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A Comparative Approach to the Order of Priority of the Allocation of Taxing Rights over Business Profits in the OECD MC, the UN MC and the Andean Pact MC – The PE broadening. An Argentinean example.

By

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OECD	Organization for Economic Co-operation and Development
UN	United Nations
MC	Model Convention
PE	Permanent Establishment
DTC	Double Tax Convention
BEPS	Base Erosion and Profit Shifting

1. Introduction

1.1 Background

In light of the Base Erosion and Profit Shifting project (hereinafter, "BEPS") delivered by the Organization for Economic Co-operation and Development (hereinafter, "OECD[1]"), it is worth revising the existing allocation rules for business income derived from some of the most followed Model Conventions. Some of the proposed changes to the OECD Model Convention (hereinafter, "OECD MC") suggested by the BEPS project have already been implemented by the United Nations Model of Double Taxation Convention between Developed and Developing Countries[2] (hereinafter, "UN MC").

In the OECD Report on BEPS it is stated that in its origins, Model Conventions were drafted with the aim of preventing double taxation in order to promote international trade. From the early 1920s, countries have worked together to eliminate double taxation in order to remove the obstacles for trade and economic growth[3]. The OECD Report on BEPS states that the cooperation developed by the States in order to prevent double taxation has reached its objective but at the same time it has proved to have some weaknesses which create opportunities for base erosion and profit shifting[4].

In this context, even though the OECD Report on BEPS states that no or low taxation are not a problem in themselves as long as they are not achieved by way of artificially segregating the taxable income from the activities that produce such income[5], it could be argued that they are indeed considered to be a problem for States. For instance, Action Plan 7 from the BEPS project aims to tackle the artificial avoidance of the PE status as it is defined by the OECD MC. However, it could be argued that the PE status can also be easily avoided without the need of any sort of artificiality. For example, the current PE threshold from the OECD MC requires either a physical presence in the source State or an indirect presence through the use of a dependent agent. Nevertheless, there are some business models that do not even need to have any sort of physical presence in the country of source, consequently, they do not even need to require to sophisticated aggressive tax planning structures. This is what happens for example with companies that simply rely on digital sources in order to sell goods in different countries without even having a PE in such countries, or on enterprises whose businesses consists only on the provision of services abroad. Thus, when looking in depth which might be the

[1] Organization for Economic Co-operation and Development. The MC used for this study is the last updated version (2014).
[2] The MC used for this study is the last updated version (2011).
[3] Action Plan on Base Erosion and Profit Shifting, OECD Report 2013, Chapter 2, Page 9.
[4] Action Plan on Base Erosion and Profit Shifting, OECD Report 2013, Chapter 2, Page 9.
[5] Action Plan on Base Erosion and Profit Shifting, OECD Report 2013, Chapter 2, Page 10.

actual aim of the BEPS project, no or low taxation are in fact a problem in themselves for States, even if they are not the result of an artificiality.

In this context, some States are seeing that due to the current PE threshold provided by the OECD MC a portion of tax revenue is being lost since there are income generating activities which end up being untaxed. Due to the fact that some activities do not fall under the scope of the PE threshold as defined by the OECD MC, States are willing to revise such threshold in order to include into the PE concept activities that up to now have been left for those countries which follow the UN MC (which is only aimed for the protection of developing countries[6]).

Nevertheless, the current PE threshold of the OECD MC was established in a way to be compatible with the objective of capital exporting countries whose desire was to give primacy to residence taxation over source taxation. According to Peggy Musgrave, capital export neutrality tends to be more desirable since it provides an efficient allocation of resources[7]. In addition to this, the best way to achieve capital export neutrality would be by choosing the "tax credit" as a mechanism for eliminating double taxation instead of "tax exemption". In this sense, capital export neutrality favours residence-based taxation[8] and the OECD´s PE threshold was defined in a manner for residence taxation to prevail over source taxation. Since capital exporting countries needed to grant a tax credit to its residents for the taxes paid abroad as a consequence of their investments, in order to achieve such "neutrality", they claimed for a narrower PE threshold. If a narrower PE threshold exists, then capital exporting countries are able to secure, to a certain extent, their revenue, since the cases in which they would have to grant a tax credit will be less abundant or will be limited only to specific situations.

The narrower the PE threshold, the more difficult for a non-resident who invests abroad to be subject to taxation in the source jurisdiction. Therefore, the cases in which the residence country of the investor would have to grant a tax credit would be restricted only to the existence of a fixed place of business or a dependent agent.

In this context, since the preferences when drafting the OECD´s PE threshold where put on a residence-based taxation system, a number of theories where elaborated in order to justify source taxation, being the benefits principle and the economic allegiance theory the strongest ones. Each of these theories

[6] United Nations Model Double Taxation Convention between Developed and Developing Countries 2011, Page VI, Paragraph 3.
[7] Klaus Vogel, "Taxation of Cross-Border Income, Harmonization and Tax Neutrality under European Community Law: An institutional approach" (1994), Page 21 cited by Dale Pinto, "E-commerce and Source-based Income Taxation", Doctoral Series, Academic Council 6, IBFD, 2003, Page 24.
[8] Dale Pinto, "E-commerce and Source-based Income Taxation", Doctoral Series, Academic Council 6, IBFD, 2003, Page 24.

require a substantial nexus between the non-resident and the source country. The current OECD´s PE threshold requires either a direct physical presence (fixed place of business) or an indirect presence through a legal representative (dependent agent).

On the other hand, Model Conventions such as the UN MC, provide a wider PE threshold, including income generating activities which are not included under the OECD PE threshold. The first justification that has been established for widening the PE threshold in the UN MC is the aim of protecting the source base of developing countries[9]. Due to this protective policy, it is accepted to expand the PE threshold for shifting less tax revenue from source countries to residence countries. Nevertheless, it should be noted that the UN MC still requires the existence of a PE in the source State in order to justify source taxation. However, another MC such as the Andean Community Income and Capital Tax Convention[10] (hereinafter, "the Andean Pact MC" or the "Andean Pact Model") achieves a full protection of the source jurisdiction by simply not including the concept of PE into the MC. In other words, source taxation, under the terms of the Andean Pact Model, does not need to be justified by the existence of a PE. The Andean Pact Model – whose Member States are categorized as developing countries[11] – tries to secure source-based taxation by way of taxing any activity developed within its jurisdiction, even if the activity does not hold a deep substance.

In this context, it can be appreciated that differences in PE thresholds – depending on the tax policy that is sought to be achieved – might cast doubt on whether residence-based taxation is preferable over source-based taxation, especially if taken into consideration the current trends on electronic commerce. While the protection of source taxation and the broadening of the taxing powers of the source country have been originally left for developing countries, such current trends on electronic commerce prove that the protection of source taxation does not necessary has to do with the level of industrialization of a country. An example of this statement, as it will be later explained, can be appreciated by the suggestions included in Action Plan 7 as regards the exclusion of the word "delivery" from the "preparatory or auxiliary activities". In other words, if this exclusion ends up been implemented, the OECD MC would have broaden the PE threshold by way of including what is known as "delivery PE". In this regard, Action Plan 7[12]

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[9] United Nations Model Double Taxation Convention between Developed and Developing Countries 2011, Page VI, Paragraph 3.

[10] The MC used for this study is the last updated version (2004).

[11] Bolivia, Colombia, Ecuador, Perú and Venezuela. The categorization as developing countries has been taken from: DAC List of ODA Recipients Effective for reporting on 2014, 2015 and 2016 flows, OECD Aid Statistics. Electronic information available at: http://www.oecd.org/dac/stats/daclist.htm

[12] Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of the PE Status", 2014/2015, OECD, Page 16.

highlights the arguments provided by the UN Commentaries in relation to the "delivery PE". Even though a large number of the developing countries do not have the so-called "delivery PE", those countries that have introduced such concept into their tax treaties, have argued that the existence of a warehouse established for delivery of goods, eases the sale of those goods in the source country without the need of having the substantial "physical presence" required by the PE threshold.

It should be noted that Action Plan 7 on its Introduction states that the causes for base erosion and profit shifting are a combination of tax planning coordinated strategies aimed for the circumvention of the PE status[13]. However, it could be argued that what Action Plan 7 tries to do is to update the PE threshold to the modern way of doing businesses around the world in order to prevent the loss of tax revenue, which is not only caused by tax planning, but is caused due to the existing threshold.

Nevertheless, as it will be later developed throughout this essay, it could be argued that updating or revising the PE threshold in order to take it closer to what the UN MC suggests, might not be the only solution for base erosion and profit shifting. In other words, I propose to consider the tax policy followed by the Andean Pact Model, which mainly consists of the elimination of the concept of PE.

By way of disregarding the PE threshold, what the Andean Pact Model tries to achieve is that the taxing rights over business profits obtained by the performance of activities within the source country, end up being allocated directly to the source jurisdiction. Moreover, there might be arguments in favour of the distribution of taxing rights on Avi Yonah´s proposal to adopt the formulary profit split method for allocating business profits from multinational enterprises.

In order to provide arguments in favour of this hypothesis, I will provide explanations on the existing linking rules that justify source taxation of business profits within the OECD´s PE threshold and the UN´s PE threshold. Ultimately, I will explain the criterion chosen by the Andean Pact Model aimed to protect the source base, which its technic might be considered similar to what Georg van Schanz had proposed already in the 19th century.

1.2 Aim

The purpose of this paper is to provide a comparison of some of the existing distributive rules for allocating the taxing rights over business profits between source and residence countries according to the OECD MC, the UN MC and the Andean Pact MC. All of these models serve the same purpose and the

[13] Action Plan 7, Page 9, Paragraph 1 of the Introduction.

same function: allocating the taxing rights over a certain type of income between source and/or residence by way of giving priority to one of them.

In order to achieve such purpose it will be necessary to analyse which are the current characteristics of the PE threshold in the different Model Conventions under analysis. The study will be approached with a comparative analysis between the linking factors between the OECD MC, the UN MC and the Andean Pact MC in regards to the PE threshold.

Moreover, since the aim of the BEPS project is to suggest possible changes to the PE definition in order to prevent the artificial avoidance of the PE status, it is worth comparing which are some of the existing linking factors that justify source taxation over business profits and what consequences might flow from the choice of certain connectors.

In this sense, Avi-Yonah explains that comparative taxation has been suggested to be:

'an instrument to advance, inter alia, successful tax reforms, cultural understanding, democratic values, legal harmonization and a better understanding of domestic tax laws'.[14]

Taking into consideration the fact that BEPS project might be questioning the existing allocation rules by way of revising the PE threshold, in this particular case, the richness of performing a comparative analysis, is to search for possible solutions to the problem of base erosion and profit shifting. In this particular context, I would like to consider what the Andean Pact Model already proposes as a solution for the protection of the source-base.

A comparative approach will facilitate an understanding of some of the common difficulties that arise in cross-border transactions as well as to identify the mechanisms chosen by each Model Convention in order to counteract such difficulties in accordance with their tax policies goals. Comparing the distributive rules of taxing powers in relation to business profits, will help to develop an understanding of the underlying differences as well as the convergences of the tax policies that each Model Convention represents.

