a permanent establishment. The calculation is to be done according to the chapters of IITL that concerns business operations, that is chapter 13 to and with 40 in IITL. To the type income of business operations, every income and expenditure are accounted that have come into existence because of the business operations.<sup>102</sup> For legal entities, the income and expenses due to assets and liabilities or capital gain or losses for the entity are accounted.<sup>103</sup>

The result is to be calculated in accordance with good faith of accounting, incomes shall be periodized as revenues and expenses shall be periodized as costs according to accounting principles as long as otherwise is not enacted in the IITL.<sup>104</sup> According to art. 11 on the Law of Branches (LB)<sup>105</sup>, a permanent establishment is obliged to keep the accounting separate from the rest of the enterprise.

### **4.2 Attribution of income**

#### **4.2.1 According to the income tax law**

Sweden applies a direct method<sup>106</sup> for attributing income to a permanent establishment, which means that the taxable income attributable to a permanent establishment is to be calculated in accordance with the legislation and that there is only actual income and costs attributable to the permanent establishment that should be considered.<sup>107</sup>

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<sup>102</sup> Ch. 13 art. 1 para. 1 IITL.

<sup>103</sup> Ch. 13 art. 2 IITL.

<sup>104</sup> Ch. 14 art. 2 para. 1-2 IITL.

<sup>105</sup> Lag (1992:160) om utländska filialer.

<sup>106</sup> See more under ch. 1.1..

<sup>107</sup> Gavelin, R, Andersson, G, Karlsson, D, Sweden, Permanent establishments, para. 52.

According to case law, there are no domestic provisions on how to attribute income to a permanent establishment,<sup>108</sup> instead the profits or losses are to be attributed to a permanent establishment to the extent they are attributable to it based on an arm's length approach.<sup>109</sup> The latter is supported by a statement made in an earlier preparatory work to the LB,<sup>110</sup> which has not been changed.

According to the preparatory work, the tax authorities are not bound by the accounting of the permanent establishment. Instead the provisions in the IITL which cover adjustment of remuneration for transactions between enterprises with economic interest in each other should be applied by analogy.<sup>111</sup> The relevant provision<sup>112</sup> covers situations where the result of an enterprise in Sweden is reduced because of provisions in a contract that would not exist between two completely independent enterprises, and the other enterprise is not subject of unlimited taxation. The rule has some exemptions from its application; if it is clear from the circumstances in the specific case that the provisions of the contract are not different from those between independent enterprises just because of the relationship between the two parties, the result should not be adjusted. In case law<sup>113</sup>, the methods for adjusting the result has been covered. The SAC stated that the TP Guidelines are not legally binding for the tax authorities, but that they could serve as a starting point for applying an arm's length method and adjusting the result. To apply the SAC finding by analogy to a permanent establishment, when analysing if an internal transaction deviates from what would be conditioned in a transaction between independent parties, the starting point is to analyse the functions performed by the parts of the enterprise. Other parts that should be taken into consideration when analysing is which part of the enterprise that assumes risks and responsibilities for different activities.

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<sup>108</sup> Case 2156-10 Administrative Court of Gothenburg, 28<sup>th</sup> of September 2010.

<sup>109</sup> Gavelin, R, Andersson, G, Karlsson, D, Sweden, Permanent establishments, para. 55.

<sup>110</sup> Prop. 1955:87.

<sup>111</sup> Prop. 1955:87, p. 64.

<sup>112</sup> Ch. 14 art. 19 IITL.

<sup>113</sup> RÅ 1991 ref. 107.

The attribution of assets and liabilities are often evident from the accounting of the permanent establishment and of the enterprise.<sup>114</sup> Some direction can be found from the wording of the provision of ITL, which enacts that an income or expense should be able to be attributed to the permanent establishment if it is related to it and the permanent establishment is subject to tax in Sweden.<sup>115</sup> According to the literature, internal interest rates are not deductible for a permanent establishment.<sup>116</sup>

#### **4.2.2 Case law**

From case law it is clear that it is the permanent establishments accounting that has to be the basis for attributing income to a permanent establishment.<sup>117</sup> In some cases, where the permanent establishment has not kept their own accounting and sent them in to the tax authorities, the courts have used an indirect method attributing income to the permanent establishment and made a discretionary assessment based on the overall income of the whole enterprise.<sup>118</sup>

