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**Does the taxation of permanent establishment
ensure source-based taxation on business profits?
An analysis of cross-border services**

by

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Summary

Services belong to the business sector which contributes most to the world's economy. Despite that there is no specific provision in the OECD Model Tax Convention which concerns the taxation of business services specifically. Instead, taxation on business services is connected to the taxation of business profits, to which the residence state of the business has the primary right. The source state may be allowed to tax business income only if it is decided the income originates from a permanent establishment in that state.

However, the lack of physical presence in the source state and harmonization in the international tax may lead to tax base erosion by avoiding a permanent establishment in the source state. The OECD issued the Action Plan on Base Erosion and Profit Shifting in 2013 and the final report of the Action 7 to prevent the artificial avoidance of permanent establishment status of the Base Erosion and Profit Shifting in 2015. Then, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in 2016, and lastly the revision of the OECD Model Tax Convention in 2017. These measures mainly aim to tackle the problem of tax base erosion from tax avoidance.

The amendment of the permanent establishment definition under Article 5 of the OECD Model Tax Convention on 21 November 2017 broadens the scope of the permanent establishment threshold for the source state. However, it may be inadequate to ensure the source-based taxation on cross-border services. In addition, an obsolete PE concept may lead to situations which suggest further non-harmonization of taxation among countries.

This thesis conducts a legal analysis based on the definition of the permanent establishment as it stands today and its practicality to ensure the rights of the source state to tax business profits from cross-border services.

Preface

I would like to express my sincere gratitude to my supervisor, Cécile Brokelind for her valuable advice to help me expand the scope of my research and develop the content of my thesis.

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Abbreviations

2017 OECD Model	OECD Model Tax Convention on Income and Capital (Condensed Version) 21 November 2017
2017 UN Model	United Nations' Model Double Taxation Convention between Developed and Developing Countries 2017
Action 7	OECD/G20 Base Erosion and Profit Shifting Project: Preventing the Artificial Avoidance of Permanent Establishment Status (Action 7)
Art.	Article
Art. 5	Article 5 of the OECD Model
Art. 7	Article 7 of the OECD Model
BEPS	Base Erosion and Profit Shifting
BEPS Action Plan	Action Plan on Base Erosion and Profit Shifting
BIAC	Business and Industry Advisory Committee to the OECD
Chap.	Chapter
Commentary	Commentary on the Articles of the OECD Model Tax Convention
DPT	Diverted Profits Tax
E-Commerce	Electronic Commerce
GDP	Gross Domestic Product
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
OECD	Organization for Economic Co-operation and Development
OECD Model	Organization for Economic Co-operation and Development's Model Convention with respect to Taxes on Income and on Capital
P.	Page number
Para.	Paragraph
PE	Permanent Establishment
UK	United Kingdom
UN	United Nations
US	United States

Glossary

BEPS	‘Base Erosion and Profit Shifting: Tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations’. ¹
Enterprise	‘The carrying on of any business’, ² in other words, ‘an organization, a company or a business that undertaken for gain’. ³
Entity	‘An organization, person or party that possesses separate existence. Options include corporations, partnerships, estates and trusts’. ⁴
Nexus	Tax connection between taxpayers and states, it is the case that ‘qualified connection exists between the state exercising its taxing power and taxable subject and/or taxable object’. ⁵
Non-resident enterprise	A non-resident entity that is carrying on any business for profits
Residence state	A state of residence-based taxation
Source state	A state of source-based taxation

¹ OECD, ‘Base erosion and profit shifting’ (OECD 2018) <www.oecd.org/tax/beps/> accessed 15 May 2018.

² OECD, ‘Model Tax Convention on Income and on Capital: Condensed Version 2017 (as it read on 21 November 2017)’ (OECD Publishing 2017) p. 29. Available at: www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm.

³ Cambridge, ‘Cambridge Dictionary’ (Cambridge University Press 2018) <<https://dictionary.cambridge.org/dictionary/english/enterprise>> accessed 15 May 2018.

⁴ OECD, ‘Glossary of Tax Terms’ (OECD 2018) <www.oecd.org/ctp/glossaryoftaxterms.htm#E> accessed 15 May 2018.

⁵ Maarten de Wilde, ‘Tax Jurisdiction in a Digitalizing Economy; Why ‘Online Profits’ are so Hard to Pin Down’ [2015] 43 (12) Intertax p. 208.

1. Introduction

1.1 Background

In international tax law, states exercise their tax jurisdiction based on principles of residence and source.⁶ The residence-based state taxes worldwide income from its residents, whereas the source-based state has its taxing right from sources within its territory.⁷ Most of the states agree to limit their tax sovereignty according to rules agreed on within tax treaties, most of which are based on the Organization for Economic Co-operation and Development's (OECD) Model Convention with respect to Taxes on Income and on Capital (OECD Model).

The international trade has developed rapidly as a result of advanced technologies in transportation, computing, and telecommunications, and also an expansion of the internet and electronic commerce (E-Commerce).⁸ As of now, services dominate two-thirds of the world's gross domestic product (GDP) in 2017,⁹ and the growth of the exports of commercial services have accelerated by 64 per cent from 2006 to 2016.¹⁰

Although cross-border services are economically significant, the OECD Model does not have specific provisions to deal with the income from cross-border business services. The income from services is primarily taxed in the residence state of the business providing them, and the source state, where the services are provided, should not have the right to tax income derived from the provision of services unless there is sufficient economic life in the source state.¹¹

Therefore, the business profits under Article 7 of the OECD Model (Art. 7) is the general rule to deal with the income from services and the permanent establishment (PE) under Article 5 of the OECD Model (Art. 5) is the threshold used to determine the taxing rights between the source and residence states.¹² With these rules, the income from business services is subject to tax in the source state only if there exists a PE through a fixed place of business or a dependent agent.

However, in today's world, a business which provides services can still benefit from the production resources of a state and serve wider markets without having a physical presence in the market destination.¹³ This, in turn, might lead to there being no taxable presence in the source state. It becomes

⁶ Dale Pinto, 'Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?' [2007] Bulletin for International Taxation p. 277.

⁷ Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015) pp. 8-9.

⁸ United Nations, 'Manual on Statistics of International Trade in Services 2010 (MSITS 2010)' (United Nations 2010) p. 12.

⁹ Central Intelligence Agency, 'The World Factbook' (CIA 2018) <www.cia.gov/library/publications/the-world-factbook/fields/2012.html#xx> accessed 4 May 2018.

¹⁰ World Trade Organization, 'World Trade Statistical Review 2017' (World Trade Organization 2017) p. 5.

¹¹ Para. 132-135 OECD Model: Commentary on Article 5 (2017); Para. 11 OECD Model: Commentary on Article 7 (2017).

¹² Pinto (n 6) p. 277.

¹³ United Nations Conference on Trade and Development, 'World Investment Report 2017: Investment and the Digital Economy—Key Messages and Overview' (United Nations 2017) p. iv.

more challenging for the source state to tax income from cross-border services as the traditional PE concept requires a physical presence and engagement of core business activities in the source state, whereas the nature of services is intangible and mobile.¹⁴

In addition, the lack of common interpretation and harmonisation in the international taxation may cause tax base erosion problem. Countries adopt different domestic tax systems, which can create the gap for multinational enterprises to avoid taxation and ‘not being taxed anywhere’ (so-called ‘double non-taxation’).¹⁵ Therefore, the source-based taxation on cross-border business services can be circumvented by avoiding creation of a PE in the source state. Recently, many countries have adopted unilateral measures to tackle the problem of PE avoidance. The obvious example is the ‘Diverted Profits Tax’ (DPT) of the United Kingdom (UK) and Australia as it aims to target large business enterprise who attempt to avoid taxation in those countries.¹⁶

With this regard, the PE threshold as an international consensus is prone to controversy since the PE threshold may not be adequate for the source state to tax the business profits from cross-border services, and it has become an instrument to avoid taxation in the source-based country.¹⁷

As a result, the OECD issued the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 to prevent the double non-taxation and reinforce the division of the right to tax taxation between source and residence states.¹⁸ Following the BEPS Action Plan, the final report of the ‘OECD/G20 Base Erosion and Profit Shifting Project: Preventing the Artificial Avoidance of Permanent Establishment Status’ (Action 7) was launched in October 2015 to update the definition of the PE in the tax treaty.¹⁹ Further, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) was adopted in November 2016 as a mechanism to implement treaty-related measures of the BEPS project across the existing treaty networks.²⁰

Lastly, the revision of the OECD Model was issued on 21 November 2017 (2017 OECD Model) for amendment of the PE definition to reflect the problems related to the PE issues under the Action 7 and previous work on the interpretation and application of Art. 5.²¹ The main change in the latest

¹⁴ United Nations, ‘Manual on Statistics of International Trade in Services 2010’ (n 8) p. 8.

¹⁵ OECD, ‘Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report’ (OECD Publishing 2015) p. 11.

¹⁶ Nana Ama Sarfo, ‘Finding Middle Ground over Unilateral Digital Taxation’ [2018] 72(4a) Bulletin for International Taxation Chap. 3.1 and 3.3.