1.3 Method and material

The study that was carried out consists of the comparison of the functions that different tax systems serve. Despite the fact that the study provides a brief analysis of domestic laws, the main objective of this paper is to focus on the policy choices proposed and followed by different international set of rules,

[14] Avi-Yonah, Nicola Sartori and Omri Marian, "Global Perspectives on Income Taxation Law", Published by Oxford Scholarship Online: May 2011, Section II.

such as the OECD MC, the UN MC and the Andean Pact MC. The transcendence of analysing the tax policies instead of a particular set of domestic laws is given by the fact tax policies 'always remain in the background and are always relevant'.[15]

The comparative study is required to describe and compare the different set of rules as well as to provide arguments for and against of each system. Nevertheless, the comparison performed also took into consideration the functions that each set of rules provides. In this sense Carlo Garbarino has stated:

'In comparative tax research what really matters is the actual function of tax rules, and because often countries share common tax problems, comparative tax research turns out to be the discovery of meaningful tax convergence of operative rules in spite of apparent divergences of tax systems in terms of statutory language or procedures. One of the main tasks of comparative taxation is therefore to focus on functional tax convergence, rather than apparent tax divergence, and the corresponding result is the discovery of deep common structures of taxation (a tax common core)'.[16]

As regards the material that has been used, there has been a selection of three Model Conventions of Tax Treaties for the Avoidance of Double Taxation. These set of rules are the OECD MC, the UN MC and the Andean Pact Model Convention. In addition, part of the material used has been the OECD Commentaries on the MC and the UN Commentaries of the MC last updated versions. Additionally, in order to provide examples of the different thresholds of the PE concept a set of three Double Tax Treaties have been used.

The sources of the material used varies from official documents taken from official websites of official organisms and institutions, as well as international databases such as the International Bureau of Fiscal Documentation (hereinafter, "IBFD") and Wolters Kluwer – Kluwer Law Online (hereinafter, "Kluwer). I have also used an Argentinean database called La Ley Online supported by Thomson Reuters in order to obtain primary source material. Nevertheless, when information provided by the domestic database has been used, such information has been supported with secondary source material provided by IBFD in order to make it available to non-Spanish speakers. Moreover, since the Andean Pact Model´s original language is Spanish, the non-official translation into English provided by IBFD has been used. However, in cases where the wording used in English differs from the

[15] Avi-Yonah, Nicola Sartori and Omri Marian, "Global Perspectives on Income Taxation Law", Published by Oxford Scholarship Online: May 2011, Section II.

[16] Carlo Garbarino, "An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research", Page 14. Electronic copy available at: http://ssrn.com/abstract=1116686

wording used in Spanish, clarification of the meaning of such words has been made by providing definitions from the Real Academia Española (Spanish Royal Academy)[17].

1.4 Delimitation

For the purpose of this paper, the analysis is only focused on the primacy of the allocation of the taxing rights over business profits.

In order to provide a better understanding of the differences in the existing tax policies behind some the current allocation rules for business profits in the Model Conventions under analysis (OECD MC, UN MC and Andean Pact MC), the paper will address the comparative approach using three Double Tax Conventions (hereinafter, "DTC") as examples:

1) Argentina – Sweden DTC from 1995 (which resembles the UN MC and provides an example of what is known as "service PE" and "delivery PE").
2) Argentina – Denmark DTC from 1995 (which resembles the OECD MC and excludes the warehouse for delivery of goods from constituting a PE).
3) Argentina – Bolivia DTC from 1976 (which follows the Andean Pact Model and does not provide a definition of PE).

All of these examples have been chosen because they all share one common factor: at least one of the Contracting parties is a developing country. Moreover, these DTCs have been selected in order to provide a clear example of the differences in the allocation rules derived from the different PE thresholds adopted in order to determine which of the two Contracting States (either source or residence country) will have primacy for taxing business profits. In addition to this, despite the fact that DTCs are the product of States´ negotiations, they tend to provide an idea of the underlying tax policy that each of those States pursue.

Additionally, the selection of the above mentioned DTCs have been made based on the fact that each of them closely reflect either the Andean Pact Model, the OECD MC or the UN MC. These examples will show some of the existing differences in determining the primacy of allocation of taxing powers between source and residence jurisdictions in relation to business profits.

As regards the comparison of the PE concept, this study will leave a side the traditional explanations of the concept of "fixed place of business" and "dependent agent", due to the fact that exists vast literature referred to them. In this context, this study will only provide explanations on the broadening of

[17] The *Spanish Royal Academy* is the official royal institution in charge of regulating the Spanish language.

the PE concept provided by the UN MC and the considerations made by the OECD MC Commentaries in that regard.

1.5. Outline

The first part of this study will provide a brief explanation on some of the traditional principles in international taxation used for justifying source taxation, such as the benefits principle and the economic allegiance principle.

Later on the study will follow an analysis of the rules on allocation of business profits in accordance to Article 7 of the OECD MC and the UN MC. Since Article 7 assigns the right to tax business profits of a non-resident to the source State only when the non-resident holds a PE in such State, I will leave the analysis of the PE threshold for the third part, after it has already been analysed the allocation rules. In particular, I will provide explanations regarding the differences in the allocation rules between the OECD MC and the UN MC. Ultimately, I will analyse the Andean Pact Model as a possible solution for BEPS.

I will then continue analysing the PE threshold. In this case, I will provide examples of DTCs signed by different countries in order to provide an explanation of the "service PE" and the "delivery PE".

2. A brief introduction to the traditional justifications for allowing source taxation or "the agreement" for limiting source taxation

2.1. Preliminary remarks

Most countries apply both source and residence based taxation at the same time. Residence taxation taxes residents on their worldwide income. Source taxation taxes non-residents on the income derived from sources located within the territory of the source country. These regimes produce cases of double taxation when a resident of a country derives income from another country. This means that the income obtained in the source country will be subject to tax there and, additionally, the same income might also be subject to tax in the residence country, since this country taxes its residents on their worldwide income. In this context, DTCs appeared as a way to solve these situations of double taxation[18].

[18] Avi Yonah Reuven S., "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing, 2015, Pages 8-9.

However, despite the existence of tax treaties aimed at eliminating double taxation, most States provide some sort of unilateral tax relief for these type of situations. Most countries contain in their domestic law either an exemption relief over income obtained abroad or grant a tax credit for the taxes paid in the source country. In this context, since most countries provide unilateral tools for eliminating double taxation, Avi-Yonah casts doubts regarding which is the real function of DTCs. In other words, he argues that the real function of a DTC is not to eliminate double taxation in itself, but instead he concludes that DTCs´ objective is to shift tax revenue from source countries to resident countries[19].

Avi-Yonah´s starting point of his hypothesis is that States would be naturally free to levy taxes on the profits derived within their jurisdictions. He states that if revenue derives from within a country, and in case there is no DTC, such country has the primacy right to tax such income (whether it is active or passive income). States would be allowed to levy taxes over the profits derived from their territories due to their sovereignty. He also argues that countries are naturally not bound by any sort of agreement such as the PE concept or any sort of "sourcing rule" that determines when the source country may levy a tax over profits derived from its territory. In other words, Avi-Yonah argues that the function of a DTC is to limit source taxation by way of shifting tax revenue from source to resident countries.[20]

Since each State would be free to tax the income arisen within its jurisdiction due to the fact that 'states often tax[ed] profits on the basis of a nexus within their boundaries'[21], DTCs appear as a legal convention in order to eliminate double taxation by way of restricting the taxing powers of the source country and shifting income to the residence country.

Avi-Yonah states that the shift of tax revenue from source to residence countries occurs in two ways. For active income, the way to shift taxable revenue is by the creation of the concept of PE – only if the non-resident holds a PE in the source State, this State would be allowed to levy taxes. Depending on how much taxable revenue is desired to be shifted, the PE threshold can be adapted. This fact will be later explained with the comparison between the OECD´s PE threshold and the UN´PE threshold.

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[19] Reuven S. Avi-Yonah, "Double Tax Treaties", Page 2. Electronic copy available at: http://ssrn.com/abstract=1048441

[20] Reuven S. Avi-Yonah, "Double Tax Treaties", Page 2. Electronic copy available at: http://ssrn.com/abstract=1048441

[21] Anshuman Chaturvedi, "Permanent Establishments and Force of Attraction: Some Implications of TD Securities, in General and from an Indian Perspective", International, Canada, India, Bulletin for International Taxation, February 2011, IBFD, Page 75.

As regards passive income, the way to shift taxable revenue is through the reduction of the withholding tax in the source State. The OECD MC provides more reduced withholding taxes whereas the UN MC provides higher withholding taxes.[22]

Notwithstanding the fact that DTCs could be understood as a way to shift taxable resources from source to residence jurisdictions, what this shift might include or involve, depends on which of the two jurisdictions obtains primacy to tax certain piece of income. In other words, it could be argued that the level of transferring of taxable income from one jurisdiction to another depends on how much do capital exporting countries are willing to give up of their tax revenue in order to achieve the desired "capital export neutrality".

In other words, since the function of DTCs is to shift tax revenue from source to residence countries, it is required to establish in which cases the shifting should occur and to what extent should the shifting occur[23].

In this context, it could be argued that DTCs appear as a legal convention which are aimed at granting primacy of taxing rights to either residence or source State depending on the type of income. Nevertheless, most of the traditional theories have focused in providing justifications for source taxation since they were aimed at protecting residence taxation. In other words, the traditional theories (benefits principle and economic allegiance) assume that shifting of tax revenue occurs the other way around as stated by Avi-Yonah – from residence to source countries.

These theories tried to justify in which cases source taxation could be triggered since the primacy to tax is given to the residence State. This implied that the residence jurisdiction would give up some tax revenue and allow the source State to levy taxes only on very specific circumstances. In this context, Pasquale Pistone has stated that the PE concept is a legal creation which its purpose is to provide a linking connector with a jurisdiction different from the one where the main establishment is located. He argues that the PE concept also serves as a criterion for source State to execute its taxing powers over business profits[24].

2.2. *The Benefits principle*

[22] Reuven S. Avi-Yonah, "Double Tax Treaties", Page 2. Electronic copy available at: http://ssrn.com/abstract=1048441

[23] Reuven S. Avi-Yonah, "Double Tax Treaties", Page 2. Electronic copy available at: http://ssrn.com/abstract=1048441

[24] Pasquale Pistone in: Michael Lang, Pasquale Pistone, Josef Schich and Claus Staringer, "The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties", Cambridge Tax Law Series, 2012, Page 13.

Some of the existing international standards generally give primacy of taxation of passive income to the residence State whereas the primacy to tax active income is given to the source State. Avi-Yonah states that this current division of taxing rights derives from the benefits principle developed by the four economists who drafted the first Report on Double Taxation[25]. However, Avi-Yonah argues that the reasoning behind such principle is now obsolete. Nevertheless, a large part of the international tax regime is based on the benefits principle.[26]

Doctrine has provided several reasons for justifying that a certain State is able to tax the profits of a non-resident. There are practical reasons such as efficiency. It is argued that active income is generally obtained by corporations instead of by individuals and, consequently, it is easier to tax a corporation in the place where such income was obtained, since defining the residence of a corporation can become a difficult task if taken into consideration that there are different criteria for establishing where a company is resident (place of incorporation or place of management and control)[27]. However, there are more profound reasons that are related to the benefits principle. This principle states that the source State provides significant benefits to the foreign enterprise to the extent that such benefits enable the non-resident enterprise to obtain income in the source jurisdiction[28].

The justification for the source State to tax is that the source jurisdiction provides directly or indirectly to the foreign enterprise certain services, like the provision of infrastructure, education, public policies, and in addition to that, it also ensures the enforcement of payments. Avi-Yonah states that 'these benefits justify source-based corporate taxation in the sense that the host country´s government bears some of the costs of providing the benefits that are necessary for earning the income'. [29] In this same sense, Richard Vann[30] also states that the source country has the right to claim taxes because it provided the economic resources for generating the foreign enterprise´s

[25] These economists were: Professor Bruins from the Netherlands, Professor Einaudi from Italy, Professor Seligman from the United States and Sir Josiah Stamp from the United Kingdom. The Report on Double Taxation was commissioned by the League of Nations to these four economists in 1923.

