IFA / YIN Lecture

Permanent Establishments in the OECD Model – Is there a mismatch between Arts. 5 and 7?

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Structure

- A. The mainstream trend: more taxing rights to the source State
- B. Consistencies and inconsistencies:
  Some extensions of Art. 5 does not match the FSEA in Art. 7(2)
- C. Policy options
- D. Resume

A. Mainstream trend:
More taxing rights to the source State

- The outset:
  Article 7(1)1 OECD MC

  [1] Profits of an enterprise of a Contracting State shall be taxable only in that State [...]

A. Mainstream trend:
More taxing rights to the source State

- But Article 7(1)1&2 OECD MC

  [1] Profits 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 PE situated therein. [2] If the enterprise carries on business as aforesaid, the profits that are attributable to the PE [...] may be taxed in that other State.

A. Mainstream trend:
More taxing rights to the source State

- attempts to lower the PE threshold:
  - acknowledgment of unmanned PEs
  - acknowledgement of service PEs
  - extension of Art. 5(2)
  - reduction of 12-months period in Art. 5(3)
  - acknowledgment of subcontractor PEs
  - reduction of Art. 5(4)
  - extension of agency PEs

A. Mainstream trend:
More taxing rights to the source State

- attempts to extend PE-related profits:
  - external transactions:
    shift from (mainly) cost-plus method to (mainly) CUPM
  - internal dealings:
    concept of „PE equity" establishes limits to deduction of (notional) interest payments „paid" by PE to head office
  - in all, FSEA (AOA) assigns adequate parts of the synergy effect to source State

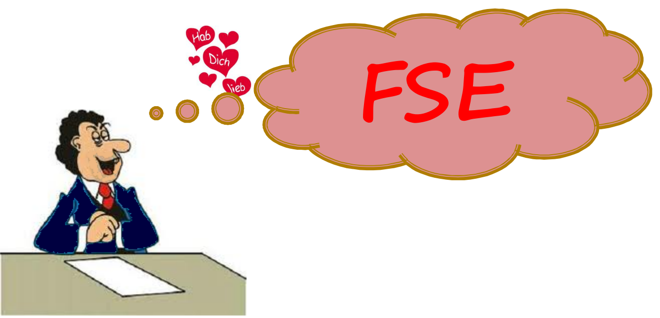
A. Mainstream trend:
More taxing rights to the source State

- Resume:

  More and more taxing rights have been shifted from the State of residence to the State of source.

B. Consistencies and inconsistencies:
Some extensions of Art. 5 does not match the FSEA in Art. 7(2)

- However, some extensions of Art. 5 do not match the FSEA in Art. 7(2).



B. Consistencies and inconsistencies:
Some extensions of Art. 5 does not match the FSEA in Art. 7(2)

- However, some extensions of Art. 5 do not match the FSEA in Art. 7(2).
  - Consistency test: Would a **corporate partisan** reasonably establish a corporation for the PoB located/the activities performed in the source State? [yes for traditional PoBs under Art. 5(1), but no for short-term services
  - Further indicators might be drawn from Art. 4(1) as well as from case law on Art.5(4) OECD MC.

B. Consistencies and inconsistencies:
Some extensions of Art. 5 does not match the FSEA in Art. 7(2)

- Consistent:
  - Delivery dock at a customer's warehouse (no PE) (no. 4.4 Comm. on Art. 5)
  - Office building where painter always works (PE) (no. 4.5 Comm. on Art. 5)
  - Major construction site at same place (PE) (Art. 5(3))
  - Many similar works, different places, same State (PE) (no. 20 Comm. on Art. 5)
  - Dependent agent (PE) (Art. 5(5))
  - Independent agent (no PE) (Art. 5(6))

B. Consistencies and inconsistencies:
Some extensions of Art. 5 does not match the FSEA in Art. 7(2)

- Inconsistent:
  - Minor construction works, same place, > 12 months (PE) (Art. 5(3))
  - Exclusion of other sites or projects from 12-months test (no. 18 Comm. on Art. 5)
  - Inclusion of subcontractors in 12-months test (no. 18 Comm. on Art. 5)
  - Conclusion of contracts by entrepreneur himself (no PE) (Art. 5(1)&(5))
  - Large-scale storage and/or delivery (no PE) (Art. 5(4))
  - Large-scale direct sales (no PE) (Art. 5(1)&(4))
  - Unmanned facilities (PE) (Art. 5(1)).