¹⁷ Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Wolters Kluwer 1991) p. 559.

¹⁸ OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (OECD Publishing 2013) p. 11.

¹⁹ OECD, ‘Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report’ (OECD Publishing 2015) pp. 13-14.

²⁰ OECD, ‘Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting’ (OECD Publishing 2016) p. 1.

²¹ OECD, ‘2017 Update to the Model Tax Convention on Income and on Capital’ (OECD 2017) pp. 2-3. Available at: www.oecd.org/ctp/treaties/2017-update-model-tax-convention.pdf.

OECD Model has resulted in a lower PE threshold and broader scope of the PE definition for establishing a broader source-based taxation.

1.2 Research question

The research question in this thesis shall be:

Does the taxation of permanent establishment ensure source-based taxation on business profits?

In order to reach the conclusion of the research question, the following sub-questions will be answered in each Chapter of this thesis:

Chapter2 What is the international tax principles that influence the PE concept?

Chapter3 What are the ‘business services’ and taxation on income from ‘cross-border business services?’?

What is the PE threshold for the source state to tax income from cross-border business services under the OECD Model?

Chapter4 What are the upcoming consequences of the revised PE definition on taxation of cross-border business services?

Does the change ensure the taxation in the source state and how can it be evaluated?

What is the current development of the source state to ensure taxation on cross-border business services?

Chapter5 What is the conclusion and recommendation for the source-based taxation?

1.3 Aim

As the OECD Model Tax Treaty gives the primary right to tax cross-border services to the residence state, whether the source state can tax such income depends on the existence of the PE.²² However, modern services are not required to have a physical presence in the source state, which causes the PE threshold to be avoided, and the lack of tax harmonisation increases tax base erosion by PE avoidance in the source state.

The change of the PE definition under Art. 5 in the 2017 OECD Model aims to solve the problem of the tax base erosion by extending the scope of PE threshold for the source state. It is questionable whether the amendment of the PE definition is adequate for the source state to tackle the problem of tax base erosion and ensure the taxation of business profits in the source state in the case of cross-border services.

²² Para. 132-135 OECD Model: Commentary on Article 5 (2017); Para. 11 OECD Model: Commentary on Article 7 (2017).

This thesis aims to conduct a legal analysis of the PE definition under the OECD Model to understand whether the PE threshold as it stands today can ensure the source-based taxation on cross-border services and whether a new threshold should be introduced to strengthen the right to tax of the source state.

1.4 Method and material

In order to answer this question, it is necessary to conduct legal research from both the internal and the external perspective, to make a ‘study of the law as it ought to be and the ways in which the desired legal reality can be achieved’.²³ The starting point was the legal-dogmatic research concerning the PE notion as it stands today, international tax principles, relevant case law and the literature.²⁴ The analysis will be done by the comparative legal method,²⁵ as well as the historical description.²⁶

Literature and academic journals are used to provide the background and more in-depth understanding of the concepts and reasons behind the law, and also the objective of the PE. The OECD Model and Commentary, including working papers, are used to observe the law as it stands today as well as the development of the law. The United Nations’ (UN) Model Double Taxation Convention between Developed and Developing Countries (UN Model) and Commentary, including working papers, is used for comparison as it provides an identical concept of the PE. Then, the domestic legislation and case law are used to observe the practical issues for the application of PE. The selection of case law is based on the decision or consequence of the case which is relevant to the problems.

1.5 Delimitation

The primary focus of this thesis is the PE definition under Art. 5 of the OECD Model. The profit attribution under Art. 7 of the OECD Model is not the main issue to be explored in this thesis. As well as, other relevant provisions in the OECD Model regarding the provision of services are also outside the scope of this thesis, e.g. International Shipping and Air Transport (Art. 8) and Employment (Art. 15).

The analysis part of this thesis is based on the definition of the PE which is the fixed place of business and the agent PE. It does not cover the Entitlement to Benefits which includes a limitation-on-benefits rule, the anti-abuse rule for PE situated in third States, and the principal purposes test rule under Art. 29 of the 2017 OECD Model.

²³ SCW Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014) p. 17.

²⁴ *Ibid* p. 18.

²⁵ *Ibid* p. 30.

²⁶ *Ibid*.

Additionally, any tax implications discussed in this thesis is only from the direct taxation perspective.

Some of the case law referred in this thesis were drafted in a language which was not English. The discussion is based on the best information available in English.

The official revision of the 2017 UN Model was issued on 17 May 2018. The discussion on this paper is intended to provide a preliminary view of the UN Model, it is not comprehensive.

1.6 Outline

In Chapter 1, the author introduces the research question to provide background to the problems, aim, research method and material, and delimitation of this thesis.

Then, in Chapter 2, in order to answer what is the tax theories behind the PE concept, the author provides the necessary background of international tax principles, PE concept and development of the BEPS project.

In Chapter 3, the author defines the term 'business services' and discusses the taxation on 'cross-border business services'. In addition, this Chapter also discusses the PE definition under the 2017 OECD Model and its Commentary. It includes the development of the PE and an overview of the 2017 UN Model. This is to understand the PE definition as it stands today as compared to the past and the UN Model.

In Chapter 4, an analysis is made by evaluating the upcoming consequences of the revised PE definition, and observing the current development around the globe. This Chapter aims to evaluate whether the PE as it stands today ensures source-based taxation on business services.

Lastly, Chapter 5 concludes the research question and provides recommendation.

2. Principles of international tax and development of permanent establishment concept

2.1 Principles of international tax

A cornerstone of international taxation is the tax sovereignty of states. The allocation of taxing rights is traditionally justified by the residence and source principles, from which double taxation may arise as a result of those principles overlapping. To solve this, tax treaties were adopted by many

countries to standardize cross-border tax treatment in the field of international juridical double taxation.²⁷

2.1.1 Jurisdiction to tax

Taxes are the revenues of the governments which are raised for contribution to public goods and services.²⁸ Tax is levied based on the ‘ability to pay’ principle meaning that the taxpayer should pay tax in accordance with their ability to pay, or their means.²⁹ Another concept is the ‘benefits principle’ which states that taxes should be paid if taxpayers utilize the government’s services.³⁰

In order for a state to create the state’s tax system, two main principles laid down as fundamental to tax systems are ‘equity’ and ‘economic efficiency’. The term ‘equity’ can be understood as fairness in which if it is a fair tax system, taxpayers are more likely to pay taxes than to evade payment.³¹ In terms of ‘economic efficiency’ or ‘neutrality’, the perception of this principle is that a tax should be neutral in order to not affect the decision making of taxpayers to achieve tax consequences.³²

In term of international circumstances, the issue of the ‘equity’ is how the countries should divide tax revenue among them, so-called ‘inter-nation equity’.³³ This is the founding principle for equitable allocation of international income between source and residence states.³⁴

From the benefit principle perspective, the inter-nation equity tends to favor source-based taxation. If a non-resident enterprise participated in the economics of the source state, it is assumed that it must be a ‘certain degree of economic allegiance’ when using the benefits provided by the state to produce the income.³⁵

The meaning of ‘neutrality’ in a global context has various meaning, but all are related to the ‘overall tax rate’ that taxpayers have to pay when they are subject to tax in more than one jurisdiction.³⁶ For an allocation of international income, the concepts of ‘capital export neutrality’ and ‘capital import neutrality’ are applied in order to achieve the ‘maximum wealth’ at the global level.³⁷

‘Capital export neutrality’ is the neutrality in the ‘location of the investment’, meaning that there should be no difference in taxation with

²⁷ Klaus Vogel and Alexander Rust, ‘Introduction’ in Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Ekkehart Reimer and Alexander Rust ed, 4th edn, Wolters Kluwer 2015) p. 1.

²⁸ Brian J Arnold, *International Tax Primer* (3rd edn, Wolters Kluwer 2016) p. 4.

²⁹ Michel Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge 2011) p. 26.

³⁰ Angharad Miller and Lynne Oats, *Principles of International Taxation* (5th edn, Bloomsbury Professional 2016) p. 6.

³¹ *Ibid.*

³² *Ibid.* p. 6.

³³ *Ibid.* p. 30.

³⁴ Eva Escribano López, ‘An Opportunistic, and Yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties’ [2015] 43(1) *Intertax* p. 7.

³⁵ *Ibid.*; Klaus Vogel, ‘Worldwide vs. Source Taxation of Income - A review and Re-evaluation of Arguments Part III’ [1998] 11 *Intertax* p. 398.

³⁶ Miller and Oats (n 30) p. 30.