In one case<sup>119</sup>, which concerned the question whether or not dividends were to be attributed to a permanent establishment in Sweden, the MoF said that the owning of the shares were not necessary for the functions performed by the permanent establishment and therefore the dividends should not be attributed to it. The owning of the shares were according to MoF i.e. not involved in the business performed at the permanent establishment. The SAC made the same judgement as the MoF. The same reasoning could be drawn from another case<sup>120</sup>, in which income from a horse (who was a permanent establishment in another state) was to be derived to the permanent establishment and subject to tax in the other state. In one case mentioned above, where the documents were not enough for the attribution of income based on a functional analysis, the Administrative Court (AC) stated that the basis for attribution of income should be the accounting of the permanent establish-

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<sup>114</sup> Gavelin, R, Andersson, G, Karlsson, D, Sweden, Permanent establishments, para. 56, and ch. 5.3.1.2.

<sup>115</sup> Ch. 35 art. 3 para. 1 d. 5 ITL.

<sup>116</sup> Lenfors, Blom, Fördelning av vinst till fasta driftställen, p. 6-7.

<sup>117</sup> RÅ 1971 ref. 50.

<sup>118</sup> Case 2156-10 Administrative Court of Gothenburg, 28<sup>th</sup> of September 2010, Case 1580-1581-08 Administrative Court of Appeal of Stockholm, 19<sup>th</sup> of July 2010.

<sup>119</sup> RÅ 1998 not. 229.

<sup>120</sup> RÅ 1993 ref. 29.

ment and that the taxable result should not deviate to much from the result of the accounting, but that the result could be adjusted on the basis of a functional analysis.<sup>121</sup>

From case law<sup>122</sup> it is clear that a permanent establishment cannot be attributed “free”<sup>123</sup> capital. The case concerned a Swedish bank with a permanent establishment in another state, with which Sweden had a tax treaty. According to the tax treaty, income that was derived from a permanent establishment in the other state was exempted from taxation in Sweden. The Swedish bank wanted to allocate “free” capital to the permanent establishment, and exempt the return of that capital from taxation in Sweden. The AC said that since no provision of the tax treaty or the IIL in Sweden permitted this, the bank could not allocate “free” capital. The Administrative Court of Appeal (ACA) agreed with the AC. The case has not been appealed.

From case law<sup>124</sup>, it is also clear that a permanent establishment cannot be allowed to deduct expenses of royalty to the rest of the enterprise. The case concerned a permanent establishment here in Sweden, who was using a trade mark of the enterprise. The permanent establishment paid royalty to a daughter company of the enterprise, which in turn paid a sum to other parts of the enterprise of which the permanent establishment was a part. The AC stated that the permanent establishment actually paid royalty to other parts of the enterprise and that such deductions were not allowed when calculating the income of a permanent establishment. The ACA denied the appeal of the case.

### **4.3 Documentation**

In Sweden there are some provisions covering the documentation of enterprises resident in Sweden and their transactions with enterprises that are only subject to tax according to the source principle. These provisions only apply when a Swedish enterprise engages in transactions when there is economic interest with the other business. The documentation shall in those cases cover, et al, a description of the enterprise and the organization, a functional

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<sup>121</sup> Case 2156-10 Administrative Court of Gothenburg, 28<sup>th</sup> of September 2010.

<sup>122</sup> Case 1444-2000 Administrative Court of Appeal of Stockholm, 21<sup>th</sup> of February 2002.

<sup>123</sup> For a definition, see ch. 3.2.2.5.