[26] Reuven S. Avi-Yonah, "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing 2015, Page 4.

[27] Avi-Yonah, Reuven S., "International Tax as International Law: An Analysis of the International Tax Regime", Cambridge tax Law Series, 2007, Page 11.

[28] Avi-Yonah, Reuven S., "International Tax as International Law: An Analysis of the International Tax Regime", Cambridge tax Law Series, 2007, Page 11.

[29] Reuven S. Avi-Yonah, "International Tax as International Law: An Analysis of the International Tax Regime", Cambridge Tax Law Series, 2007, Page 11.

[30] Richard Vann, "Current Trends in Balancing Residence and Source Taxation", University of Sydney, Faculty of Law, December 2014, Sydney Law School Research Paper N° 14/107. Electronic copy available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2538269

income. In addition, Miller and Oats state that even if an enterprise is not resident of a certain country, it may still obtain profits there by using the facilities and infrastructure of that country[31]. As a consequence of this, the country where the profits are sourced is allowed to tax such profits[32]. In other words, the benefits principle states that the source State provides significant benefits to the foreign enterprise to the extent that such benefits enable the non-resident enterprise to obtain income in the source jurisdiction[33].

2.3. The Permanent Establishment requirement

Despite the reasons for justifying source taxation over non-resident´s profits, both the OECD and the UN Model Conventions require that there must be a permanent establishment (hereinafter, "PE") in order to enable the source State to tax non-resident´s business profits.

In this context, it is worth mentioning the general criterion set for taxing business profits. Article 7 of the OECD Model as well as Article 7 of the UN Model state that as a general rule the profits obtained by an enterprise of a Contracting State shall be taxable only in such State. However, if the enterprise carries on business in another Contracting State through a PE situated in that other Contracting State, the profits obtained by the foreign company attributable to the PE may be taxed in such other Contracting State (the source State). It has been stated that since the last third of the nineteenth century, States have been concluding tax treaties which confer exclusive taxing rights to the residence State 'as long as the taxpayer has not maintained a PE in the source State'[34], which means that source taxation would only be triggered if the non-resident holds a PE in the host State.

Thus, it is apparent the current existing international standard requires that the non-resident has a minimum presence or substance in the source jurisdiction in order to be subject to source taxation. Such minimum threshold is known as a permanent establishment. In this sense, Reimer, Urban and Schmid state that the PE threshold is used to define when a particular type of income should or should not be taxed in the jurisdiction where it is originated. In this sense, the PE threshold serves as a prohibition for the source State to

[31] Angharad Miller and Lynne Oats, "Principles of International Taxation", Bloomsbury, Fourth Edition, 2014, Page 25.
[32] Angharad Miller and Lynne Oats, "Principles of International Taxation", Bloomsbury, Fourth Edition, 2014, Page 25.
[33] Reuven S. Avi-Yonah, "International Tax as International Law: An Analysis of the International Tax Regime", Cambridge Tax Law Series, 2007, Page 11.
[34] Ekkehart Reimer, Nathalie Urban, Stefan Schmid, "Permanent Establishments. A domestic Taxation, Bilateral Tax Treaty and OECD Perspective", Wolters Kluwer, Law&Business, PWC, 2012, Page 10, Par. 32.

levy taxes over a non-resident who obtains income but which only has a small or not even a close connection to the economy of such State[35].

However, the PE threshold varies according to the tax policy the States want to achieve. The PE threshold contained in the OECD MC is quite narrow since the OECD MC was drafted in order to fulfil the expectations of developed and industrialized countries. The idea behind establishing such a narrow threshold was to limit source taxation in order to, indirectly, give primacy to residence taxation. Since industrialized countries were the ones who provided capital to invest abroad, if the profits derived from the foreign investments were to be taxed both in the residence State of the investor and in the source State where the profits were generated, then there would be no reason for investing abroad. Even if States provided tax reliefs unilaterally, the need for promoting international trade required that the combination of domestic and foreign taxation had the most neutral effect possible.

One of the reasons for providing a narrow threshold for the existence of a PE in the OECD MC had to do with the fact that in order to promote investment abroad this type of investment needed to have the same effect as if the investment was made within the same country of the resident person. In this context, the need for ensuring that investing abroad or locally would have the same effect, the residence State needed to provide a tax relief for the taxes paid abroad over the income earned abroad[36]. This is known as Capital Export Neutrality (hereinafter, "CEN").

CEN requires that the investor´s decision to invest either in its own country of residence or in another country, should not be influenced by any tax wedge[37]. Whereas Capital Import Neutrality (hereinafter, "CIN") requires that the investment made by a foreign investor in a certain jurisdiction shall bear the same tax burden that a local investor would bear in the same jurisdiction[38].

Residence-based taxation is considered to be in line with CEN. CEN implies that the investor should pay the same total amount of tax, including both the domestic tax and the foreign tax, regardless of where the income comes from (either from domestic sources or foreign sources). CEN is best achieved if the

[35] Ekkehart Reimer, Nathalie Urban, Stefan Schmid, "Permanent Establishments. A domestic Taxation, Bilateral Tax Treaty and OECD Perspective", Wolters Kluwer, Law&Business, PWC, 2012, Page 11, Par. 35.
[36] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", WU International Taxation Research Paper Series N° 2014-03. Universität Wien, Page 30.
[37] Wolfgang Schön, "International Tax Coordination for a Second-Best World (Part I)", World Tax Journal, October 2009, IBFD, Page 71.
[38] Wolfgang Schön, "International Tax Coordination for a Second-Best World (Part I)", World Tax Journal, October 2009, IBFD, Page 71.

country of residence of the investor grants a tax credit for the taxes paid abroad[39].

However, in order not to see the residence State´s revenue reduced due to the granting of reliefs, States promoted for a narrower PE threshold in order to limit the cases that could give rise to a PE in the source State. In this sense, Adolfo Martín Jimenez states that:

'The fear of industrialized countries to give up revenue in favour of source countries probably was an additional driving force behind the position adopted, first, by the League of Nations and later on by the London and OECD Models'.[40]

Contrary to what happens with the PE threshold contained in the OECD MC, the UN MC provides a definition of PE which tends to give the primacy of taxing rights to the source State. Since the UN MC is aimed to help or protect developing countries, the PE concept is used as a mechanism to strengthen the taxing powers of such developing countries[41], which in most cases are the countries were foreign investments are made.

2.4. The Economic Allegiance Theory

The foundation of the current standards for determining the linking factors for source jurisdiction, can be found in the Report on Double Taxation commissioned by the League of Nations in 1923. The four economists who drafted the Report went over different options for a standard criterion of tax jurisdiction, such as political allegiance or nationality, residence, domicile or permanent residence, and location of wealth or origin.

One of those economists – Seligman – proposed that for double taxation issues it would be useful to combine two principles of major importance: "origin" and "residence" into something bigger that was called "economic allegiance" or "economic interest". Through the "economic allegiance" principle, Seligman considered that it was possible to recognize the taxing

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[39] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", WU International Taxation Research Paper Series N° 2014-03. Universität Wien, Page 7.

[40] Adolfo Martín Jiménez, "Preventing the Artificial Avoidance of the PE Status", Papers on Selected Topics in Protecting the Tax Base of Developing Countries", September 2014, Page 14. Moreover, Adolfo Martín Jimenez: *As a matter of fact, the elimination of double taxation was a concern of countries with enterprises doing business abroad and, because these countries, in order to promote cross-border commerce, gave relief for taxes paid abroad, it was natural that they tried to limit the source country power to tax income obtained by their residents in order to avoid tax costs for their –by them very affected because of the War and the Great Depression-- budgets. There was the feeling that relief should be split between source and residence countries, or, in some cases of balanced trade, that source countries could give up their rights if a reciprocal treatment was granted to their business.*

[41] Pasquale Pistone in: Michael Lang, Pasquale Pistone, Josef Schich and Claus Staringer, "The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties", Cambridge Tax Law Series, 2012, Page 13.

rights of the country of origin and the country of residence and, from that point onwards they could agree on how to share those taxing rights. Nevertheless, he recognized that 'this problem is perhaps the most difficult in the whole realm of double taxation because of the conflicting interest of various countries" particularly the differing interests of borrowing and saving countries'. [42]

The second part of the Report on Double Taxation established the 'four elements of economic allegiance – origin of the wealth; the situs of the wealth; enforcement of the rights to wealth; and residence or domicile – which determine the country of taxation'. [43] The Report in itself was aimed at giving primacy to taxing rights to the resident State. The only exception to the residence State taxation was the existence of a PE, which has remained the same since that time till nowadays[44]. The historical and practical idea was that the source country would only be able to tax business profits derived from the physical presence of production factors ("fixed elements") located in the within its jurisdiction[45].

It is worth mentioning that despite the fact that the Report on Double Taxation appeared to introduce the "economic allegiance" concept (which provided the existing distributing rules of taxing rights), Klaus Vogel points out that this concept had already been introduced previously by a German author, Georg van Schanz. Moreover, Klaus Vogel states that the authors of the Report on Double Taxation did not follow the original "economic allegiance" concept provided by Georg von Schanz[46].

From the very origins, the German author from the 19th century argued about tax liabilities and he stated that the only principle that could be fair and equitable for distributing the tax burdens between taxpayers is the principle of the "economic allegiance". He completely discarded the residence as a benchmark for determining tax liabilities as well as nationality or even the mere physical presence in a territory. He considered that all these parameters, such as residence, nationality or physical presence lead to the negative aspect

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[42] Sunita Jogarajan, "Stamp, Seligman and the Drafting of the 1923 Experts' Report on Double Taxation", World Tax Journal, 2013 (Volume 5), No. 3, Published online: 23 September 2013, 4.7.

[43] Sunita Jogarajan, "Stamp, Seligman and the Drafting of the 1923 Experts' Report on Double Taxation", World Tax Journal, 2013 (Volume 5), No. 3, Published online: 23 September 2013, 7.

[44] Adolfo Martín Jiménez, "Preventing the Artificial Avoidance of the PE Status", Papers on Selected Topics in Protecting the Tax Base of Developing Countries", September 2014, Page 14.

[45] Adolfo Martín Jiménez, "Preventing the Artificial Avoidance of the PE Status", Papers on Selected Topics in Protecting the Tax Base of Developing Countries", September 2014, Page 15.

[46] In Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 4.

of which the taxpayers were taxed but they did not obtain anything in return. In other words, they did not acquire any sort of benefit from the State that levied the taxes, or, in the best scenario, they would only obtain a partial benefit. For these reasons, according to Klaus Vogel, Georg van Schanz considered that these parameters were unfair and inequitable.[47]

Klaus Vogel also states that Georg van Schanz argued that the most fair and equitable parameter for distributing the tax burden on taxpayers would be the "economic allegiance" principle. Nevertheless, Vogel explains that Georg van Schanz expressed that he knew that this criterion might be generally disapproved because it tended to revert the historical and well accepted benefit principle.[48] Schanz argued that the economic allegiance principle could be based on mere consumption or based on business activities:

'To the extent economic allegiance is founded on consumption, residence would constitute a suitable criterion, but it could not be the only controlling principle. Where a person is economically bound not only to the state of his or her residence, but also to another state through business activities or by way of income arising in the other state, Schanz deems the allegiance to this other state, the source state, to be more important than that to the state of residence'.[49]

Vogel explains that Georg van Schanz argued that even though the Residence State should get its portion of income, the source State – where the income is generated – should get a greater portion of such income. In this context, Georg van Schanz considered it necessary to divide the tax base following this parameter: greater piece of share to the source State and a smaller one to the residence State[50].