³⁷ AHM Daniels, ‘Sovereign Affairs’ [2000] 29 (1) *Intertax* p. 4.

regard to the place of the investment as either domestic or foreign investment.³⁸ The income should be taxed at worldwide income in the residence state, and the tax in the source state should be credited against the tax in the residence state.³⁹ This is in accordance the ability to pay principle that tax burden of resident taxpayers is equal as regard to their income in the territory and abroad.⁴⁰

‘Capital import neutrality’ is the neutrality in the ‘source of the investment’, meaning that there should be no difference in taxation for all investors regardless of their tax residency.⁴¹ In other words, the income should be taxed by the source state, and the exemption of income should be given by the residence state.⁴² The tax burden in the source state should be the same for both resident and non-resident taxpayers according to the benefits principle.⁴³

The concept of jurisdiction to tax was based on (i) the ‘equity’ principle that the source state should have the right to tax income of non-resident taxpayers if a certain economic participation is met; (ii) the ‘economic efficiency’ principle that tax should be neutral for the residence state to tax all income from its resident taxpayers, or for the source state to tax all income arises within its territory.

2.1.2 Residence and source

A state is justified in its taxing rights based on a nexus or connection between the state and the income or the activities that generate the income.⁴⁴ Traditionally, most of the countries determine their ‘tax jurisdiction’ based on the ‘dual taxing principles of residence and source’.⁴⁵

The source states have their sovereignty to tax the income which is incurred in their territory from both resident and non-resident taxpayers.⁴⁶ This is based on the benefit principle that the taxpayers should pay tax as a compensation or fee for the services provided by the government.⁴⁷

The residence state exercises their taxing rights through the ability to pay principle that the taxpayers should pay tax according to their ability to earn income from worldwide.⁴⁸ Thus, the principle of residence means taxation of worldwide income from its resident taxpayers.⁴⁹

³⁸ Miller and Oats (n 30) p. 30; Klaus Vogel, ‘Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part II)’ [1988] 10 Intertax p. 311.

³⁹ Daniels (n 37) p. 4.

⁴⁰ Maarten F. de Wilde, ‘Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy’ [2010] 38 (5) Intertax p. 294.

⁴¹ Miller and Oats (n 30) p. 31; Klaus Vogel, ‘Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part II)’ (n 38) p. 311.

⁴² Daniels (n 37) p. 4.

⁴³ de Wilde, ‘Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy’ (n 40) p. 295.

⁴⁴ Arnold, *International Tax Primer* (n 28) p. 15.

⁴⁵ Pinto (n 6) p. 277; Avi-Yonah, *Advanced Introduction to International Tax Law* (n 7) pp. 8-9.

⁴⁶ Vogel and Rust (n 27) p.12.

⁴⁷ Pinto (n 6) p. 288.

⁴⁸ Pinto (n 6) p. 280.

⁴⁹ Vogel and Rust (n 27) p. 12.

The interaction of the residence and source taxation causes the overlapping of taxing rights between the states which creates the vital issue in international taxation, 'double taxation'.⁵⁰

2.1.3 Double taxation

Double taxation is the situation where the same income or profit of the same taxpayer is subject to tax more than one time for the same period of time.⁵¹ The legal definition frames double taxation as 'juridical double taxation' which can be defined as 'the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods'.⁵²

If the double taxation occurs, the credit system and the exemption system are used to relief such burden. The credit system is when a residence state gives credit for tax paid abroad against the domestic tax. The exemption system is when the residence state exempts income that has been taxed in another country.⁵³

Basically, the contracting states apply their domestic law under the limitation of the tax treaties. The taxable income is classified into a category of income e.g. business profits, dividend or royalties. The double taxation may arise from the 'qualification conflict' that the states interprets differently on the types of the income that should apply under the tax treaties by different domestic law.⁵⁴

Otherwise, the disagreement of the 'existence of PE at the source state' is the scenario where the source state deems the PE existence in its territory, but the residence state denies such view. Both states tax the same income and the residence state rejected to give a tax relief under the tax treaties.⁵⁵

When the double taxation exists, it is essential for the states to allocate their taxing rights in order to avoid the double taxation.

2.1.4 Introduction to tax treaties

Globalization makes the international trade overgrows, which causes taxpayers are liable to tax in more than one countries. Therefore, the tax treaties involve in this issue by allocating taxing rights between contracting states on cross-border income.⁵⁶

The majority of tax treaties is based on the OECD Model,⁵⁷ which is significant as a source of common interpretation for different countries to

⁵⁰ Miller and Oats (n 30) p. 27.

⁵¹ Avi-Yonah, *Advanced Introduction to International Tax Law* (n 7) p. 3; Miller and Oats (n 30) p. 96; Arnold, *International Tax Primer* (n 28) p. 43.

⁵² Para. 1 OECD Model: Introduction (2017).

⁵³ Miller and Oats (n 30) p. 96.

⁵⁴ Andreas Waltrich, *Cross-Border Taxation of Permanent Establishments: An International Comparison* (Wolters Kluwer 2016) pp. 127-128.

⁵⁵ Ibid.

⁵⁶ López (n 34) p. 7.

⁵⁷ Ariane Pickering, 'Enterprise services – General Report' [2012] 97A IFA Cahiers p. 20.

apply tax treaties.⁵⁸ It also provides certainty in the international taxation and ensures the taxpayer rights under the tax treaties.⁵⁹ The wide acceptance of the OECD Model creates the same standard of international tax rules, reduce the problem of double taxation, and facilitate the trade and investment.⁶⁰

The first OECD Model drafted by the League of Nations in 1927 was based on two principles in the report of the four economists.⁶¹ The first principle was the ‘first bite at the apple’ that if the income arises in the source state, the taxing rights should be prioritized to the source state.

The second principle was developed from the benefit principle that ‘the active (business) income should be taxed primarily at source while the passive (investment) income should be taxed primarily on a residence basis’.⁶² As a result, the responsibility of preventing double taxation and the right to tax passive income relies on the residence state in the OECD Model.

Even though the business income should be taxed at source, the minimum threshold is required to justify the establishment of the ‘economic allegiance’ in the source state.⁶³ Therefore, the threshold of PE was included in the tax treaty as a ‘legal convention’ to determine a sufficient ‘degree of economic presence’ to the state where the PE is located.⁶⁴

2.2 Development of permanent establishment concept

2.2.1 Traditional requirement of physical presence

Arvid A. Skaar said that ‘[t]he notion of permanent establishment is one of the most important issues in treaty-based international fiscal law’.⁶⁵ This is because the PE is the cornerstone to determine the tax jurisdiction and the tax base on income from business profits of the non-resident enterprise.⁶⁶ The residence state has the primary rights to tax business profits, the source state is able to tax such income under only one qualification – the existence of PE, which is used as an exception to ensure a sufficient link between the taxpayer and the source country.⁶⁷

In 1928, the PE concept in the Model Convention of the League of Nations emphasized on the industry that had a fixed location rather than the business

⁵⁸ Miller and Oats (n 30) p. 145.

⁵⁹ *Ibid* p. 158.

⁶⁰ Arnold, *International Tax Primer* (n 28) p. 142.

⁶¹ In March 1923, the study of the problem of double taxation were reported by Professor Bruins from the Netherlands, Professor Einaudi from Italy, Professor Seligman from the United States and Sir Josiah Stamp from the United Kingdom.

⁶² Avi-Yonah, *Advanced Introduction to International Tax Law* (n 7) pp. 4-5.

⁶³ Avi-Yonah, *Advanced Introduction to International Tax Law* (n 7) p. 23; Miller and Oats (n 30) p. 235.

⁶⁴ López (n 34) p. 8; Skaar (n 17) pp.72, 559.

⁶⁵ Skaar (n 17) p. 1.

⁶⁶ Ekkehart Reimer, ‘Permanent Establishment’ in Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Ekkehart Reimer and Alexander Rust ed, 4th edn, Wolters Kluwer 2015) p. 297; United Nations and others, ‘United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries’ (United Nations 2015) p. 16.

⁶⁷ Klaus Vogel, ‘“State of Residence” may as well be “State of Source” – There is no Contradiction’ [2005] Bulletin – Tax Treaty Monitor p. 422.

without a fixed place of business.⁶⁸ This is because significant businesses at that time were manufacturing and retailing which required fixed capital, e.g. factory and machinery.⁶⁹ Hence, the PE concept is historically founded on the ground that labour and capital of the business are immobile, and it required an establishment in the source state. Consequently, the criterion to constitute a PE which is required a physical presence and engagement of the core activities of the business in the source state was accepted for the allocation of taxation rights to the source state.⁷⁰

In the 1980s, the major business has gradually shifted from the manufacturing to the service business and intangibles, and the business become more mobile.⁷¹ The service business grows more significant in the international trade than the manufacturing business. The personnel, machinery, and capital can be moved freely and are not necessarily located at the place where the services are performed.