<sup>124</sup> Case 4418-2000 Administrative Court of Appeal of Stockholm, 13<sup>th</sup> of December 2000.

analysis, a description of the arm's length method for remuneration and a comparability analysis.<sup>125</sup>

The description of the enterprise and the organization shall describe the legal structure of the enterprise and also relevant financial information about the enterprises.<sup>126</sup> The transactions between two enterprises with economic interest in each other shall be described, the description shall et al contain the value of the transaction, amount, conditions of the contract and costs associated with the product.<sup>127</sup> The functional analysis shall contain a description of the roles of the enterprises and specify functions, assets and risks undertaken by the different enterprises.<sup>128</sup> The documentation shall contain information of how the enterprises applies the arm's length method they have chosen.<sup>129</sup> The documentation shall also contain a comparable analysis of internal and external transactions.<sup>130</sup>

These provisions do not however cover the situation when a permanent establishment engages in transactions with other parts of the same enterprise.<sup>131</sup> A permanent establishment is though obliged to document the above mentioned criteria when it is engaged in transactions with other enterprises in economic interest to the enterprise as a whole, if the transaction is related to the permanent establishment.<sup>132</sup>

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<sup>125</sup> Ch. 19 art. 2 d. a-b Lag 2001:1227 om självdeklarationer och kontrolluppgifter.

<sup>126</sup> Art. 3-4 SKVFS 2007:1.

<sup>127</sup> Art. 5, *ibid.*.

<sup>128</sup> Art. 7, *ibid.*.

<sup>129</sup> Art. 8, *ibid.*.

<sup>130</sup> Art. 9, *ibid.*.

<sup>131</sup> Prop. 2005/06:169, p. 110.

<sup>132</sup> Skv M 2007:25, ch. 3.3 Fast driftställe.

## 5 Comparison of the OECD approach and the Swedish approach

Both the AOA and the Swedish approach is that the permanent establishment is a separate and independent enterprise. Both approaches adjust the result of the permanent establishment if transactions with the rest of the enterprise are not in accordance with the arm's length principle. One major difference is that the Swedish approach has the accounting of the permanent establishment as a basis for attributing income, while the AOA has the functional and factual analysis as a basis for attributing income. The Swedish approach also contains a functional analysis, but that is a second step and should only be applied if it is relatively clear that the accounting of the permanent establishment does not show the reality.

The attribution of assets and risks are according to the Swedish approach often evident from the accounting of the permanent establishment, unless a functional analysis does not prove otherwise. The AOA has the functional and factual analysis as a basis for attributing assets and risks. In the report, the significant people function is of major relevance for the attribution of the latter.

The AOA is that a permanent establishment should be allocated "free" capital, and that it should have the same creditworthiness as the rest of the enterprise. As is evident from case law<sup>133</sup>, the Swedish approach does not allow the permanent establishment to be allocated "free" capital. The reason for this is, according to the ACA, that there are no provisions in IIL that admits the enterprise to do that.

The AOA allows permanent establishment to deduct royalty payments to the rest of the enterprise, as long as they are in accordance with the arm's length principle. The Swedish approach does not, according to case law<sup>134</sup>, allow the permanent establishment to do this.

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<sup>133</sup> See ch. 4.2.2.

<sup>134</sup> Ibid..

## **6 Legal status of the Commentaries and the 2010 report in Sweden**

### **6.1 Constitutional perspective**

Sweden is a dualistic state, which means that agreements made by the government have to be incorporated into Swedish law to be applicable by the individual.<sup>135</sup> According to ch. 8 art. 3 para. 1 d. 3 CL, provisions regarding taxes can only be made through law, and no other instruments. According to ch. 10 art. 1 international agreements with other states or organisations are to be entered by the government, and according to ch. 10 art. 3 para. 1 d. 1 they require the parliament's approval if a law needs to be reformed or a new law needs to be made. A tax treaty that the Swedish government concludes with another state therefore first has to be approved by the parliament and then be incorporated into the Swedish law by creating a law.

When it comes to the proposition to the laws incorporating the treaties into Swedish law, the government has often said that the tax treaty is connected to the OECD model tax convention, for example see the tax treaty between Sweden and Poland,<sup>136</sup> with explanations where the tax treaty has deviated from the model tax convention.

### **6.2 Case law**

In RÅ 1996 ref. 84, the Supreme Administrative Court (SAC) established the principles of the interpretation of a tax treaty. The facts of the case were that due to a business restructuring a Swedish company was going to become a parent company of foreign fund corporations. The corporations were registered legal entities in another state and were subjected to a low tax in the other state. According to Swedish law, a parent company would be taxed for the income of a foreign company if the foreign company were not a corporation according to Swedish law. A foreign company was a corporation if it was resident in the other state, and that a tax treaty was applied and the company was resident in the other state according to the treaty. There was an existing tax treaty between Sweden and the other state, which was exactly like the wording of the OECD model tax convention at the time the treaty was concluded. The contemplated parent company requested an answer from the

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<sup>135</sup> Warnling-Nerep, Lagerqvist Veloz Roca, Reichel, Statsrättens grunder, Norstedts juridik, second edition, Vällingby 2007, p. 145.