Nevertheless, according to Klaus Vogel, Georg van Schanz´s theory was misunderstood or adapted to the circumstances of the beginning of the 20th century. Some authors understand that the "economic allegiance" concept from Schanz is the equivalent of the benefits principle. Klaus Vogel clearly states that:

'All that has remained from his suggestions is the term 'economic allegiance', which is applied, however, today as a blanket term by everyone to his or her convenience. The four experts appointed by the League of Nations in 1921 to

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[47] In Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 4.
[48] In Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 218 onwards.
[49] In Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 218 onwards. Emphasis added.
[50] In Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 219.

prepare a report on question of double taxation2' - Gijsbert Bruins from the Netherlands, Luigi Einaudi from Italy, Edwin Seligman from the United States and Sir Josiah Stamp from the United Kingdom - in their report delivered in 1923 adopted the term, but their conclusions and recommendations were practically the opposite of those Schanz had proposed'.[51]

Today one of the most accepted ways to give rise to source taxation is if the foreign company has a PE in the source State, which can be appreciated when analysing Article 7 of the OECD MC and the UN MC. However, by its definition, the PE concept is still very attached to a physical presence to a higher extent in the OECD MC and to a lower extent in the UN MC. Consequently, there are still non-resident companies economically bounded to the source State but which are not subject to tax there. Apart from the fact that some corporations artificially avoid the PE status, the current PE definition (as it is defined by the OECD MC and the UN MC) is also leaving a side persons who are still economically linked not only to their residence State, but also to the source State due to the performance of business activities or due to the arising of income in the source jurisdiction.

2.5.*Intermediate remarks*

From the explanation provided above, it can be appreciated that throughout history, doctrine has attempted to justify source taxation assuming that the primacy to tax always corresponds to the residence State. It could be argued that those theories were incentivized due to the fact that originally the only way to perform business activities in another country was by having a substantial presence there. However, commerce has changed in a way that there is no need to have a substantial presence in order to perform a business in another country. Moreover, as it has already been explained, Georg van Schanz had already stated that the physical presence in a jurisdiction is not a requirement in order to justify income taxation.[52] For these reasons, it could be argued that the PE requirement in order to trigger source taxation might not be useful to solve the problems of base erosion and profit shifting. In this context, I would like to consider the possibility of the Andean Pact Model as a possible solution to BEPS.

From this point onwards, the comparative approach of this paper will be performed taking into consideration Avi-Yonah´s point of view that the objective of a DTC is to shift tax revenue from source countries to residence countries. The comparative approach will show that the more industrialized

[51] Klaus Vogel, “Worldwide vs. source taxation of income – A review and re-evaluation of arguments” (Part I), Intertax, 216, 1988/8-9, Page 219.
[52] Klaus Vogel, “Worldwide vs. source taxation of income – A review and re-evaluation of arguments” (Part I), Intertax, 216, 1988/8-9, Page 219.

the Contracting States taking part in a DTC are, the narrower the PE concept is and, consequently, the bigger the shifting of taxable revenue from source to residence countries. On the other extreme, the less developed the countries taking part in a DTC are, the wider the PE concept is (if there is any sort of PE requirement) and, consequently, the smaller the shifting of taxable income from source to residence jurisdictions (if there is any shifting at all).

3. How does the law stand today? What problems arise due to the application of different criteria as regards the shifting of taxable income from the source jurisdiction to the residence jurisdiction?

3.1. The rules for the allocation of business profits between residence and source countries (the OECD MC and the UN MC). The rules for attributing profits to a PE (OECD MC and UN MC)

Both the OECD MC and the UN MC establish in Article 7.1 that the business profits obtained by an enterprise resident in a Contracting State, shall be taxable in that State. However, if that enterprise carries on business activities in another State through a PE, then the profits attributable to such PE may be taxed in the State where the PE is located, namely the source State[53]. As it can be noticed, triggering source taxation depends on what is considered to give rise to a PE in the source State. According to the OECD MC Commentaries, Article 5 of the MC (PE concept) does not allocate taxing rights over business profits in itself. Once it is determined that a non-resident performs activities through a PE in the source country, then it is necessary to establish which are the profits (if any) that the source country may tax[54].

The OECD Commentaries confirm the rule that only if the non-resident has a PE in the source country, can such foreign enterprise be regarded as having participation in the economic life of the source State to the extent that such State can have taxing powers over the non-resident´s PE profits[55]. As regards the concept of PE, Pasquale Pistone states that the PE concept is a legal creation which its purpose is to provide a linking connector with a jurisdiction different from the one where the main establishment is located. He argues that

[53] The rule contained in Article 7 of the OECD MC and UN MC does not apply to specific cases such as profits derived from the operation of ships and aircraft in international traffic or for certain categories of income that may also constitute business profits such as income derived from personal activities of an entertainer or sportsperson.

[54] OECD MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 2.

[55] OECD MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 11.

the PE concept also serves as a criterion for source State to execute its taxing powers over business profits[56].

3.2. Limitations to the attribution of profits to the source State – The force of attraction

According to the OECD version of Article 7 the source State where the PE is located has the right to tax only the profits attributable to the PE and is not allowed to tax other profits that the foreign enterprise may derive within the source country but not through the PE[57]. The OECD MC rule constitutes a prohibition of what is known as the "force of attraction" rule. According to this rule, the source country would be able to tax not only the profits attributable to the PE but also other income arising from the source territory as long as the non-resident holds a PE in the source jurisdiction. Thus, the "force of attraction" rule would give the right to the source country to tax income of the non-resident such as business profits not attributable to the PE and also dividends, interests and royalties derived within the host country[58].

This "force of attraction" rule has been highly rejected worldwide mostly by developed countries. On the one hand, the detractors of this principle have stated that the "force of attraction" rule is undesirable because it taxes income from activities that are totally unrelated to the existing PE. On the other hand, such countries also claim that the activities that would fall under the "force of attraction" would not have enough substance to even constitute a PE and still would be subject to taxation. Additional arguments against this rule are also related to the fact that it would generate uncertainty for taxpayers[59].

The OECD Commentary provides an example of the rejected practice: a foreign enterprise sets up a PE in another country in order to perform manufacturing activities and, at the same time, another part of the same enterprise sells different products in the same country through independent agents. If the host country, where the PE is located, would aggregate and tax the profits of each activity (the manufacturing performed by the PE and the sales performed by the independent agents), it would constitute a tax policy that 'would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention'.[60] As it can be appreciated, the objective of the OECD´s profit attribution rule is to limit the taxing rights of

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[56] Pasquale Pistone in: Michael Lang, Pasquale Pistone, Josef Schich and Claus Staringer, "The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties", Cambridge Tax Law Series, 2012, Page 13.
[57] OECD MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 12.
[58] OECD MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 12.
[59] UN MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 6.
[60] OECD MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 12.

the source country only to what can be attributable to the PE. Nevertheless, even though a limited version of the "force of attraction" rule has been accepted by the UN MC, this version does not promote the above mentioned example rejected by the OECD.

Conversely, Article 7 of the UN MC states if the non-resident has a PE in the source country, the profits of the non-resident may be taxed by the source State 'but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment'.[61]

The UN MC "force of attraction" rule is still a limited version of the general one. In other words, the "limited force of attraction" rule implies that once the foreign enterprise holds a PE in the source State, the source country is allowed to tax the business profits 'arising from transactions by the enterprise in the source country, but not through the permanent establishment'.[62] This means, that the source country may tax the business profits other than those of the non-resident that are directly attributable to a PE, such as sales of the same goods or similar ones 'as those sold through that permanent establishment or other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment'.[63]

The "limited force of attraction" only extends to <u>other business profits</u> apart from those attributable to the PE, but <u>does not include dividends, interests and royalties</u>:

'If an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule applies if the permanent establishment is used for other business activities and the same or similar activities are performed without any connection with the permanent establishment'.[64]

In other words, the strength of the "limited force of attraction" is such that for example, if an enterprise holds a PE in the source State, through which it renders services, all other income derived from services of the same or similar kind provided within the source state by the same enterprise but not through

[61] Article 7 of the UN MC.
[62] UN MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 4, Page 141.
[63] UN MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 4, Page 141.
[64] UN MC Commentaries on the Articles of the Model Tax Convention, Article 7, Paragraph 6.

the PE, may still be attributed to that PE and be subject to taxation in the host country.[65]

3.3. The risk of the Force of Attraction Rule – What are the possible uses of the rule?

It could be argued that there are points of view for supporting the "limited force of attraction" rule. On the one hand some of the supporters state that this rule prevents administrative problems such as establishing which the activities related with the PE are and which profits are supposed to be attributable to the PE[66]. It should be noted that for a country to include the attraction rule in its DTCs, the rule must exist beforehand in its domestic law.

On the other hand, some of the States that have introduced such a rule into their DTCs mention that the purpose of the rule is not to work as an "attraction rule" but instead as an anti-abuse measure[67]. The purpose of using the "attraction" rule as a safeguard measure, is to neutralize the efforts of foreign enterprises to carry on direct sales instead of carrying on them through the PE and avoid source taxation[68]. The UN MC in its Commentaries state that some of the States that adopt the "limited force of attraction" rule, consider that this rule should be left aside when the foreign enterprise is able to prove that the sales or business activities similar to the ones performed by the PE in the same source State were carried out not by the PE but instead by the non-resident for reasons other than obtaining treaty benefits. In this sense, the UN MC Commentaries state:

'This recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment'.[69]

An example of this statement is reflected in the positions adopted by some non-OECD economies in respect to the OECD MC. Argentina (as well as Morocco and Thailand) in respect to Article 7 of the OECD MC stated that where there is a PE situated in its territory, it reserves the right to apply the "limited force of attraction rule" as it is indicated in the UN MC. However, Argentina states that it will apply this rule as a sort of a "safeguard rule against abuse", consequently it will preclude the application of such a rule when the non-resident shows that the sales and/or the activities were not carried out

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[65] Prof. Wim Wijnen, Prof. Jan de Goede, and Andrea Alessi, "The Treatment of Services in Tax Treaties", Bulletin for International Taxation, January 2012, IBFD, Page 31.
[66] UN MC Commentaries, Article 7, Paragraph 6.
[67] An example of this situation is Mexico which has made a reservation on Article 7 of the OECD MC. Also Argentina, Morocco and Thailand have expressed this view in the OECD MC.
[68] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", WU International Taxation Research Paper Series N° 2014-03. Universität Wien, Page 22, Paragraph (iv).
[69] UN MC Commentaries, Article 7, Paragraph 7.

through the PE for reasons other than obtaining a benefit from the tax treaty[70]. In this context, Argentina has mostly included the "limited force of attraction" rule as a safeguard clause into the DTCs concluded with other States. Argentina would not be allowed to apply the "attraction" rule in itself, mainly because its domestic law does not provide so. Nevertheless, the attraction rule as a safeguard has not been implemented so far, since there have been no cases where the tax authorities have claimed abuse in order to apply it[71].