2.2.2 Problem of taxing cross-border services

In the past, it might not be a problem for the source state to tax on income from traditional business services. However, the modern services can be performed anywhere, and the service provider does not need any physical presence to perform the services. If the service provider sends its employees to provide services in the source state for a short period, the source state is not entitled to tax income from such services if there is no PE in the source state.⁷² An introduction to an E-Commerce also shows how companies avoid having a PE in the source state where they have a business presence. The website can provide goods or services to customers in a distant place without having employees or place of business.⁷³

Based on the PE concept, the criterion for the fixed place of business is that it requires an area in which ‘fixed in a geographical sense and permanent in a temporal sense’.⁷⁴ The dependent agent is a deeming rule which is not required a fixed place of business, but the scope of application is limited only the activity of ‘conclusion of contracts’. These two criteria for the PE set a high threshold for the source state to tax income from business services. As *Brian J. Arnold* stated that ‘the higher threshold, the less income to be taxable by the source state and the more income of the residence state’.⁷⁵ Therefore, it is difficult for the source states to tax income from those services based on the current rule of the PE.⁷⁶ In the

⁶⁸ United Nations, ‘Commentaries on the Articles of the United Nations Model Double Taxation Convention Between Developed and Developing Countries’ (United Nations 1980) para. 1 General Considerations on Article 5 Permanent Establishment.

⁶⁹ Skaar (n 17) pp. 65-66.

⁷⁰ Skaar (n 17) pp. 66-67.

⁷¹ Avi-Yonah and Xu (n 62) p. 99.

⁷² *Ibid* p. 304.

⁷³ de Wilde, ‘Tax Jurisdiction in a Digitalizing Economy; Why ‘Online Profits’ are so Hard to Pin Down’ (n 5) p. 796.

⁷⁴ Brian J. Arnold, ‘Threshold Requirements for Taxing Business Profits under Tax Treaties’ [2003] Bulletin – Tax Treaty Monitor p. 478.

⁷⁵ Brian J. Arnold, ‘The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess – Expanded Version’. [2010] 65(2) Bulletin for International Taxation chap. 2.2.6.

⁷⁶ Santos and Lopes António Carlos dos Santos and Cidália Mota Lopes, ‘Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment’. [2016] 5-6 EC Tax Review p. 302.

absence of the fixed place of business or the dependent agent, income from business services is taxable only in the residence state.⁷⁷

The problem arises when the service provider is a resident of the state that has no income tax or tax in a low rate, it creates the circumstance of ‘double non-taxation’ where the income is not subject to tax anywhere because of the lack of taxable presence in the source state. The PE is used as a key factor to determine the right of the source state to tax income from business services.⁷⁸ Meanwhile, the PE threshold is also used as an instrument to avoid taxation in the source state.⁷⁹

2.2.3 Development of base erosion and profit shifting

The main purposes of the OECD Model are not only to eliminate double taxation, but also to prevent double non-taxation or tax reduction through tax evasion and avoidance.⁸⁰ Due to the different tax system among the states, the multinational enterprises have exploited the benefit from the loophole resulting that the ‘income not being taxed anywhere’,⁸¹ and tax base erosion of the states all over the world.

In July 2013, the BEPS Action Plan was published by the OECD; the aim is to prevent and eliminate the double non-taxation arose from the erosion of worldwide tax base, and reinforce taxation between source and residence state without changing ‘the existing international standards on the allocation of taxing rights on cross-border income’.⁸² The action plans regarding the PE issue addressed in the ‘tax challenges of the digital economy’ (Action 1), the ‘prevent treaty abuse’ (Action 6), and especially the ‘prevent the artificial avoidance of PE status’ (Action 7).⁸³

Following the BEPS Action Plan, the final report of Action 7 was released in 2015; the main goal is to tackle the issue of artificial tax avoidance by circumventing the PE status in the source state. Hence, the Action 7 intended to review and update the definition of the PE in the OECD Model to ‘prevent abuses’ and ‘restore the full effects and benefits of international standards’ by focusing on closing the loophole on the tax strategies that usually used by the Multinational Enterprises to avoid the PE status.⁸⁴

In order to implement the measures on the existing tax treaties under the BEPS project, the MLI was signed by 68 jurisdictions on 7 June 2017.⁸⁵ This is a multilateral instrument under Action 15 of the BEPS project to

⁷⁷ Miller and Oats (n 30) p. 315.

⁷⁸ Luzius U. Cavelti, Christian Jaag and Tobias F. Rohner, ‘Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD’s Actions against Base Erosion and Profit Shifting’. [2017] World Tax Journal p. 359.

⁷⁹ Skaar (n 17) p. 559.

⁸⁰ Para. 16.1 OECD Model: Introduction (2017); OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (n 18) p. 10.

⁸¹ OECD, ‘Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report’ (n 15) p. 11; Santos and Lopes (n 76) p. 299.

⁸² Avi-Yonah and Xu (n 62) p. 101; López. (n 34) p. 6; OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (n 55) p. 11.

⁸³ OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (n 18) pp. 19-20.

⁸⁴ OECD, ‘Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report’ (n 19) pp. 13-14.

⁸⁵ OECD, ‘Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting (Status as of 22 March 2018)’ www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf accessed 15 May 2018.

modify the definition of the PE in the OECD Model and existing bilateral tax treaties to match with the final report of the BEPS Action 7. According to Art. 12-15 of the MLI,⁸⁶ the principal proposed modifications in the tax treaties are as follows:

The first modification is the revision of the dependent agent concept by enlarging the scope to cover the commissionaire arrangement that has been used by firms to avoid the dependent agent in the source state. The agent acts on behalf of the non-resident enterprise, the sales or services agreements are made under the name of the agent which is not binding the non-resident enterprise.⁸⁷ Thus, there is no PE in the source state. The exception scope for independent agent definition was also reduced in this modification.⁸⁸

Secondly, specific activity exemptions were revised. With the new exceptions, if the activities in the source are merely the 'preparatory and auxiliary', such activities do not constitute a PE in the source state. Furthermore, the revision brings the addition of the 'fragmentation of activities' between 'closely related enterprise' to limit the scope of the 'preparatory and auxiliary' activities.⁸⁹

Lastly, the 'splitting up of contracts' was defined to separate the single project in source state into many projects to avoid time-threshold under the construction PE. Thus, it suggested to revise the wording to avoid such situation.⁹⁰

The OECD Council approved the 2017 OECD Model on 21 November 2017; the main changes followed the MLI on the issues of dependent agent and independent agent under Art. 5(5)(6). The specific activity exemptions and fragmentation rule under Art. 5(4)(4.1) were partly changed. However, the provision regarding the splitting up of contracts under Art. 5(3) has not been changed.⁹¹ In addition, the OECD updated the Commentary regarding the 'fixed place of business' in the Commentary based on the previous works on the interpretation and application of Art. 5.⁹²

In conclusion, the changes in the OECD Model does not change the existing standards on the allocation of taxing rights between the source and residence states. The aim is to address the tax base erosion by amending the definition of the PE. Although the main reason for the change in the OECD is raised

⁸⁶ OECD, 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (OECD Publishing 2016) Available at: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beeps.pdf>; OECD, 'Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (n20) pp. 39-47.

⁸⁷ Fernando Souza de Man, *Taxation of Services in Treaties between Developed and Developing Countries: A Proposal for New Guidelines* (IBFD 2017) p. 123.

⁸⁸ Art. 12 MLI (2017).

⁸⁹ Art. 13 MLI (2017).

⁹⁰ Art. 14 MLI (2017).

⁹¹ The OECD included in paras. 52, 78 OECD Model: Commentary on Article 5 (2017); Johann Hattingh, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies' [2018] 72(4/5) Bulletin for International Taxation p. 241.

⁹² OECD, 'Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (Revised public discussion draft)' (OECD 2012).

from the problem of the base erosion from tax avoidance, the consequence also affects the taxation on business services as the PE is the only threshold to determine taxation in the source state.

3. Permanent establishment on cross-border business services

3.1 Definition of cross-border business services

With regard to the term ‘business services’, it is not defined either in the OECD Model or the UN Model. It is referred to services related to ‘profit-seeking enterprise’ in the economics literature.⁹³ While the tax scholars defined that ‘services comprise any work done for another person for remuneration is taken as point of departure’.⁹⁴

Broadly speaking, the ‘services’ may refer to any activities which do not trade or manufacturing in goods. Services can be classified into two categories: ‘traditional services’ and ‘modern services’.⁹⁵ This classification refers to the nature of the business that a service provider performs. Traditional services usually require physical presence and close relationship between buyers and sellers, e.g. transport, travel or retailers.⁹⁶ Meanwhile, modern services are, for example, information and communication technology, finance or intellectual property services.

The OECD Model has defined the term ‘business’ so that it shall ‘include the performance of professional services and other activities of an independent character’.⁹⁷ The term ‘business profits’ is used under Art. 7 as a reference to the ‘profits of an enterprise’.⁹⁸ The OECD Model also stated that the term ‘enterprise’ applies ‘to the carrying on of any business’,⁹⁹ in other words, ‘the entity to which profits can be attributed’.¹⁰⁰

In this thesis, the term ‘business services’ shall refer to any services performed by an enterprise to gain profits. Whereas the term ‘income from cross-border business services’ shall refer to a situation where a resident of one country provides business services to a resident of another state and derives income as business profits from the provision of services.

⁹³ Harry I. Greenfield, *Manpower and the growth of producer services* (Columbia University Press 1966) p. viii.