C. Policy options
Overview

What?	Where?
Withdraw all extensions of the PE definition	Art. 5
Withdraw FSEA	Art. 7 (2)&(3)
Three instead of two rules for Business Profits	Art. 7(4) NEW
Extend the Royalty concept & introduce source State taxation	Art. 12 NEW

C. Policy options
I. Withdraw all extensions of the PE definition

- The AOA requires an conservative PE design.
- This might suggest
  - narrow interpretation of existing rules,
    especially with regard to
    - unmanned facilities
    - service PEs
    - attribution of subcontractor's activities to the taxpayer
    - aggregation of more than one place for the computation of minimum periods or for the application of Art. 5(4)
  - redraft of the wording of Art. 5.

C. Policy options
II. Withdraw FSEA

- Alternatively, a broad PE definition can be maintained if the FSEA is being withdrawn
  - pro:
    - difficulties where dealings are invisible under private law
    - difficulties where units are allowed to behave in a way that would be inadmissible for any FSE
  - contra:
    - neutrality argument – consistency with Art. 9
    - OECD commitment to strengthen taxation by the source State

C. Policy options
III. Three instead of two rules for Business Profits

- Maintain the current text of both Art. 5 and Art. 7 (2), but
- return to a less artificial interpretation of Art. 5 (≈ Art. 49 TFEU)
- and insert a new rule on source State taxation in non-PE cases.

C. Policy options
III. Three instead of two rules for Business Profits

- Draft Art. 7(4):

Notwithstanding the provisions of paragraphs 2 and 3, profits of an enterprise of a Contracting State may be taxed in the other Contracting States if they are derived from

(a) the furnishing of services, including consultancy services, by the enterprise through employees or other personnel engaged by the enterprise for such purpose,

but only if activities of that nature continue [for the same or a connected project] within the other Contracting State for, or

(b) the sale of [...] at a net price of more than [...] [currency] to one or more residents of that other State in,

a period or periods exceeding in the aggregate 183 days in any twelve month period.

C. Policy options
III. Three instead of two rules for Business Profits

Implications:

Draft Art. 7(4) as a whole

- goes far beyond the force-of-attraction rules in Art. 7(1) UN MC;
- does not require the FSEA.
  Rather, the computation of pertaining profits is basically a matter of domestic law, with prevalence assigned to the source State (Art. 23);
- might require an arm's-length clause similar to Arts. 11(6) and 12(4) OECD MC;
- does not trigger PE provisions in Arts. 10(4), 11(4), 12(3), 13(2), 15(2)(c), 21(2) or 22(2) OECD MC.

C. Policy options
III. Three instead of two rules for Business Profits

Implications on services rendered in the source State:

Art. 7(4)(a)

- keeps taxation of business profits and of employment income consistent,
- maintains 183-day rule for employment income,
- but NB: if an individual employees stays in the source State for 100 days and is then replaced by a colleague who stays there another 100 days, taxation of business profits is assigned to the source State while employment income remains taxable only in the State of (employee's) residence.

C. Policy options
III. Three instead of two rules for Business Profits

Implications on large-scale sales:

Art. 7(4)(b)

- keeps taxation of business profits from the export of goods consistent to the taxation for the export of services,
- comes close to VAT/GST in the source State,
- is not useful where domestic law of the the source State does not provide for any income taxes upon these sales;
- should always be connected with a subject-to-tax clause in Art. 23;
- should also apply where taxpayer delivers goods to a PE which a third-country resident maintains in the source State (cf. Art. 11(5)(2)). Example: PE clause in Art. 7(4)(b).

C. Policy options
III. Three instead of two rules for Business Profits

Implications on large-scale sales:

Art. 7(4)(b)

- might require an anti-treaty shopping mechanism.
- Most notably, a strict interpretation of „sale … to" in the sense of beneficial ownership of the person/PE *and* effective transportation to the source State is indispensable. Contractual relationship as such is insufficient.
- What if recipient transports the goods or merchandise on to a third country, or back to the State of residence? Can VAT rules help?

C. Policy options
III. Three instead of two rules for Business Profits

Evaluation

- Draft Art. 7(4) ensures more source State taxation,
- is flexible for amendments or cuts,
- challenges the demarkation line between income tax and VAT/GST in the source State.
- Refinements required.