According to a study carried out by the Universität Wien, the countries that more often include the "limited force of attraction" rule in their DTCs are: Nigeria, Indonesia, Vietnam, Tanzania, Kenya, India, Thailand and Kazakhstan. However, it has been stated that these countries, in some of their DTCs, apply the rule only in abusive circumstances[72].

In this context, it could be argued that the "limited force of attraction" rule might serve two different purposes. On the one hand, as it has already been mentioned, it would serve just as a tax policy. It could happen that a country´s domestic law permits taxation of not only profits attributable to the PE but also other profits derived from the source State belonging to the head office of the PE.

On the other hand, it could serve as a "safeguard" clause to counteract abusive practices. In either of the two cases, uncertainty arises due to the need to determine when an activity is similar to the one perform by the PE. It could be argued that it becomes difficult to determine when a good, merchandise or activity is "similar" to other ones. In this regard, it could be argued that the most important aspect is the "similarity test" in order to determine if business profits not attributable to a PE might still be subject to source taxation. In addition to this, some other problems regarding interpretation might also arise. For instance, the boundaries established by the UN MC in respect of the "limited force of attraction" have not always been respected.

For example, one of the countries that has included the "limited force of attraction" rule in its DTCs has been India. A decision issued by the Income Tax Appellate Tribunal of Delhi shows a wider interpretation of this rule. An example of the wider interpretation of the "limited force of attraction" can be given by *SNC-Lavilin/Acres Inc. v. ADIT*[73] case which involved the

[70] OECD MC Commentaries, Positions on Article 7, Paragraph 3.

[71] Rubén Horacio Malvitano, branch reporter, E&Y Partner Argentina, IFA Cahiers 2014 - Volume 99A: Cross-border outsourcing – issues, strategies and solutions – Argentina, Page 79, IBFD.

[72] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", WU International Taxation Research Paper Series N° 2014-03. Universität Wien, Page 4.

[73] *India - SNC-Lavilin/Acres Inc. v. ADIT*, 16 September 2011 (Decision), IBFD version.

interpretation of the rule under the Canada-India DTC[74]. Before providing further information, it is important to mention that the DTC involved follows the exact wording of the UN MC[75]. In this case, the foreign enterprise was a Canadian resident which provided technical consultancy services to an Indian client. Some of the services rendered by the Canadian resident were partly performed in India and partly in Canada. As a consequence of the services rendered in India, the Canadian resident had a PE in India[76]. Consequently, the business profits attributable to the PE were subject to taxation in India. However, the Indian tax authorities understood that due to the "limited force of attraction" rule, the profits obtained by the enterprise for the services performed in Canada were also subject to taxation in India. The Income Tax Appellate Tribunal of Delhi confirmed the tax authorities' point of view and understood that due to the "limited force of attraction" rule established in the Canada-India DTC (Article 7.1.b), the entire income obtained by the Canadian resident was taxable in India. The Indian Tribunal took into consideration the fact that the work performed in Canada was the same or similar as the type of work performed through the PE located in India. Therefore, those similar activities even if they had been performed outside the host State were still subject to taxation in that country.

This decision shows a wider interpretation of the "limited force of attraction". While the UN MC version only extends the taxing rights of the host State over the sale of similar goods or the performance of similar activities as those of the PE but still performed within the source country, the Indian Tribunal of Delhi extended the rule and the source country taxing rights to activities performed outside the host State. Nevertheless, the Income Tax Appellate Tribunal of Mumbai followed a stricter interpretation of the UN MC.

In *Clifford Chance v. ADIT*[77] the question brought to the Tax Tribunal was whether the provision of consultancy services provided by a UK residence outside India were subject to tax in India. The problem arose due to the provision of business profits contained in the India-UK DTC[78]. The provision

[74] Agreement Between the Government of Canada and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, E102409 - CTS 1997 No.16.

[75] Canada – India DTC. Article 7.1: "The 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 permanent establishment situated therein. If the enterprise carries on or has carried on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to: a. that permanent establishment, and; b. sales of goods and merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment."

[76] The concept of service PE will be later developed in point 5.2.1.1.

[77] India - Clifford Chance v. ADIT, ITA No. 2060-61/ Mum/ 2008, Decision date: 13 May 2013, IBFD version.

[78] UK – INDIA DOUBLE TAXATION CONVENTION SIGNED 25 JANUARY 1993, Entered into force 25 October 1993.

states: '(1) The 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 permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is directly or indirectly attributable to that permanent establishment*'*. In this instance, the Mumbai Court concluded that the services provided outside of India where not directly attributable to the PE. In addition, the offshore services could neither be considered as *indirectly* attributable due to the fact that Article 7.3 of the India-UK DTC limited the scope of the expression *indirectly*[79]. Even though the Mumbai Court considered that the services rendered outside India were not subject to taxation in India, the Court did not derived its decision from the interpretation of the "limited force of attraction rule". Moreover, the Court reasoned that Article 7.1 of the India-UK DTC was not comparable to Article 7.1 of the UN MC.

3.4.Intermediate commentaries

If the "limited force of attraction" rule is not considered as a "safeguard clause", but instead as a tax policy, it can be seen as either an extension of the source state's right to tax or a limitation of the shift of taxable resources from the source state to the residence state. In any case, the force of attraction rule could be argued to bring several uncertainties, because as it has been shown some Courts interpret it a in a wider manner than what it is expected to be. However, some other States only include it in its tax treaties as an anti-abuse rule, which means that they do not pretend to widen its taxing powers but only to use it in cases where there is an abusive situation (in this last case, it could also be argued which of the two parties, either the taxpayer or the tax authorities, have to satisfy the burden of proof). An additional problem of interpretation could be argued to exist with the words "same or similar". These words imply a subjective interpretation by the tax authorities and the judges.

If the "limited force of attraction" rule is only considered to be a tax policy, it is worth noting Avi-Yonah´s idea that the aim of DTCs is to shift tax revenue from source to residence countries, due to the fact that nothing would prevent the source country first tax any profit arising within its territory, except for an agreement such as the concept of PE for active income. Therefore, the OECD rule for allocation of profits could be argued to consist

[79] India – UK DTC. Article 7.3 states: "(3) Where a permanent establishment takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of profits of the enterprise arising out of those contracts which the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole shall be treated for the purposes of paragraph (1) of this Article as being the profits indirectly attributable to that permanent establishment."

in an expansion of the shift of taxable profits from the source to the residence country, since the host State is prevented from taxing the income other than the one attributable to the PE. A wider shifting of taxable income from source to the resident State ensures capital export neutrality, therefore the residence country would have to grant a tax credit for the taxes paid in the source country only in very specific circumstances.

3.5.Attribution of profits

Despite the differences between the OECD MC and the UN MC, they both state that the rule for the determination of the profits attributable to a PE is based on the arm´s length principle. The profits that the PE makes are the ones that it is expected to make as if it were a separate and independent company performing the same or similar activities and functions as well as involving similar assets and risks. The aim of the rule is to determine that the profits attributable to the PE are 'determined as it if were a separate enterprise'.[80] As a consequence of this, it could happen that profits would be attributable to the PE even though the company had not made any profits at all or vice versa.

Once the profits attributable to the PE are taxed by the source State, the residence State must grant a tax relief to the enterprise. Article 23 of the OECD MC an UN MC states that when a resident of a Contracting State derives income that may be taxed in the other Contracting State, the residence State shall exempt such income or grant a tax credit allow equal to the income tax paid in the State of source.

4. The Andean Pact solution – Each one gets what it deserves

There are few existing multilateral tax treaties in force, one of those is the Andean Community Pact, first signed in 1971 and lastly updated in 2004[81]. For reasons that will later be provided, this Pact could be seen as a reflection of Georg van Schanz´s theory of economic allegiance. Georg van Schanz considered there to be an allegiance with the source State when a person is economically bound to the host State 'through business activities or by way of income arising in the other state'.[82] Moreover, according to Klaus Vogel, Georg van Schanz stated that the physical presence in a jurisdiction is not a requirement in order to justify source taxation. In this sense, the Andean Pact MC holds particular characteristics that bear some resemblance to the concept

[80] OECD MC Commentaries, Article 7, Paragraph 17.
[81] The 2004 update was concluded by Bolivia, Colombia, Ecuador, Peru and Venezuela.
[82] Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 5.

of “economic allegiance” of Georg van Schanz as regards the concept of PE, the concept of source, and the allocation rules.

First of all, as a general rule, Article 2 f) of the Andean Pact MC states that the meaning of the expression “source of production” refers to the ‘activity, right or asset that generates or may generate an income’.[83] It is worth noting that the Andean Pact MC definition of “source of production” is close with what Peggy and Richard Musgrave have stated of the concept of “source”. They defined the source ‘as the place of the income-generating activity and [they] discuss primarily the attribution of business profits when business activities are carried on in more than one country’.[84] Klaus Vogel discussed that the source ‘refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good. In contrast, the type of connection that establishes the 'source' of income cannot be defined generally’.[85]

In addition, Article 3 of the Andean Pact provides a general rule for the allocation of taxing rights among the Member States. This general rule states that regardless of the nationality or domicile of the persons (whether a natural person or a company) income of any kind that these persons would obtain, shall be only taxable in the Member State in which such income has its source of production. As a consequence of this, the other Member States which, in accordance with their domestic law, hold the power to tax such income must exempt it from taxation. In particular, as regards business profits, Article 6 states that profits resulting from business activities shall be taxable only by the Member State where they were obtained/effected/performed/executed[86].

I is worth noting that the Andean Pact MC does not use the term nor the concept of PE, but instead provides a list of examples of cases in which it is considered that a company performs activities in the territory of another Contracting State. The list is not exhaustive and comprises several examples also given by the PE definition of the OECD MC and the UN MC. However, as the list is not complete, any type of activity performed within a Member State will be subject to taxation in such host country. Due to the lack of a definition such as the PE concept, the source State is free to tax whichever activity occurs within its territory and the residence State is the one which has to cede its right to taxation. In this sense, the lack of the PE concept in the Andean Pact MC shows that any economic connection, whether a substantial

[83] Unofficial translation, IBFD.
[84] Klaus Vogel, “Worldwide vs. source taxation of income – A review and re-evaluation of arguments” (Part I), Intertax, 216, 1988/8-9, Page 8.
[85] Klaus Vogel, “Worldwide vs. source taxation of income – A review and re-evaluation of arguments” (Part I), Intertax, 216, 1988/8-9, Page 8.
[86] The Spanish version uses the verb “efectuar”. According to the Real Academia Española (Spanish Royal Academy) this verb involves the execution of something, in particular of an action. The IBFD unofficial translation of the 1971 version of the Andean Convention uses the verb “obtain”.

or a loose link, of a non-resident with the source jurisdiction, justifies the primacy of source taxation.

It is noticeable that the Andean Pact Model 'adopts exclusive source taxation'[87] and provides only the exemption method as the default method for relieving from double taxation. This is in line with the tax policy objective of the Andean Members, which are capital importing countries, and which support source-based taxation and believe that residence countries should cede their taxing powers to source countries[88]. In addition, the tax policy of these countries provides an example of capital import neutrality achievement, since investments from other countries compete on equal footing with local investors in the domestic market. In this case the neutrality is completed with the exemption method as a way to grant tax relief from double taxation, which means that the exclusive right to tax remains in the hands of the host State and the residence State has the obligation to exempt the income from tax.[89]

The Andean Pact could be argued to be a perfect example of Avi-Yonah´s theory that DTCs´ purpose is to shift taxable income from source countries to residence countries, since under basic circumstances the source country is 'allowed to impose the first tax on any revenue deriving from sources within'[90]. Since there is no concept that functions as a limitation for source taxation (as the PE concept does), there is no actual shift from source to residence jurisdiction. Moreover, Article 7 of the Andean Pact establishes that when a company carries out activities in two or more Member Countries, each of them may tax the income generated within their territory. In other words, it does not matter whether there is a fixed place of business or a dependent agent, or a building site; it does not matter whether the activities are carried out during a certain period of time; it does not matter whether the business activities have any type of substance as the one required by the OECD MC or the UN MC. As long as a foreign company conducts activities in the territory of another Contracting State, they will be subject to taxation in the country where they were performed. Moreover, the Andean Pact restricts residence taxation to the extent that in case a company conducts activities in two or more Member States, each of them is allowed to tax what is produced within their territories.