<sup>136</sup> Proposition 2004/05:121, p. 41 ff.

MoF concerning the taxation of income from the corporations. The MoF interpreted an article in the tax treaty, which was exactly like in the model tax convention, in a way that the corporations were not resident in the other state. The contemplated parent company appealed the judgement to the court.

The SAC stated that the interpretation of the tax treaty should be done in accordance with the parties' mutual intention, and that the methods of interpretation in the Vienna Convention on the Laws of Treaties (VCLT)<sup>137</sup> should be applied. The SAC stated that the interpretation at a first instance concerned the parties of the treaty, but that it also should cover the situation between individuals and the authorities. Beside the general methods of interpretation, the SAC went on to state that when a bilateral tax treaty or an article therein was designed in a way that it was in the model tax convention at the time, there were reason to assume that the parties tried to obtain the result that was in the Commentaries. The SAC went on to check the different, according to the VCLT, legal sources and the Commentaries. The SAC then ruled that the fund corporations were resident in the other state according to the tax treaty and thus foreign corporations according to the Swedish law and that the contemplated parent company were not going to be subject to taxation of their income.

The SAC has in other cases had no problem interpreting tax treaties in accordance with the Commentaries existing at the time the treaty was concluded, if the treaty in the case was based on the model tax convention and with the same wording.<sup>138</sup> The SAC has also stated that the Commentaries are relevant even when there is a purely domestic situation.<sup>139</sup> In some cases the SAC also has taken care of later amendments to the Commentaries.<sup>140</sup>

RÅ 2001 ref. 38 also concerned the interpretation of a term in a tax treaty. According to the proposition to the law incorporating the treaty into Swedish law, the term should have the same meaning as it should have according to the model tax convention and the Commentaries at the time. In this case the SAC did pay attention to later amendment to the

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<sup>137</sup> Vienna Convention on the Laws of Treaties, Vienna 1969.

<sup>138</sup> RÅ 1987 ref. 158, RÅ 1987 ref. 162, RÅ 1995 not. 68.

<sup>139</sup> RÅ 2001 ref. 50.

<sup>140</sup> RÅ 1991 not 228, RÅ 2001 ref. 38.

Commentaries, the reason for it seems to be that the later amendments did not add anything new other than clarification.

## 7 Analysis

### 7.1 Reformed income tax law

#### 7.1.1 Predictability and certainty

The Commentaries and the 2010 report are not legally binding for Sweden as a state, although as is evident from RÅ 1996 ref. 84, they are binding for the authorities when interpreting tax treaties based on the OECD model tax convention they are connected to and the tax treaties have the same wording. The report is thus “binding” when Sweden concludes tax treaties based on the model tax convention as it is now.

As mentioned above, tax law should be predictable and free from good faith. For purposes of predictability and costs for both Sweden and enterprises, there seems to be a need to reform the provisions regarding attribution of income to a permanent establishment. The Swedish ITL and the report do not differ that much from each other, like specified above.<sup>141</sup> Both treat the permanent establishment as a separate entity, although the report may give a more correct picture of the income that should be attributed to the permanent establishment since it takes the functional and factual analysis as a basis and not the accounting of the permanent establishment as the Swedish law does.

Lenfors and Blom argue that the Swedish law as it is now is unpredictable.<sup>142</sup> Von Uthmann has said that the ruling in the case concerning attribution of “free” capital can be questioned, since the ruling was not appealed to the SAC.<sup>143</sup>

The question is then if the Swedish law is unpredictable. There is, like mentioned in ch. 4.1, not much legislation on how to attribute income to a permanent establishment. The Swedish courts have lead the way on how to interpret the provisions of attribution of income. In my opinion is the case law rather clear. The basis on how to attribute income to a permanent establishment is the accounting of the permanent establishment, a second step is a functional analysis and last there is an adjustment of transactions not made at an arm’s length with the rest of the enterprise. What could be questioned is the cases regarding the

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<sup>141</sup> See ch. 5.