⁹⁴ Wim Wijnen, Jan de Goede and Andrea Alessi, ‘The Treatment of Services in Tax Treaties’ [2012] *Bulletin for International Taxation* p. 27.

⁹⁵ Prakash Loungani and others, *World Trade in Services: Evidence from A New Dataset* (International Monetary Fund 2017) pp. 7-8.

⁹⁶ *Ibid.*

⁹⁷ Art. 3 para. 1 sub-para. h OECD Model (2017).

⁹⁸ Art. 7 para. 1 OECD Model (2017).

⁹⁹ Art. 3 para. 1 sub-para. c OECD Model (2017).

¹⁰⁰ Ekkehart Reimer, Stefan Schmid and Marianne Orell, *Permanent Establishments A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (3rd, Wolters Kluwer 2014) p. 162.

3.2 Taxation on cross-border business services

The international trade in services has been developing drastically in recent years.¹⁰¹ The development of technologies creates enormous new business models. The growing of international trade means more attention requires for allocation of taxing rights of on profits from cross-border business services. Although cross-border services are economically significant, the OECD Model does not have specific provisions to deal with the income from business services. In particular, the development of the OECD Model occurred during the industrial revolution where the primary business was mainly the manufacturing business.¹⁰²

In the absence of specific provisions, Art. 7 is the general rule to deal with the income from services and Art. 5 is the only threshold used to determine the taxing rights between the source and residence states.¹⁰³ With these rules, the income from business services is not subject to tax in the source state unless there exists a PE through a fixed place of business or a dependent agent. The non-resident enterprise may provide services to customers without becoming subject to tax in a source country because of the high threshold to impose a tax on business income in the source state.¹⁰⁴ The source state has a burden of proof for the existence of the PE.

3.3 Development of permanent establishment under the OECD Model Tax Convention

The first OECD Model was published in 1963 as a draft and was revised in 1977 and 1992. In 1992, the OECD decided that the OECD Model should be ambulatory with frequent updates rather than having complete revisions. Thereafter, the OECD Model was updated in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and the latest happened in 2017.¹⁰⁵

During the period, the main changes focused on the ‘fixed place of business; then the service PE clause was introduced as a commentary in 2008. The significant updates are summarized as follows:

In 1963, the OECD stated in the Commentary that the general definition under para. 1 is the essential characteristic of a PE, namely that it has a distinct ‘situs’ or a ‘fixed place of business’.¹⁰⁶ It is a PE if the place is fixed and the business was performed in that place.

The first draft also provided the non-exhaustive list of prima facie examples of PE in para. 2 and the list of specific activity exceptions from the general

¹⁰¹ See Appendix II ‘Economic data of International Trade in Services’.

¹⁰² Skaar (n 17) pp. 65-66.

¹⁰³ Miller and Oats (n 30) p. 315.

¹⁰⁴ Brian J. Arnold, ‘Taxation of income from services’ in United Nations and others, ‘United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries’ (n 66) p. 48.

¹⁰⁵ Arnold, *International Tax Primer* (n 28) p. 140.

¹⁰⁶ OECD, ‘Commentaries on the Articles of the Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital Convention Between (State A) And (State B) for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital’ (OECD 1963) para. 2 Commentary on Article 5.

definition in para. 3. The aim was to ‘foster international trade and for the convenience of administration’.¹⁰⁷ The dependent agent was drafted in para. 4, an agency PE must be those who are dependent on both legal and economic perspectives. The agent should be deemed to be a PE only if that agent has sufficient authority to bind the enterprise in the business activity.¹⁰⁸

In 1977, the term ‘place of business’ was expanded to cover any premises, facilities or installations used for carrying on the business, whether used exclusively for the business or whether no premise is available. The mere certain amount of space at its disposal could be considered as a PE, despite if it belongs to another enterprise.¹⁰⁹ In addition, the place of business must be a fixed one. Thus, it should have ‘a link between the place of business and a specific geographical point as well as a certain degree of permanency’.¹¹⁰

The OECD added a ‘Construction PE’ which was a building site or construction or installation project lasts more than 12 months.¹¹¹ The addition was replaced in para. 3 and the list of specific activity exceptions was renumbered to para. 4 and the dependent agent was renumbered to para. 5, which are the same paragraphs as the current 2017 OECD Model.¹¹²

In 2000, Art. 14 concerning income from independent professional services was eliminated due to the fact that the criteria of ‘fixed base’ were similar to the ‘fixed place of business’, therefore the PE threshold under Art. 5 and business profits under Art. 7 became applicable to that income.¹¹³

In 2003, the OECD added the explanation of taxation on electronic commerce in the Commentary concerning whether the operation of computer equipment is regarded as the fixed place of business.¹¹⁴

In 2008, the wording of service PE was introduced as an alternative provision in the Commentary for countries that are reluctant to adopt the principle of exclusive resident taxation of service income.¹¹⁵ The PE was deemed to exist even if there was no fixed place of business of the non-resident enterprise in the source state.¹¹⁶

The income from services is primary residence-based taxation, and source state should not have the right to tax on income derived from the provision

¹⁰⁷ Para. 5 OECD Model: Commentary on Article 5 (1963).

¹⁰⁸ Paras. 15, 16 OECD Model: Commentary on Article 5 (1963).

¹⁰⁹ OECD, ‘Commentary on the Model Double Convention on Income and Capital’ (OECD 1977) para.4 Commentary on Article 5.

¹¹⁰ Paras. 5, 6 OECD Model: Commentary on Article 5 (1977).

¹¹¹ Para. 15 OECD Model: Commentary on Article 5 (1977).

¹¹² OECD, ‘Model Tax Convention on Income and on Capital 2014 (Full Version)’ (OECD Publishing 2014) pp. M17-18. Available at www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm.

¹¹³ OECD, ‘Model Tax Convention on Income and on Capital 2014 (Full Version)’ (n 112) p. C(5)-1.

¹¹⁴ OECD, ‘OECD Income and Capital Model Convention and Commentary’ (OECD 2003) para. 42.1-42.10 Commentary on Article 5.

¹¹⁵ OECD, ‘OECD Income and Capital Model Convention and Commentary’ (OECD 2008) para. 42.14 Commentary on Article 5.

¹¹⁶ Hans Pijl, ‘The OECD Services Permanent Establishment Alternative’ [2008] European Taxation p. 472.

of services unless there is a sufficient economic life in the source state.¹¹⁷ The service income should be taxed in the same way as other business income, the same PE threshold should apply to all business activities.¹¹⁸ This optional provision contains two tests that are: either i) an individual present in the source state for more than 183 days in any 12 months and the enterprise accounts for more than 50 per cent of the business income from services performed, or ii) a period of the same or connected project is more than 183 days in any 12 months.¹¹⁹

In conclusion, the text in Art. 5 remains unchanged since the revision in 1977 until the latest revision in 2017.¹²⁰ The changes during the period between 1977 to 2014 were made as clarifications in the Commentary, which increased from 24 paragraphs in 1963 to 169 paragraphs in 2017 (excluding observations on the Commentaries).¹²¹

3.4 Threshold of permanent establishment under the OECD Model Tax Convention

If Art.7 is applicable to income from business services, the profits from a provision of services in the source state is not taxable in the source state unless the profits are attractable to the PE situated in the source state.¹²² Therefore, it will need to determine whether there is a PE under Art. 5 of the tax treaty or not. There are two PE thresholds: (i) A fixed place of business (Actual PE); and (ii) A dependent agent (Deemed PE or Agency PE). The analysis of the PE threshold under Art. 5 of the 2017 OECD Model is as follows:¹²³

3.4.1 Fixed place of business (Actual permanent establishment)

Under the 2017 OECD Model, the definition regarding the ‘fixed place of business’ in Art. 5(1) did not change in the Model itself, but the OECD expanded the Commentary, with an intention to achieve a clearer interpretation and application of the provisions.¹²⁴

The general principle of the PE is ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’.¹²⁵ This is the case when a non-resident enterprise has a physical presence for providing services in the source state through a fixed place of business for a certain period.¹²⁶ From the legal perspective, in order to determine whether or not there is a fixed place of business, there are three criteria: (i) it must be a

¹¹⁷ Paras. 132-135 OECD Model: Commentary on Article 5 (2017); Para. 11 OECD Model: Commentary on Article 7 (2017).

¹¹⁸ Para. 42.11 OECD Model: Commentary on Article 5 (2008).

¹¹⁹ Miller and Oats (n 30) p. 304.

¹²⁰ OECD, ‘Model Tax Convention on Income and on Capital 2014 (Full Version)’ (n 112) pp. M 17-19.

¹²¹ OECD Model (1963); OECD Model (2017).

¹²² Para. 132 OECD Model: Commentary on Article 5 (2017).

¹²³ See Appendix I ‘Changes to Article 5 of the OECD Model Tax Convention on Income and Capital (21 November 2017)’.

¹²⁴ Para. 3 OECD Model: Commentary on Article 5 (2017).

¹²⁵ Art. 5 para. 3 OECD Model (2017).