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[87] Victor Thuronyi, "Tax Law Design and Drafting", Volume 2, International Monetary Fund, 1998, Page 729, Footnote 20.
[88] Victor Thuronyi, "Tax Law Design and Drafting", Volume 2, International Monetary Fund, 1998, Page 729, Footnote 20.
[89] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", Vienna University, WU International Taxation Research Paper Series, No. 2014 – 03, Page 7. Electronic copy available at http://ssrn.com/abstract=2398438
[90] Reuven S. Avi-Yonah, "Double Tax Treaties: An Introduction", University of Michigan, Page 2. Electronic copy available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1048441

5. What is the nexus that justifies source or residence taxation? – The variations in the PE threshold. The examples of the OECD MC, UN MC and Andean Pact MC

5.1.The PE

The existing international standards require that in order for a non-resident to be taxed by the source jurisdiction it must have a certain presence in such jurisdiction. That presence is known as a PE. Only if a foreign company has a PE in the source State, may it be required to pay taxes in the source State. In this context, the concept or the definition of PE becomes a determining factor.

At its origins, cross-border transactions closely depended on physical presences; it was in this context that the PE concept was conceived[91]. Because of this, the foundations of the PE concept are based on the existence a fixed place of business which necessarily implies a physical presence of the foreign company in the source jurisdiction. This meant that in cases where the economic link was not sufficient, it was easier to leave the levy of taxes to the residence State. In this line of ideas, in the Final Report on the Concept of PE of 8th November 1957 it was said:

‘A special provision to deal with these people [itinerant merchants, pedlars, watermen, circuses and travelling entertainers] is not, in the view of the Group, necessary because the incomes will, in general, be small and it is likely to be most difficult to tax them in any country except the one in which they reside . . . loss of tax which a country may suffer through giving up its right to tax itinerants, etc., from other countries is likely to be more or less compensated by the fact that it will have the sole right to tax itinerants residing within its own border*’.*[92]

Nevertheless, the PE threshold varies in accordance with the tax policy pursued by a country. This means that depending on the PE threshold, the taxing powers of the source State might be larger or smaller. In addition, the PE threshold also determines to certain extent which of the two jurisdictions

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[91] Eva Escribano López has said: *After all, the economic context in which the PE concept arose is a context characterised by the so-called brick-and-mortar business models. Thus, in a context in which a physical presence was critical to perform any kind of business activities (including the provision of almost all services), a threshold entirely based on this parameter seemed to be an appropriate way to measure a sufficient degree of involvement in the economic life of the host state, sufficient enough to trigger taxing rights by the latter state* (Eva Escribano López, “An oportunistic, and yes appropriate, revision of the source threshold for the twenty-first century tax treaties”, Intertax, Volume 43, Issue 1, 2015 Kluwer Law International BV, The Netherlands, Page 8).

[92] Adolfo Martín Jiménez, “Preventing the Artificial Avoidance of the PE Status”, Papers on Selected Topics in Protecting the Tax Base of Developing Countries”, September 2014, Footnote 47.

– either source or residence – have primacy of taxing rights over business profits of a non-resident.

Some of the existing variations in the PE threshold currently used by some countries will be analysed following a list of examples provided by DTCs signed between at least by one developing country.

5.2.The examples

5.3.Argentina – Sweden DTC from 1995. The broadening of the PE Threshold. The departure from the OECD MC. Comparison between the "service PE" of the UN MC and the suggested "service PE" provision introduced by the OECD Commentaries in 2005. The concept of "delivery PE"

5.4.The "service PE"

The Convention between the Kingdom of Sweden and the Argentine Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income[93] (hereinafter, "Argentina – Sweden DTC"), concluded in 1995 follows the UN MC and as a consequence of this, provides a clear example of primacy of the allocation of taxing rights given to the source State.

It is worth mentioning that the Argentina – Sweden DTC of 1995 is a renegotiation of the same tax treaty concluded in 1962. However, the 1962 version did follow the OECD MC instead of the UN MC and as a consequence of this, it provided a PE threshold much narrower, which required the existence of a fixed place of business or a dependent agent in the source State in order to constitute a PE. In most cases, the tax treaties signed by Argentina during 1970 -1980 tended to be negotiated taking as a parameter the OECD MC whereas, after the 1990´s, tax treaties that had already been signed where re-negotiated having as a parameter the UN MC[94].

The Argentina – Sweden DTC of 1995 places Argentina in a better position when allocating the taxing rights of business profits between Sweden and Argentina. This tax treaty involves a developed country (Sweden) and a developing country (Argentina)[95]. Most likely the developed or industrialized country would try to follow the OECD MC, which its essence is to give certain priority on the allocation of taxing rights to the residence State by way

[93] Entered into force in June 5th, 1997.

[94] Michael Lang, Pasquale Pistone, Josef Schuch and Claus Staringer, "The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties", Cambridge Tax Law Series, 2012, Page 45.

[95] DAC List of ODA Recipients Effective for reporting on 2014, 2015 and 2016 flows, OECD Aid Statistics. Electronic information available at: http://www.oecd.org/dac/stats/daclist.htm

of restricting the PE threshold. In contrast, the developing country would try to follow the UN MC.

The UN MC is aimed at developing countries and tries to protect source taxation since this Model is based on the assumption that the source State is the developing country. To this end, the UN MC is aimed at providing a larger portion of taxing rights to the source jurisdiction. This means that larger amounts of profits generated in the source State will be subject to source taxation. This is exactly what happens with the Argentina – Sweden DTC of 1995, because it departures from the OECD MC and provides a larger PE threshold, more business activities will give rise to a PE in the source country (Argentina) and as a consequence of this, larger amounts of profits generated by Swedish corporations will be subject to taxation in Argentina. Nevertheless, the UN MC as well as the OECD MC requires the existence of a PE in the source jurisdiction in order to justify the taxation of the income obtained by a non-resident.

The way in which the UN MC achieves the protection of the source-base by granting larger taxing rights to the source State can be seen in the PE definition. The UN MC gives certain priority to the source State when distributing the taxing rights of business income between the residence and the source. The priority can be appreciated in Article 5 of the UN which provides a broader PE threshold so as to include not only the profits attributable to a fixed place of business or a dependent agent, but also are included in the PE definition what it is known as “service PE” and “delivery PE”.

In our example it can be appreciated that Article 5 of the DTC between Argentina and Sweden of 1995 states that for the purposes of the DTC, "permanent establishment" comprises a fixed place of business through which the business of an enterprise is wholly or partly carried on.

However, when the OECD MC in Article 5.2 states that the term PE also includes 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 relating to the exploitation of natural resources, the Argentina – Sweden DTC keeps this same structure. However, it also provides an additional provision: Article 5.3 which contemplates what it is known as “service PE”.

Article 5.3 states:

‘Notwithstanding the provisions of paragraphs 1 and 2 of this Article, the furnishing of services, including consultancy and exploration services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, shall be considered a permanent establishment where such

activities continue within the country for a period or periods aggregating more than six months within any twelve month period.'[96]

This provision resembles Article 5.3 (b) contained in the UN MC. The slight difference between the Argentina – Sweden DTC of 1995 and the UN MC is that the UN MC provides a more specific time period, instead of six months, the UN MC says “183 days”.

Overall, the essence behind this Article is to tax services rendered by a Swedish enterprise in Argentina which might even include consultancy and exploration services, and which last for more than six months in a twelve months period (even if the services are supplied by shorter periods than six months, if these periods are aggregated and result in a larger period of six months in a twelve month period, are also considered to be a PE).

This provision shows that there is no need for a Swedish enterprise to have a fixed place of business or a dependent agent in Argentina in order to give rise to a PE, but as long as the Swedish enterprise supplies services in Argentina through employees or personnel engaged by the Swedish enterprise, and if the time requirement is also fulfilled, the Swedish company is going to be considered to have a PE in Argentina, and as a consequence of that, the profits attributable to such PE are going to be subject to taxation in Argentina.

It is worth noting that the provision or supply of services by a non-resident in another country, even if they consist of consultancy services, do not in itself give rise to a PE under the OECD MC. However, this does happen in the UN MC. This situation does not require a physical place of business. In other words, the foreign provider of the services is not required to have a fixed place of business in the source jurisdiction, however, it is still required to have some kind of presence: at least an employee or personnel engaged by the foreign enterprise. As Jean Schaffner says, the traditional “physical PE” can only exist if there is a sufficient infrastructure, whereas the “service PE” only requires the presence of employees in the source country supplying the relevant services[97]. In contrast as what it is required by Article 5.5 of the OECD MC (dependent agent) the employee of Article 5.3 (b) of the UN MC is not even required to conclude any type of contracts in the name of the principal[98].

The so-called “service PE” is aimed at protecting the source base since it still provides a “nexus” with the source jurisdiction that is not as strict that the “physical PE” (fixed place of business) and allows at the same time to the

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[96] Argentina – Sweden DTC of 1995.

[97] Jean Schaffner, “The Territorial Link as a Condition to Create a Permanent Establishment”, Intertax, Volume 41, Issue 12, Kluwer Law International BV, The Netherlands, 2013, Page 643.

[98] Ekkehart Reimer, Stefan Schmid & Marianne Orell, “Permanent Establishments, A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective”, Third Edition, Wolters Kluwer Law&Business, PWC, 2014, Page 119, Paragraph 402.

source country to levy taxes on the profits derived within its territory. The idea behind this provision is that the foreign company derives income within the source country, and in addition the foreign enterprise benefits from the infrastructure provided by the source country. In other words the "nexus" established by the "service PE" provides a manifestation of economic allegiance from the non-resident with the source territory, and it serves as justification for source taxation.

The "service PE" concept does not rely on the fact that a foreign enterprise is supplying services to a resident of the source State, instead this concept only relies on the fact that there must be at least an individual present in the source jurisdiction performing the services[99].

The "service PE" shows a restriction to the limitation provided by the OECD MC PE threshold. In other words, even though the OECD MC provides that the source jurisdiction may tax the profits attributable to the PE of a foreign company, the PE threshold is limited by a physical nexus. The immediate effect of this nexus is that all the remaining activities, such as the provision of services in the source State, as they do not fall under the scope of PE, are not subject to taxation in the source country and end up being taxed at residence (if taxed). In this context, it could be argued that the "service PE" constitutes a departure from the limitation established by the OECD MC in regards to source taxation.

The UN MC Commentaries express that developing countries requested the introduction of the "service PE" due to the fact that they considered that management and consultancy services supplied in developing countries by developed or industrialized States generated large amounts of profits[100]. However, the PE threshold provided by the OECD MC has also brought some concern to developed countries which are foreign investment receptors. In this context, in 2005 the OECD MC Commentaries incorporated a chapter called "The Taxation of Services" at the end of the Commentaries on Article 5. These Commentaries incorporate the concept of "service PE" and provide some guidance to those countries willing to incorporate such concept into their tax treaties. However, the "service PE" concept has not been introduced in the Model itself.