<sup>142</sup> Lenfors & Blom, *Fördelning av vinst till fasta driftställen*, p. 8-9.

<sup>143</sup> Von Uthmann, K, Sweden, *Cahiers de droit fiscal international*, The attribution of profits to permanent establishments, Sdu Fiscale & Financiële Uitgevers, volume 91b, Amsterdam 2006, p. 634.

allocation of “free” capital and deductible royalty payments to the rest of the enterprise. Since none of those cases were appealed to the SAC, there is uncertainty of how it really is.

Another perspective of predictability and certainty is the one of foreign enterprises that wants to establish a permanent establishment in Sweden. Especially if there is a tax treaty between Sweden and the state where the enterprise is resident, and the tax treaty is based on the 2010 OECD model tax convention and has the same wording. The enterprise might then assume that income are attributed according to the 2010 report, but the Swedish law does not conform to it and this creates uncertainty and non-predictability.

### **7.1.2 Separate entity**

The Swedish IITL has the approach that the permanent establishment is a separate and independent enterprise, but as it has been showed in the case law, the Swedish law has not been admitting some things that the 2010 report does.

When treating the permanent establishment as a separate entity it is necessary to admit the need for “free” capital, just like it is for every independent enterprise. The reason for attributing “free” capital to the permanent establishment is for purposes of creditworthiness.<sup>144</sup> No enterprise is entirely built on debt from others. Therefore, when treating a permanent establishment as a separate and independent entity, there might be a need for the legislator to implement in the income tax law that the permanent establishment shall be attributed “free” capital.

When it comes to royalty, which a permanent establishment according to case law cannot deduct if it is paid to the rest of the enterprise, for the permanent establishment really being seen as a separate and independent entity there might be reason to reform the Swedish IITL. The remuneration should be in accordance with the arm’s length principle.

### **7.1.3 The golden rule of double tax conventions**

Another approach on why the Swedish IITL should be reformed is that one basic premise with tax treaties is that they cannot extend a state’s right to tax a subject, it can only limit the right to tax.<sup>145</sup> This is also evident from the Swedish law incorporating tax treaties,

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<sup>144</sup> See ch. 3.2.2.5.

<sup>145</sup> Reimer, E, Permanent establishment in the OECD Model Tax Convention, Permanent establishments, para. 15.

which enacts that articles in the treaty only should be applicable where they limit Sweden's right to tax.<sup>146</sup>

If the Swedish legislator do not reform the ITL, and conclude new tax treaties with other states using the model tax convention and with the same wording, the problem might be that a the tax treaty allows Sweden to tax return on "free" capital of the permanent establishment but not the Swedish ITL. The same goes with royalties paid to a permanent establishment or a head office in Sweden. Seen from a fiscal perspective, there might be reason to reform the Swedish ITL.

## 7.2 Documentation

One of the reasons to implement laws requiring enterprises to document internal dealings is that they better can prove that they have done transactions at an arm's length.<sup>147</sup> Another is that tax authorities of states easier can control if enterprises make transactions at an arm's length. It is by other words to secure the tax base.<sup>148</sup> When it comes to Sweden, different meanings have arisen as to the purpose of the documentation. The main reason is to secure the tax base. The government and the tax authorities argue that the documentation also increases certainty for enterprises.<sup>149</sup> Bernath has said that, in Sweden, the only reason implementing obligation of documentation is to protect the tax base, since the rule concerning adjustment of the result is applicable only when profit or losses has left Sweden and not the other way around.<sup>150</sup> I have to agree with Bernath on this.

In the preparatory work to the Swedish provisions regarding documentation the tax authorities wanted the provisions to also cover a permanent establishment and its dealings with the rest of the enterprise.<sup>151</sup> There were several instances that did not agree with the

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<sup>146</sup> Art. 2 Lag (2005:248) om skatteavtal mellan Sverige och Polen.

<sup>147</sup> Tomsett, E & Blackwood, P, Documentation requirements in international transfer pricing, New York 1995, p. 1.

<sup>148</sup> Prop. 2005/06:169, p. 88.