¹²⁶ Paras. 10-11 OECD Model: Commentary on Article 5 (2017); Jacques Sasseville and Arvid A. Skaar, ‘Is there a permanent establishment?’ - General Report’. [2009] 94A IFA Cahiers pp. 23-24.

place of business; (ii) the place of business must be fixed; and (iii) the business must be wholly or partly carried in the place of business.¹²⁷

The first condition of ‘the place of business’ means that the non-resident enterprise has a physical presence in a tangible place in the source state, no matter if the staff or any personnel are at that place.¹²⁸ It can be any office, facilities, installations, machinery, equipment or even a space at the disposal of the enterprise to be used for business.¹²⁹ All this can be regarded as the establishment of the non-resident enterprise in the source state.¹³⁰

The term ‘at the disposal’ broadens the concept of the ‘fixed place of business’ as it can be a place of business even if the non-resident enterprise has no formal legal right to use that place, only a certain degree of control over the place is sufficient.¹³¹ It established another test which was not specified in the text of Art. 5 in the OECD Model, *Skaar* called this test the ‘right of use test’ which is met if the non-resident enterprise can use the place without any limitation or prevention from the others, in other word, freely uses the place.¹³²

In 2017, the OECD added more clarification to the term ‘at the disposal’, saying that in the absence of the formal legal right, the mere presence in a certain space does not mean that it is at the disposal of the non-resident enterprise. It depends on whether the enterprise has the ‘effective power’ to use the place, and the degree of the presence and activity performed at that place.¹³³

The second condition is that the place of business must be ‘fixed’, the OECD defined that ‘it must be established at a distinct place with a certain degree of permanence’.¹³⁴ There must be ‘a link between the place of business and a specific geographical point’ and ‘a certain degree of permanency’ in order to be a ‘fixed place of business’.¹³⁵ This is a crucial criteria as it requires a connection between the place of business and the location within the territory of the source state, and such connection should meet a minimum time threshold.¹³⁶

The last condition is that the business activities must be ‘carried on wholly or partly through a place of business’. Under this condition, the activity is not necessary to have a productive character which means that it can be a back office where there is no production of income, but such activities must be performed regularly in that place in order to establish a connection

¹²⁷ Para. 6 OECD Model: Commentary on Article 5 (2017).

¹²⁸ Para. 6 OECD Model: Commentary on Article 5 (2017).

¹²⁹ Para. 10 OECD Model: Commentary on Article 5 (2017).

¹³⁰ *Skaar* (n 17) p. 111.

¹³¹ Para. 11 OECD Model: Commentary on Article 5 (2017); Alfred Storck and Alexander Zeiler, ‘Beyond the OECD Update 2014: Changes to the Concept of Permanent Establishments in the light of the BEPS Discussion’ in Michael Lang and others (eds), *The OECD Model Convention and its Update 2014* (IBFD 2015) p. 243.

¹³² *Skaar* (n 17) pp. 155-158.

¹³³ Para. 12 OECD Model: Commentary on Article 5 (2017).

¹³⁴ Para. 6 OECD Model: Commentary on Article 5 (2017).

¹³⁵ Paras. 21, 28 OECD Model: Commentary on Article 5 (2017).

¹³⁶ *Skaar* (n 17) p. 125; Storck and Zeiler (n 131) p. 244.

between the place of business and the business activity performed by the non-resident enterprise (business connection test).¹³⁷

Apart from the general rule under Art. 5(1), the construction, building site or installation can be a PE under Art. 5(3) if it lasts more than 12 months (so-called construction PE).¹³⁸ This is not a deeming rule, it must be met the condition under the ‘fixed place of business’ as well, but there is additional time-threshold to constitute a PE.

In addition, there is the list of specific activity under Art. 5(4) relating to the maintenance of facilities or goods which is the exception to the general principle under Art. 5(1). If an enterprise performs activities under a non-exhaustive list in this paragraph, it is not considered to constitute a PE provided that the overall activities performed in a fixed place of business are a mere of ‘preparatory or auxiliary character’.¹³⁹

The OECD amended the text in this paragraph to make it clearer that the nature of the ‘preparatory or auxiliary character’ refers to all activities under Art. 5(4)(a) to (f). As the previous wording under Art. 5(4)(a) to (d) can be interpreted in a way meaning that the exception can apply automatically merely if the activities are performed through a fixed place of business, without consideration to the ‘preparatory or auxiliary character’.¹⁴⁰

There is an additional provision under Art. 5(4.1) that the exceptions under Art. 5(4) shall not apply if the fixed place of business is used in a manner of ‘cohesive business operations’, and (i) by the ‘same enterprise or a closely related enterprise’ and it constitute a PE; or (ii) the overall activity is not considered ‘a preparatory or auxiliary character’ (so-called ‘anti-fragmentation rule’).¹⁴¹

3.4.2 Dependent agent (Agency permanent establishment)

The agency PE can exist even if there is no fixed place of business, this is when a non-resident enterprise constitutes a PE if the criteria under Art. 5(5) is met without considering the general principle of fixed place of business.¹⁴² The agency PE can exist in several situations, for instance: (i) employees who conclude contracts under the name of a non-resident enterprise; (ii) an associated enterprise in the source state (e.g. local subsidiary); or (iii) an independent enterprise who has economic relations with a non-resident enterprise (e.g. dependent agent).¹⁴³

¹³⁷ Para. 35 OECD Model: Commentary on Article 5 (2017); Skaar (n 17) p. 155.

¹³⁸ Art. 5 para. 3 OECD Model (2017).

¹³⁹ Art. 5 para. 4 OECD Model (2017); Para. 58 OECD Model: Commentary on Article 5 (2017).

¹⁴⁰ OECD, ‘Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report’ (n 19) p. 28.

¹⁴¹ Para. 79 OECD Model: Commentary on Article 5 (2017).

¹⁴² Para. 82 OECD Model: Commentary on Article 5 (2017).

¹⁴³ Dinis Tracana, ‘The Effect of the OECD/G20 BEPS Initiative on the Attribution of Profits to Permanent Establishments: The Special Case of Agency Permanent Establishments’ [2017] 71(3) Bulletin for International Taxation p. 215; Philip Baker and Richard Collier, ‘2008 OECD Model: changes to the Commentary on Article 7 and the attribution of profits to permanent establishments’ [2009] 63(5) Bulletin for International Taxation pp. 201-202.

Under the 2014 OECD Model, the agency PE should be deemed to exist if a dependent agent acted on behalf of a non-residence enterprise in the source state and conclude contracts ‘in the name of that enterprise’.¹⁴⁴ There is a lot of controversial arguments regarding this term as it can be interpreted in different ways between civil and common law. The common law tends to interpret based on commercial or economic approaches, whereas the civil law is based on the legalistic approach.¹⁴⁵

This led to the problem that if a dependent agent concluded contracts under its own name (not the name of the non-resident enterprise), the PE would not exist as there was no formal legal right for binding the non-resident enterprise, nor would a PE exist if a dependent agent substantially negotiated the contracts in the source state, but the contracts were concluded outside the source state.¹⁴⁶ This leads to the change in the definition to cover this situation.

Based on the new wording in 2017, which replaced the term ‘habitually exercise an authority to conclude contracts’, the PE can now exist by two scenarios;¹⁴⁷

- 1) A dependent agent who concludes contracts under the name of the non-residence enterprise. This can apply to all contracts that legally bind the non-resident enterprise which create rights and obligations between the non-resident company and third parties; or
- 2) A dependent agent who concludes contracts under its own name which are not legally binding to the non-resident enterprise but are contracts for (i) ‘the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that enterprise has the right to use’; or (ii) ‘for the provision of services by that enterprise’.

In addition, there is an exception that it is not regarded as an agency PE if the person is acting as independent agent in the ordinary course of business under Art.5(6). However, such person will not be considered as independent agent if the activities performed in the source state are exclusively for a non-resident enterprise or closely related enterprise.

3.5 Comparison of permanent establishment under the OECD Model Tax Convention and the UN Model Double Taxation Convention

The first UN Model was developed in 1968 and was published in 1980. The UN revised the Model in 2001, 2011 and the latest 2017.¹⁴⁸ This chapter

¹⁴⁴ Art. 5 para. 5 OECD Model (2014).

¹⁴⁵ See Hans Pijl, ‘Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1’ [2013] Bulletin for International Taxation pp. 3-25.

¹⁴⁶ OECD, ‘Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report’ (n 19) p. 15.

¹⁴⁷ Para. 92 OECD Model: Commentary on Article 5 (2017).

¹⁴⁸ United Nations, ‘Model Double Taxation Convention between Developed and Developing Countries’ (United Nations 2018) Available at: http://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf; Arnold, *International Tax Primer* (n 28) p. 140.

analyses the similarity and difference between the UN Model and the OECD Model to see their development on services taxation.