The incorporation of the "service PE" concept even only in the Commentaries of the OECD MC shows some willingness to protect or reinforce the source base taxation. The "service PE" concept in the OECD Commentaries provides the idea that States have started seeing that some important revenues are being lost because the PE definition in itself. It could be argued that the limitations to source taxation once introduced were suitable for the brick and wall type

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[99] OECD MC Commentaries, Paragraph 42.31.

[100] UN Commentaries, Page 107/108, Commentary on Article 5 Subparagraph 3 (b), Paragraph 9.

of commerce. However, with changes in the economy and the way trade can be developed without the need of having a significant physical presence in a certain territory, the result is that there are some activities that are still linked to the source jurisdiction and that generate profits but are left untaxed if the traditional PE concept continues to be applied.

In other words, States´ concerns are related to the fact that there are services being performed in their territories, but as they do not fall under the scope of the PE definition, are left untaxed. These States consider that if the services are performed within their jurisdictions, they should have the right to tax the profits derived even if such profits from those services are not attributable to the traditional concept of PE.

The OECD MC Commentaries provide a clear justification for allocating the taxing rights of income derived from services to the source State: there are some significant level of business activities, such as services, that do not even require the presence of a fixed place of business[101], but still imply an economic connection and engagement with the host State.

At the same time, the arguments given in order to prevent source taxation over services, such as administrative and compliance costs, are considered to be insufficient in order to exclude source taxation. In fact, there are some States that due to their domestic legislations already tax the supply of services by a non-resident in their territory. These Sates tend to have in their domestic law a withholding tax that should be withheld by the resident who is making the payment to the non-resident. However, the OECD MC Commentaries state that the taxes should be levied over the profits attributable to the services rendered in the source State and not be levied over the payments made by the residents to the non-residents[102].

In comparison with the UN MC´s "service PE" provision, the period of time required to constitute a PE is the same: a period or periods exceeding in the aggregate 183 days in a twelve months period. However, the "service PE" provision suggested by the OECD Commentaries provides some additional requirements that the UN MC provision does not require. The OECD Commentaries´ suggested provision states that it shall be considered to constitute a PE the furnishing of services performed through an individual who complies with the time threshold of 183 days in a twelve months period and in addition to this, more than 50 % of the gross revenues attributable to active business activities of the enterprise during such period of time are generated by the services rendered by such individual in the source State[103]. It shall also be deemed to constitute a PE when during the same time threshold the services are performed by one or more individuals who are present in the

[101] OECD MC Commentaries on Article 7, Paragraph 42.16.
[102] OECD MC Commentaries to Article 5, Page 115 onwards.
[103] OECD MC Commentaries on Article 7, Paragraph 42.23 a).

source country rendering such services and those services are performed for the same project or for connected projects[104].

This suggested provision by the OECD establishes an extension of the PE threshold broadening to some extent the taxing rights of the source State as regards profits derived from services. Nevertheless, this suggested provision limits to some extent the allocation of those taxing rights to the source jurisdiction. If we compare the OECD provision with the UN provision, the first option of the OECD "service PE" version provides an additional requirement. This requirement states that the services must generate profits that represent more than 50% of the gross revenues attributable to the business activities performed by the foreign enterprise. On the other hand, the second case covered by the OECD provision resembles the UN MC version: they both require the rendering of services through individuals and such services must be supplied for an aggregating period of 183 days in a twelve months period for the same or a connected project. This last provision shows a departure from the original PE threshold as well as from the original limitation of the allocation of taxing rights to the source taxation.

As regards the persons who are involved in the furnishing of services, the UN MC states that such persons need to be employees of the non-resident enterprise or other personnel engaged by the non-resident. In this sense, the OECD MC Commentaries on taxation of services states that it should be applicable the general rule that applies to PEs. This means that the business of the foreign enterprise shall be performed by the entrepreneur or persons who are under a paid-employment relationship with the non-resident enterprise.

5.5.Intermediate conclusions on "service PE"

Avi-Yonah has mentioned that the concept of "source" has turned out to be a "legal concept" rather than an "economic concept". In this sense, even though economists cast doubts regarding the possibility of establishing that income has a natural defined source, the concept of "source" is still necessary. In this context, "source" tends to be defined by "source rules" which are generally accepted[105], such as the PE concept.

Avi-Yonah´s conceptualization of "source" is different from what Peggy and Richard Musgrave have previously stated about this concept. According to Klaus Vogel, these authors have analysed the concept and have defined it *as the place of the income-generating activity and* [they have] *discuss*[ed] *primarily the attribution of business profits when business activities are*

[104] OECD MC Commentaries on Article, Paragraph 42.23 b).
[105] Reuven S. Avi-Yonah, "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing, 2015.

carried on in more than one country[106]. In this context, Klaus Vogel discusses that source 'refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good*'.*[107] Taking in consideration Peggy and Richard Musgrave´s idea of "source", it could be argued that the "service PE" concept justifies source taxation due to the fact that there is some sort of income-generating activity by the non-resident in the source jurisdiction. However, Avi-Yonah´s point of view that the concept of "source" is a legal convention also makes sense, especially when it is taken into consideration that Avi-Yonah understands that one of the aims of Double Tax Treaties is to shift tax revenue from source jurisdiction to residence jurisdiction.

5.6.The "delivery PE". A comparison between the Argentina – Sweden DTC of 1995 and the Argentina – Denmark DTC of 1995

Another example of broadening of the PE threshold provided by the UN MC and followed by the Argentina – Sweden DTC of 1995 is what is known as the "delivery PE".

Both the OECD MC and the UN MC in Article 5.4 provide an exhaustive list of cases that shall be deemed not to constitute a PE. The lists of both MC resemble each other except for a key word: delivery.

On the one hand, according to the Argentina – Sweden DTC of 1995, (which resembles the UN MC) the cases that shall be deemed not to constitute a PE are:

(a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e),

[106] Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 8.
[107] Klaus Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (Part I), Intertax, 216, 1988/8-9, Page 8.

provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character[108].

On the other hand, according to the Argentina – Denmark DTC of 1995[109] (which resembles the OECD MC), the cases that shall be deemed not to constitute a PE are:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e) provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

As it can be appreciated, the Articles of both tax treaties are similar and they all constitute situations which will not constitute a PE even if the non-resident holds a fixed place of business in the source country[110]. The only exception is the fact that the purpose of the use of facilities or the maintenance of stock in the host State changes according to which of the two MC is followed. The OECD MC allows the use of the facilities or conservation of goods in the source country as long as they are used or kept for storage, display or delivery. However, the version of the UN MC has eliminated the purpose of "delivery", which means that a delivery activity might constitute a PE in the host State[111]. For example, in cases in which a non-resident holds a warehouse where it keeps goods with the objective of delivering them, that situation would constitute a PE. As a consequence of that, the profits attributable to such PE will be subject to taxation in the source country.

One of the reasons for having excluded the term "delivery" was because a number of States considered that holding a stock of goods for rapid delivery

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[108] Article 5.4 of the DTC between Argentina – Sweden of 1995.
[109] Convention between the Government of the Kingdom of Denmark and the Government of the Republic of Argentina for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital. Entered into force in the 4th of September 1997.
[110] UN MC Commentary referring to the OECD MC Commentary, Page 119, Paragraph 18 of the UN.
[111] UN MC Commentary, Page 97.

would enable the sale of goods owned by the non-resident in the source country and would ensure the earning of profits without being taxed in the host State[112].

In other words, if the OECD MC is followed, the maintenance of stock of goods for the purpose of delivery in the source country would enable a foreign company, which sells goods online, to promptly deliver the sold goods in the host State without constituting a PE. Consequently, as no PE would be held in the host country, no taxes would be levied by such jurisdiction. However, a business activity as the one provided in the example, is far from resembling to a preparatory or auxiliary activity. It is worth mentioning that the aim of the list of cases provided by Article 5.4 of the OECD MC as well as the UN MC is to prevent the taxation of activities that are merely preparatory or auxiliary. In other words, according to the OECD Commentary the common feature of all the listed activities is that they are preparatory or auxiliary[113]. However, the sections a) to d) of Article 5.4 do not explicitly express that they have to be preparatory or auxiliary activities. The purpose of that list is only provided by the Commentaries.

In this context, States have shown some concern and it is one of the issues of discussion under the BEPS project to the extent that one of the proposed amendments to the PE definition of the OECD MC is to clarify that all the activities listed in Article 5.4 are subject to the condition of being preparatory or auxiliary[114].

If the core business of a foreign company involves a prompt delivery of goods after selling them online, it could be argued that it is quite unlikely that such activities qualify as auxiliary or preparatory. Instead, it is quite likely that they are the principal business activity of the company. In this context, the solution provided by the UN MC, by eliminating the word “delivery” from the list of Article 5.4, ensures that foreign companies who hold an economic connection with the source State would be subject to tax there.

Nevertheless, there are some disadvantages that States deciding to delete the word “delivery” should consider. On the one hand, the UN Commentary states that it might happen that the revenue collected by the “PE delivery” might not always consist of large sums. On the other hand, the UN Commentary forecasts that due to the lack of attention to the characteristics of the “PE delivery”, tax authorities might end up attributing too much

[112] UN MC Commentary, Page 124, Paragraph 20.
[113] OECD MC Commentary, Page 103, Paragraph 21.
[114] Public Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of the PE Status”, 2014/2015, OECD, Amendment “E”, Page 15, Paragraph 15 onwards.

income to those PEs. Consequently, it might produce an increase of litigation procedures[115].

Nonetheless, despite the difficulties that might arise due to the deletion of the word "delivery", such measure has been proposed in Action Plan 7 against BEPS. In case the amendment "E" is not adopted (clarification that all the activities of Article 5.4 have to be preparatory or auxiliary) the other suggestion to be adopted would be amendment "F" which, if applied would produce the deletion of such word giving birth to the so-called "delivery PE".

5.7.The protection of natural resources also widens the PE threshold

Only as a further exemplification of broadening of the PE threshold, the tax treaties analysed above provide special characteristics not contemplated in the UN MC.

The Argentina – Sweden DTC of 1995 states in Article 5.5 that offshore activities performed in the other Contracting State related with 'the exploration or exploitation of the seabed and subsoil and their natural resources situated in that other State, as well as fishing conducted in the exclusive economic zone of that State, shall be considered a permanent establishment where the activities are carried on for a period or periods exceeding in the aggregate 30 days in any twelve month period'.

At the same time, Argentina – Denmark DTC of 1995 also broadens the PE threshold when considering that fishing activities, which continue for a period of more than three months within any twelve month period, also constitute a PE.

5.8. Intermediate commentaries on the PE definition in Argentina´s domestic law

According to Article 69 b) of the Argentinean Income Tax Law, a PE of a foreign company shall be deemed to be considered as a resident for tax purposes, and as a consequence of this it would be subject to worldwide taxation. However, a non-resident which does not hold a permanent establishment or agency in Argentina will be subject to tax only on Argentinian-source income[116].

In this context, Article 14 of the Income Tax Law also provides that branches as well as permanent establishments should keep their accounting records separately from their parent companies and other branches and other

[115] UN MC Commentary, Page 124, Paragraph 21.
[116] Corporate Taxation Argentina, IBFD, Author: Eduardo O. Meloni, Page 22 (The chapter is based on information available up to 1st of October 2014).

permanent establishments or subsidiaries of these. In addition, when necessary they should provide corrections in order to determine their taxable income sourced in Argentina. Moreover, in case of an insufficient accounting or when it does not accurately reflect Argentina's net income source, the tax authorities may consider that the domestic entities and the foreign entities form an economic unit and may determine the respective net gain subject to tax[117].