C. Policy options
IV. Extend royalty concept & introduce source State taxation

Option no. 4:

- Delete Art. 5(5)-(7) OECD MC,
- maintain the current text of Art. 7 OECD MC as a whole, but
- extend the royalty definition in Art. 12(2) OECD MC to
  - services of any kind, including consulting, contract-concluding, and corresponding preparatory activities, but only if exercised in the other contracting State for; and
  - the sale of goods or merchandise at a net price of more than [...] [currency] to one or more residents of that other State in,

  a period or periods exceeding in the aggregate 183 days in any twelve month period;
- and insert a right of the source State to tax on the basis of gross income, but with the tax rate capped (≈ Art. 12(2) UN MC).

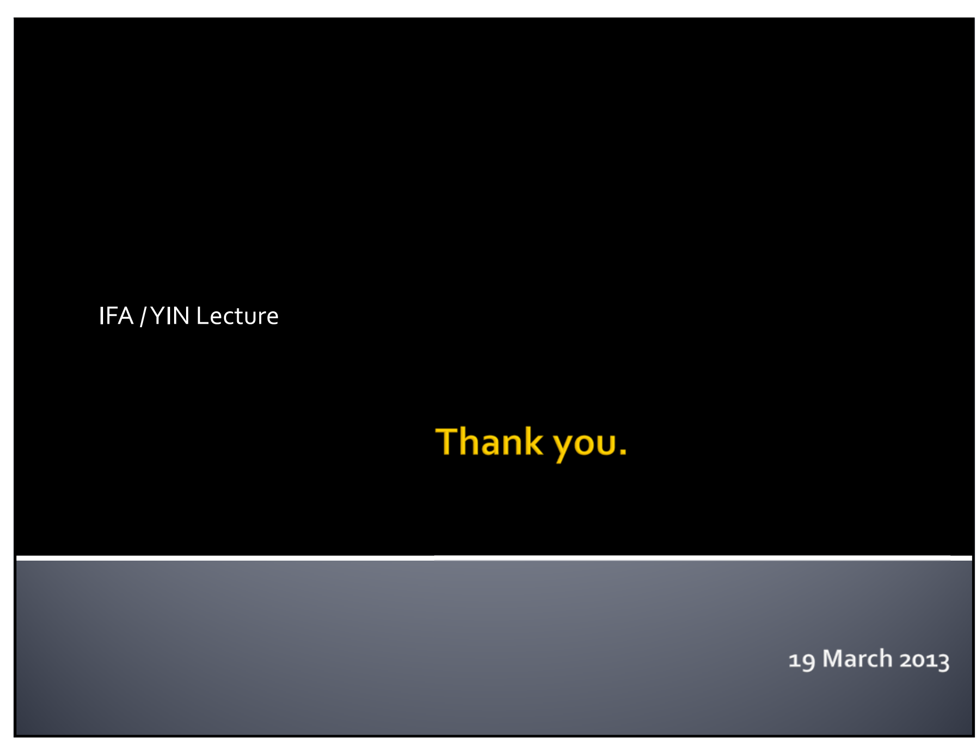
C. Policy options
IV. Extend royalty concept & introduce source State taxation

Implications:

- Like option no. 3, an amendment to Art. 12, too, is a helpful exoneration of Art. 5 from too policy-driven impurities.
- Unlike Art. 7 which brings about a fractioning of the tax base, the draft Art. 12(2) would fraction the tax along the rates.
- Unlike Art. 7 where most (all?) States tax on a net basis in accordance with their domestic law, source State taxation in the context of Art. 10-12 (new) assigns gross inflows to a taxation by the source State. Helpful?
  - more simple
  - maximum rates might vary (low for capital-intensive goods and merchandise; higher for services which are less capital-intensive)

D. Resume

- Manifold kick-backs of Art. 7 to the design and interpretation of Art. 5.
- Tensions, inconsistencies.
- Scrutiny of four ways out:
  - restrict Art. 5
  - redo AOA
  - amend Art. 7 by a service rule and a delivery rule
  - extend Art. 12 to services and the delivery of software, combined with capped taxation at source on a gross basis (≈ Art. 12(2) UN MC)
- While I prefer a combination of options (1)&(4), each of the four attempts has inherent advantages.
- Separately and jointly, they might help OECD Member States to arrive at a higher degree of source State taxation.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Thank you.
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