The UN Model is broadly similar to the OECD Model, but in general, the UN Model focuses on the developing countries and provides a broader PE threshold for source-based taxation.¹⁴⁹ While the OECD Model favors capital-exporting countries (residence state) over capital-importing countries (source state).¹⁵⁰ In this regard, Art. 5(1) is the general provision that the service income under the business profits can be taxed by a source state only if the non-resident enterprise carries on business through a PE situated in the source state.¹⁵¹

According to the 2017 UN Model that has been released on 17 May 2018, the main changes regarding the PE definition in Art. 5 is basically in accordance with the 2017 OECD Model regarding the prevention of PE avoidance. The UN also adopted the identical provisions with regard to 'Specific activity exemptions' under Art. 5(4) in the OECD and UN Model, 'Anti-fragmentation rule' under Art. 5(4.1) in the OECD and UN Model, and 'Dependent agent' under Art. 5(5)(7) in the UN Model and Art.5(5)(6) in the OECD Model.¹⁵²

However, the difference is that the UN followed the OECD Commentary regarding the 'at disposal' concept under Art. 5(1) but did not adopt the term 'effective power'. Furthermore, the dependent agent under Art. 5(5) of the UN Model has more authority that the PE can exist if the agent habitually maintains a stock of goods and regularly delivery it on behalf of the non-resident enterprise, while the activity of the agent under the OECD is limited to the conclusion of the contract.¹⁵³

According to Art.5 (3)(a) of the UN Model the period for the construction services to constitute a PE is 6 months, which is lower than the 12 months in the OECD Model.¹⁵⁴ Importantly, the UN Model has the specific provision for taxation on services, so-called the 'Service PE' under Art. 5(3)(b) of the UN Model. The Service PE is existed if a non-resident enterprise provides services including consultancy services through its employees or engaged personnel in another state more than 183 days in any 12 months period.¹⁵⁵ This is a time-threshold that constitutes a sufficient level of presence to establish a PE instead of the 'fixed place of business' threshold.¹⁵⁶

This Service PE clause has been revised in the 2017 UN Model by removing the words 'for the same or a connected project' from the text of Art. 5(3)(b)

¹⁴⁹ Carrie Brandon Elliot, 'News Analysis: The Convergence of U.N. and OECD Global Tax Policy' [2018] *Journals Tax Analysts*.

¹⁵⁰ Arnold, *International Tax Primer* (n 28) p. 141.

¹⁵¹ Art. 5 UN Model (2017).

¹⁵² United Nations, 'Model Double Taxation Convention Between Developed and Developing Countries' (United Nations 2011) Art. 5.; Art. 5 UN Model (2017); Art. 5 OECD Model (2017).

¹⁵³ Para. 1 UN Model: Commentary on Article 5 (2017).

¹⁵⁴ Para. 1 UN Model: Commentary on Article 5 (2017).

¹⁵⁵ Art. 5 para. 3(b) UN Model (2017).

¹⁵⁶ Brian J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties' (n 74) p. 480.

of the UN Model.¹⁵⁷ By doing this, the UN broadens the scope of the Service PE, the reason is to avoid the artificial arrangement by separating the period in the project not exceeding the time-threshold, and the administrative issue of complicated interpretation by tax authorities. The participation of economic life in the source state by providing services more than 183 days should be sufficient for source state to tax the service income regardless of how many projects.¹⁵⁸

In addition to the revision of the PE definition in Art. 5, the UN also adopted new Art. 12A to tax service income from technical, managerial, and consulting service fees on a gross basis without a requirement of physical presence.¹⁵⁹ Therefore, the withholding tax will be levy based on the rate that depend on the negotiation of the contracting states. The source state is able to tax more income from the services even though the non-residence enterprise has no physical presence in the source state.

Another related provision is Art. 14 of income from professional service or other independent personal services,¹⁶⁰ while the OECD had removed this article from the Model in 2008.¹⁶¹ The deletion of Art. 14 could be resulting in a reduction of the tax base on service income of the source state.¹⁶²

As of today, the OECD Model does not have a specific provision regarding the income from independent personal services and technical services. Hence, all business service income is covered by the business profits which is taxable only if a non-resident enterprise has a PE in the source state. The development of the UN Model and the OECD Model has slightly departed from each other as the UN Model instead concerns to provide more leeway, e.g. Art. 5(3)(b), Art. 12A and Art. 14 to the source state in order to tax income from business services.

4. Analysis of permanent establishment and current development

4.1 Evaluation of permanent establishment threshold

This Chapter aims to analyse the upcoming consequences of the application of the PE threshold, and provide an evaluation of whether the revised PE threshold ensure taxation on cross-border services in the source state. The analysis of the upcoming consequences is based on the definition of the PE under the 2017 OECD Model, and the evaluation is based on the main functions of the PE threshold that are: (i) to provide ‘increased certainty’ of

¹⁵⁷ Para. 9 UN Model: Commentary on Article 5 (2017).

¹⁵⁸ Para. 12 UN Model: Commentary on Article 5 (2017).

¹⁵⁹ United Nations and others, ‘United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries’ (n 66) p. 42; Carrie Brandon Elliot, ‘News Analysis: The Convergence of U.N. and OECD Global Tax Policy’ (n 149).

¹⁶⁰ Art. 14 UN Model (2017).

¹⁶¹ OECD, ‘Model Tax Convention on Income and on Capital 2014 (Full Version)’ (n 112) p. C(5)-1.

¹⁶² Para. 15.2 UN Model: Commentary on Article 5 (2017).

whether the law is applicable or not; and (ii) to ensure ‘effective enforcement’ of taxation at source.¹⁶³

Firstly, the ‘legal certainty’ shall be referred as ‘certainty of law’ that ‘the law itself needs to be reliable with objective qualities such as clarity and determinacy, and for the law to be held ‘certain’, it must be applied by means of impersonal and uniform processes’.¹⁶⁴ In case of tax law, the law should be predictable and reliable from taxpayers’ perspective that they can legally apply and foresee the outcome without unanticipated events.¹⁶⁵

Secondly, the ‘effective enforcement’ is whether the tax authorities ‘will be able to enforce any tax liability effectively’.¹⁶⁶ In this case, it is related to the practicality of the application of the law rather than the legal term. It examines the possibility of the tax authorities to apply the threshold in practice.

The following discussion it is not intended to be comprehensive, but to raise some issues from the PE threshold under the 2017 OECD Model.

4.1.1 Fixed place of business

In the 2017 OECD Model, the amendment of the OECD broadens the scope and lowers the PE threshold. The trend of broadening the scope of the PE can be seen by the development of the term ‘fixed place of business’ as follows:

In 1963, the general principle of the ‘fixed place of business’ referred to a condition that the business must be ‘carried on’ through that fixed place of business. It required a physical link between the place within the territory of the source state and the business performed by the non-resident enterprise, no matter if the business was profitable or not.¹⁶⁷

In 1977, the meaning of ‘fixed place of business’ was extended by means of an explanation in the Commentary. This revision established one underlying criterion in the concept of ‘fixed place of business’ which still stands until the present day: the test of ‘at the disposal’. A place of business may exist if a non-resident enterprise has a right to use that place for carrying on its business. Hence, it must not be a place formally owned or rented by the non-resident enterprise, a pitch in the market or storage of goods is sufficient to be a ‘place of business’.¹⁶⁸ The interpretation of the ‘right of use’ at that time was that the non-resident enterprise should have ‘a legal right of use to the place of business as an owner or a lessee, exclusive right to use the premises is not required’.¹⁶⁹

¹⁶³ Brian J. Arnold, ‘Threshold Requirements for Taxing Business Profits under Tax Treaties’ (n 74) p. 483.

¹⁶⁴ Humberto Ávila, *Certainty in Law* (Springer International Publishing 2016) p. 72.

¹⁶⁵ *Ibid* p. 197.

¹⁶⁶ Brian J. Arnold, ‘Threshold Requirements for Taxing Business Profits under Tax Treaties’ (n 74) p. 479.

¹⁶⁷ Paras. 2, 3, 7 OECD Model: Commentary on Article 5 (1963).

¹⁶⁸ Paras. 4 OECD Model: Commentary on Article 5 (1977).

¹⁶⁹ Art. 5 para. 4 OECD Model (1977); Skaar (n 17) p. 157.

In 2003, the new commentary amplified the scope of the ‘fixed place of business, stating there was no requirement of a ‘formal legal right’ to use the place of business, the mere fact that the non-resident enterprise has a ‘certain amount of spaces at its disposal’ for carrying on the business activities is sufficient to be a place of business.¹⁷⁰ In other words, the illegal occupation by the non-resident enterprise would be acceptable from the OECD point of view. The interpretation was changed from the ‘legal right’ to be the ‘control’ over the place.