<sup>149</sup> Ibid., p. 102.

<sup>150</sup> Bernath, A, De svenska dokumentationsreglerna, IUR-information 2006:10, p. 13-14.

<sup>151</sup> Prop. 2005/06:169, p. 100.

tax authorities and the government wanted to exempt the permanent establishment from the obligation of documentation in the event of further research in the area.<sup>152</sup>

In the report, it is stated that chapter V of the TP Guidelines should be applied by analogy to a permanent establishment. The main problem with a permanent establishment is that it is not a legal entity, and not necessarily has documents of transactions within the enterprise.

A permanent establishment does however need to have a separate accounting, and it must be assumed that the accounting is based on transactions within the enterprise as well. The accounting is based on vouchers, which according to the Swedish Accounting Law (AL)<sup>153</sup>, are evidence of the fact that a transaction has taken place.<sup>154</sup> A voucher should contain information of the date it has been compiled, when the transaction took place, what the bill contained, what amount the bill was on and who the counterpart was.<sup>155</sup> According to the Swedish Law of Value Added Tax (LVAT)<sup>156</sup>, a voucher should also contain a specification of the character of the product or service that was provided to the counterpart.<sup>157</sup>

The difference between the account the permanent establishment and the obligations of documentation are thus a functional analysis, a description of the enterprise and organization and a comparability analysis.<sup>158</sup> The costs for making these analysis's are from what I assume deductible for the permanent establishment, seeing that they are costs related to the business. Seeing that documentation are evidence that the permanent establishment has conformed with the price adjustment-provision, and made transactions with the rest of the enterprise at an arm's length, the costs for providing these documents will probably not be that big. If the enterprise is a multinational enterprise, they will probably have routines for performing functional and comparability analysis's.

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<sup>152</sup> Ibid., p. 110.

<sup>153</sup> Bokföringslag (1999:1078).

<sup>154</sup> Ch. 5 art. 6 para. 1 AL.

<sup>155</sup> Ch. 5 art. 7 para. 1 AL.

<sup>156</sup> Mervärdesskattelag (1994:200).

<sup>157</sup> Ch. 11 art. 8 para. 1 d. 6 LVAT.

<sup>158</sup> See ch. 4.3 for a definition of what the documentation should contain.

The AOA is that tax authorities should encourage documentation efforts by taxpayers so that the internal dealings are adequately documented for purposes of recognition and of adequate documentation of the applied arm's length principle.<sup>159</sup> To the question of whether or not it is proportionate, in the light of need for documents and costs and burden for the taxpayer, to oblige permanent establishments to document internal dealings, the question has to be yes. The main reason for the answer is that a permanent establishment is a separate entity and should in all perspectives be seen as one, and that a permanent establishment already have its own accounting and like mentioned above the costs would probably not be that big. The only situation where it will not be proportionate to oblige permanent establishment to document internal dealings is when the permanent establishment is part of a small enterprise, that do not have the routines for performing functional and comparability analysis's. Maybe the Swedish law should exempt enterprises with a total turnover under a fixed amount, or transactions under a fixed amount.

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<sup>159</sup> The 2008 report, para. 262.

## **8 Summary and conclusion**

The AOA on how to attribute income to a permanent establishment is that the permanent establishment is 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 other parts of the enterprise. The Swedish approach on how to attribute income to a permanent establishment is that the permanent establishment is a separate and independent enterprise. According to the AOA, the functional and factual analysis is the basis on how to attribute assets and risks to a permanent establishment, while the Swedish approach is that the accounting of the permanent establishment is the basis for attributing assets and risks.

The conclusion of this thesis is that the Swedish IITL should be reformed to better conform to the report due to reasons of certainty and predictability. Seeing that the Swedish legislator has let the administrative courts interpret the non-existing provisions, the best way to reform the IITL is by law. The reform should allow a permanent establishment to be allocated “free” capital, and to allow it to deduct royalty to other parts of the enterprise.

The conclusion of the question whether or not the legislation on documentation of transactions between enterprises with economic interest in each other also should cover permanent establishment and its dealings with the rest of the enterprise, is that the provisions also should cover these transactions since it would not be an unproportionate burden on the taxpayer.

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