The Income Tax Law does not provide any sort of definition for the PE concept. Nevertheless, the Minimum Deemed Income Tax Law provides a list of cases that shall be considered to constitute a PE: a branch; a sole proprietorship; a fixed place for the supply of technical, scientific or professional services provided by natural persons; an agency; a permanent representation; a place of management or administration; an office; a factory; a workshop; a rural immovable property (even if it is not exploited); a mine, quarry or other place of extraction of natural resources; a construction or assembly site; and fixed place of business for acquiring goods or for collecting information for the enterprise[118].

In addition, the PE threshold becomes wider when the PE definition provided by the Minimum Deemed Income Tax Law departures from the traditional definitions of the OECD MC as well as the UN MC and states that it shall constitute a PE: the use facilities for the purpose of storage, display or delivery of goods by the person, company, sole proprietorship or undivided estate to whom they belong as well as the maintenance of stocks of such goods for such purposes.

Despite the broad non-exhaustive list of cases that constitute a PE according to Argentina´s domestic law, the Tax Authorities have issued an Opinion (DAT 150/1994)[119] in which a taxpayer had requested to be treated, for tax purposes, as a permanent establishment of a foreign company. The Opinion of the Tax Authority concluded that the taxpayer shall be deemed to be treated as a permanent establishment as long as it fulfills the legal and jurisprudential requirements that would enable the tax authorities to conclude that a permanent establishment exists. The Tax Authorities highlighted a decision issued by the National Tax Court in 1980 in which it was stated that a permanent establishment requires not only the existence of fixed facilities but also the continued pursuit of activities. In addition, in order to determine whether a PE exists, it constitutes a matter of fact that will require a complex

[117] Unofficial translation.
[118] Corporate Taxation Argentina, IBFD, Author: Eduardo O. Meloni, Page 19 (The chapter is based on information available up to 1st of October 2014). Also Law N° 25.063 (Impuesto a la Ganancia Mínima Presunta - Minimum Deemed Income Tax Law), Article 2(h).
[119] DICTAMEN 150/1994 DIRECCION ASESORIA TECNICA DAT Nacional, Date: 15th of September of 1994. Source: La Ley Online, Thomson Reuters, Checkpoint.

examination of the establishment's activities and also its permanence, the powers of management or administration in decision-making, and its relationship with the head office[120]. These criteria have consistently been reiterated by the National Tax Court in further decisions, such as *Unión Pak Sociedad Anónima*[121].

Taken in totality, doctrine holds that in order to determine whether a PE exists or not, it mostly constitutes a matter of fact and evidence[122].

5.9.Argentina – Bolivia DTC of 1976 – The non-existence of PE

The Convention Between the Argentine Republic and the Republic of Bolivia for the Avoidance of Double Taxation with respect to Taxes on Income or Profits and on Capital and Net Wealth (hereinafter, "Argentina – Bolivia DTC") entered into force in 1979[123]. This DTC has been negotiated following the Andean Pact MC which means that it favours source-based taxation.

First of all the Argentina – Bolivia DTC distributes the taxing rights between the Contracting States: the income, the gains or profits of any nature, derived by persons of any nationality or domicile, shall be taxable in the Contracting State where such income, gains or profits arise.

Secondly, as regards business profits, Article 7 states that they shall be taxable only by the Contracting State in which such business activities have been carried on. In case an enterprise carries on activities in both Contracting States, each of them may tax the income, gains or profits derived from within its territory. This article resembles the Andean Pact MC, however, the Argentina – Bolivia DTC does not provide any list of cases in which a company shall be considered to conduct activities in the territory of the other Contracting State. In other words, the DTC does not provide any sort of definition in order to justify or to restrict source taxation, which means that any activity[124] performed by an enterprise in one of the Contracting States is going to be subject to taxation there no matter if the activity involves a loose economic connection with the host State.

It could be argued that the PE description provided by the Argentinean domestic law is as wide as the list of situations that are considered to constitute activities performed by a foreign company in the host State

[120] La Industrial Paraguaya Argentina S.A., T.F.N. Sala C 11/3/80, Unofficial translation.
[121] Unión Pak Sociedad Anónima, Tribunal Fiscal de la Nación, Sala C, Date of Decision: 6th of June of 2010, Paragraph VI *in fine*.
[122] Diana M. Queirolo in Chapter IX, Impuesto sobre la Ganancia Mínima Presunta (Minimum Deemed Income Tax Law), Régimen Tributario Argentino (Argentinean Tax Regime), Gustavo J. Naveira de Casanova et all., Abeledo Perrot, 2010, Page 298.
[123] Effective date: 1st of January of 1980.
[124] Article 2(g) of the Argentina – Bolivia DTC defines "business activitiess" as "activities" undertaken by enterprises of either of the Contracting State.

contained in the Andean Pact MC. This means that both lists are merely exemplary and, they indirectly imply that any sort of activity performed within their territories is going to trigger source taxation.

In this sense, it could also be argued that both the Andean Pact MC and Argentina´s domestic law, do not even need to provide any definition (not even descriptive) in order to clarify what triggers source taxation. The position adopted by Argentina and Bolivia in the DTC reflects the lack of necessity to even provide a list of circumstances that would be considered as constituting activities undertaken by an enterprise in the other State.

In this context, it could be argued that Avi-Yonah´s statements regarding the fact that "source" is only a "legal concept" and not an economic one, could be only applicable to the OECD MC and the UN MC. It could be argued that both the benefits principle and the economic allegiance principle (as it was understood by the four economists who drafted the Report on Double Taxation) also served as a legal convention aimed at establishing when source taxation was justified. However, it could be argued that the Andean Pact MC provides arguments against such statement, since this MC assigns taxing rights to the Contracting State where the income had its source of production. Moreover, in order to clarify any doubt, the Andean Pact provides a definition of "source of production", which refers to any activity, right or asset that generates or may generate an income.

If taking into consideration what the Andean Model prescribes, the benefits principle and the economic allegiance principle could not even become applicable to this situation, because source taxation is triggered despite considering if the enterprise received any sort of benefit from the host country. In addition, there is no requirement of substantial economic allegiance with the host State as the current OECD or UN PE threshold requires.

Nevertheless, even though the Andean Pact definition of "source of production" resembles Peggy and Richard Musgrave definition of "source" (the place of the income-generating activity), it could also be argued that income does not have a 'naturally defined source'.[125] In fact it could be argued that a piece of income might have more than one source. However, Avi-Yonah explains that the source rules applicable to active income are substantive since these type of rules try to track the economic source of income[126].

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[125] Avi- Yonah, "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing, 2015, Page 12.
[126] Avi- Yonah, "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing, 2015, Page 12.

6. Final remarks

The comparison developed throughout this paper shows that the primacy of taxing rights over business profits differs in accordance with the tax policy that the countries involved seek to achieve. It could be stated that the order of priority given to source taxation changes according to the economic development and industrialization of the countries involved.

Even though the three MCs compared in this paper show that all of them give primacy of taxing rights over business profits to the source jurisdiction, the OECD MC and the UN MC limit the ability of the source State to tax business profits only to income that is attributable to the PE. Even though the UN MC tries to expand the PE threshold in order to prioritize source taxation in more numerous situations than what the OECD PE threshold allows, the UN MC still requires the existence of a PE in order to justify or trigger source taxation.

Alternatively, the Andean Pact MC provides a distribution of the taxing powers merely based on source taxation. It could be argued that the division of taxing rights effected by the Andean Pact MC is more impartial, unbiased and fairer since each of the contracting parties obtains what it deserves. In this sense, the Andean Pact MC states that the "source of production" refers to the activity, right or asset that generates or that is able to generate an income[127]. However, it could also be questioned, to what extent does a piece of income only has one source of production.

Nevertheless, the Andean Pact MC complies with the tax policy that its Member countries aim to achieve. The Andean Members aim for a capital importing neutrality which involves that anyone who is doing business in a certain State face the same type of tax regime[128] and are subject to the same tax rates.

On the other hand, it could also be stated that the distribution of taxing rights proposed by the Andean Pact lacks fairness since if it had not been for the foreign investment created by the residence State, the source country would not have been able to benefit from the use of the foreign capital to finance costs or projects. In this sense, McLure quotes Hufbauer who provides arguments against the idea that residence countries should share their revenue on portfolio income with source countries[129]. Hufbauer claims that due to the

[127] Article 2(f) Andean Pact MC.

[128] Charles E. McLure, JR., "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm", National Tax Journal, Vol. 45, No. 2 (June, 1992), Published by National Tax Association, Page 146. Electronic copy available at: http://www.jstor.org/discover/10.2307/41788955?uid=3738984&uid=2&uid=4&sid=21106827238933

[129] Charles E. McLure, JR., "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm", National Tax Journal, Vol. 45, No. 2 (June, 1992), Published by National Tax Association, Page 149. Electronic copy available at:

creation by the residence country of a favourable economic environment, the creation of portfolio capital was possible, allowing its later investment in other countries. In this context, he argues that the residence country should be rewarded for that work[130]. Even though Hufbauer´s arguments are addressed for "portfolio investments", his arguments could also be applicable to foreign direct investments.

Nevertheless, it has been stated that any type of transfer of taxing rights from source to residence countries economically harms the developing countries, since these countries´ revenue mostly derives from taxing non-residents due to the fact that domestic corporate tax is generally quite limited[131]. It has also been stated that foreign direct investment adds value to a country´s economy[132].

Nevertheless, the Andean Pact distribution of the tax jurisdiction resembles some of the current proposals for taxing multinational enterprises such as the formulary profit split method. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst propose to adopt the formulary profit split method for allocating business profits and they explain that the method would imply a division of income 'from each business "activity" of a multinational group among the countries in which that activity is conducted'[133]. Even though this method also involves an agreement in regards with the formula applicable – which it also involves an agreement for the assignment of liabilities, risks and functions – the method also tries to track back, to some extent, the source of production. The method proposed also seeks to distribute and assign taxing rights to those countries where the activity was performed, which means that it is promoted as a mechanism for taxing business profits at source.

Despite the existing arguments which support or discourage source-based taxation, some of the examples of Action Plan 7 aimed at fighting BEPS, such as the introduction of the "service PE" and "delivery PE", show that the traditional order of priority of taxing rights is changing and heading towards to a broader PE threshold. And one of the consequences of the broadening of

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http://www.jstor.org/discover/10.2307/41788955?uid=3738984&uid=2&uid=4&sid=21106827238933

[130] Charles E. McLure, JR., "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm", National Tax Journal, Vol. 45, No. 2 (June, 1992), Published by National Tax Association, Page 149. Electronic copy available at: http://www.jstor.org/discover/10.2307/41788955?uid=3738984&uid=2&uid=4&sid=21106827238933

[131] Reuven S. Avi-Yonah "Advanced Introduction to International Tax Law", Elgar Advanced Introductions, Edward Elgar Publishing, 2015, Page 93.

[132] Michael Lang and Jeffrey Owens, "The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base", WU International Taxation Research Paper Series N° 2014-03. Universität Wien, Page 3.

[133] Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split", Florida Tax Review, Volume 9, 2009, Number 5, Page 508.

the PE threshold is the change in the allocation rules of taxing rights over the business profits.

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