In 2017, the concept of ‘fixed place of business’ was stated that in the absence of the formal legal right to use the place, it could be considered that the place is ‘at the disposal’ if the non-resident enterprise has ‘the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there’.¹⁷¹

The term ‘effective power’ is the new concept in the 2017 OECD Model that sets the bar of the PE threshold to a significantly lower level. There is no clear definition of the ‘effective power’, instead examples were given in the Commentary. It could be the case that an enterprise has an exclusive right to use a place for carrying its business activities (legal possession), or an enterprise is allowed to use the specific place of another enterprise to perform business activities on a continuous basis for a certain period.¹⁷² It was not clear what the actual meaning of the ‘effective power’ is and whether ‘the term is required a qualified ability to use and access certain place, or only an enterprise is able to perform its work at a certain place at a given time’.¹⁷³ This question can be illustrated by the two examples in the Commentary as follows:

The painter

One of the most controversial example since 2003 and still included in the 2017 OECD Commentary is a painter who works 3 days in a week for 2 years in the office building. The presence of the painter in the building where he performs the main function of his business can constitute a PE of the painter.¹⁷⁴

The example did not refer to any certain room or location that the painter can exercise a minimum level of power to control the place as his place of business. It expresses a broad definition of the PE concept under Art. 5(1) as the mere presence and function of activities performed over a period of time can constitute a PE.¹⁷⁵ The broad definition means that the condition of ‘fixed’ that the place of business should be located at a specific geographical

¹⁷⁰ Para. 4.1 OECD Model: Commentary on Article 5 (2003).

¹⁷¹ Para. 12 OECD Model: Commentary on Article 5 (2017).

¹⁷² Ibid.

¹⁷³ Storck and Zeiler (n 131) p. 246.

¹⁷⁴ Para. 4.5 OECD Model: Commentary on Article 5 (2003); Para. 17 OECD Model: Commentary on Article 5 (2017).

¹⁷⁵ Storck and Zeiler (n 131) p. 244.

nexus has been disregarded in this example as the mere ‘presence’ in that place can consider the ‘place of business’.¹⁷⁶

The sub-contractor

According to the OECD, if the non-resident enterprise carries on the business in the source state through a local sub-contractor, either if the sub-contractor is acting alone or together with the employees of the non-resident enterprise, the PE can be deemed to exist if there is evidence to show that the non-resident enterprise ‘clearly has the effective power to use that site’. For example, if the enterprise has the ownership or legal possession to control access and use of the site.¹⁷⁷ This concept goes far beyond than the ‘Painter’ case as even without the actual presence of employees, only the power to control the place can be regarded as a PE.

In addition, the time-threshold of the construction PE under Art. 5(3) can be counted if any sub-contractors (different contractors) work on the construction site at the disposal of the general contractor (non-resident enterprise). The factors to indicate that the construction site is at the disposal of the non-resident enterprise are: (i) the enterprise has the legal possession to control and use of the site; and (ii) take all responsibility in that site.¹⁷⁸

Hence, it can be interpreted that if a non-resident enterprise sub-contracts all work to a resident sub-contractor in the source state, but the non-resident has the right under the sub-contract agreement to access and use the office of the sub-contractor, then a PE could exist. This is the case even though there are no employees of the non-resident enterprise who work in that place and the non-resident enterprise has the effective power to use the site.¹⁷⁹

It can be assumed that the PE threshold has been lowered to include the situations where a non-resident enterprise does not have an actual physical presence in the source state, instead the mere ‘legal concept of contractual responsibilities and liabilities’, which is now possibly sufficient to constitute a PE.¹⁸⁰

Based on the above examples, the concept of ‘at the disposal’ expresses a prominent level of legal uncertainty as the concept is not mentioned in the definition in the text of Art. 5, rather in the clarification in the Commentary. This idea was supported by the comments from the business sector that ‘BIAC expressed concerns about the uncertainty of the concept “at the disposal”’ and ‘[t]oo heavy a reliance on an exclusively facts and circumstances approach will inevitably lead to situations where neither tax

¹⁷⁶ Para. 21 OECD Model: Commentary on Article 5 (2017).

¹⁷⁷ Para. 40 OECD Model: Commentary on Article 5 (2017).

¹⁷⁸ Para. 54 OECD Model: Commentary on Article 5 (2017).

¹⁷⁹ Peter Koerver Schmidt, ‘The Creation of a Permanent Establishment Through the Use of Subcontracting: A New Danish Ruling Adds to the Discussion’, [2018] 46(2) Intertax p. 176.

¹⁸⁰ Jan de Goede and others, ‘Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention: Response from IBFD Research Staff’ [2012] 66 Bulletin for International Taxation p. 316.

authorities nor taxpayers will be in a position to determine in advance whether a PE exists'.¹⁸¹

The purpose of the PE is to allocate taxing rights to the source state if there is a sufficient economic presence of activities or functions in the source state. The concept of the 'fixed place of business' usually requires a certain degree of physical presence and fixed place of business, if the mere 'civil law responsibility' is sufficient to constitute a PE, 'the concept would become so diluted as to be virtually useless'.¹⁸²

Therefore, the source state can benefit from the extension of PE threshold by interpreting the law more extensively. However, it will increase the legal uncertainty for taxpayers whether or not there is a PE in the source state, and it is unforeseeable due to the complication of law interpretation.

In term of enforcement, it is evident that the criterion of 'fixed place of business' is effective for the tax authorities to enforce due to the nature of this criterion that requires a physical presence in a tangible place. As long as a physical presence in the territory exists, the tax authorities should be able to 'take enforcement action' on the assets of the non-resident enterprise.¹⁸³

The non-residence enterprise can provide service without any physical presence or tangible assets in the source state. The threshold of 'fixed place of business' maybe practical for taxing certain traditional services that requires a physical presence, e.g. construction, but it may be inadequate for imposing tax on modern services that do not have a fixed place of business such as-commerce as it lacks a connection between the state and taxable object.

4.1.2 Dependent agent

The PE exists if a dependent agent acts on behalf and concludes or performs any activities that lead to a conclusion of contracts. The criterion is that it must be a 'physical presence' which is a dependent agent in the source state, and the agent must habitually perform certain activities on behalf of the non-resident in the source state. The requirement of 'fixed place of business' is not required in the source state.

In the 2017 OECD Model, the change in Art.5 (5) is the requirement of 'habitually exercise an authority to conclude contracts' which has now been replaced by the wording of 'habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise'.¹⁸⁴ Based on this condition, there are two tests: (i) the 'primary test' which is

¹⁸¹ See BIAAC comments in OECD, 'Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (Revised public discussion draft)' (n 80) p. 5.

¹⁸² Ibid pp. 5-6.

¹⁸³ Brian J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties' (n 74) p. 479.

¹⁸⁴ Para. 5 OECD Model: Commentary on Article 5 (2017).

based on ‘contract law’; and (ii) the ‘supplement test’ which is focused on ‘subjective activities’.

The primary test shall refer to the term ‘conclude contracts’ under the domestic law of the source state. The OECD specifies that the contracts can be concluded without ‘any active negotiation’ by the agent, or the contracts are signed outside the source state, or the signatory person is another non-resident company.¹⁸⁵

The ‘supplement test’ refers to the term ‘habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise’. This is a more subjective test which includes situations where the agent’s activities in the source state resulting directly in the conclusion of contracts abroad; or the agent’s activities are ‘intended’ to result in the conclusion of contracts regularly.¹⁸⁶

With this regard, the threshold on the dependent agent is lowered by an extension of the ‘conclusion of contracts’ test from the legal-based concept to be the factual concept. The activities of the agent in the source state that are intended to result in the conclusion of the contract to are considered to have a ‘sufficient taxable nexus’ in the source state.¹⁸⁷

Furthermore, the contracts that the agent has concluded must be ‘in the name of enterprise’, this is the case where a legal binding would be required between the principal (enterprise) and the customers in the source state.¹⁸⁸ Otherwise, the contracts must be: (i) the transfer of ownership or the right to use property; or (ii) the provision of services. This can be understood in the way that the agency PE can exist without a legal binding of the contracts between the non-resident enterprise and the customer in the source state.¹⁸⁹

In this case, it implies that a threshold of the dependent agent can be met even if there is no formal legal relationship between the client and principal (indirect agent), only the economic bond is required to establish the agency PE.¹⁹⁰ The example can be demonstrated as follows:

Online contract¹⁹¹

If a non-resident enterprise (principal) has a wholly-owned subsidiary (agent) in the source state, the agent contacts customers by email, telephone or visit at the customer’s office to convince those customers to make the service contract with the non-resident enterprise. The contract must be concluded online via the website. The agent informs the price, standard term, fixed price structure but has no authority to modify the contracts. In

¹⁸⁵ Para. 87 OECD Model: Commentary on Article 5 (2017).

¹⁸⁶ Para. 88 OECD Model: Commentary on Article 5 (2017).

¹⁸⁷ OECD, ‘Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report’ (n 19) p. 15.

¹⁸⁸ Para. 91 OECD Model: Commentary on Article 5 (2017).

¹⁸⁹ Para. 91-92 OECD Model: Commentary on Article 5 (2017).

¹⁹⁰ Tracana (n 141) p. 214.

¹⁹¹ Para. 90 OECD Model: Commentary on Article 5 (2017).

this case, the subsidiary is considered a dependent agent and constituted a PE in the source state.

In this example, it demonstrates that the threshold of the ‘dependent agent’ is broader as it included the online services where the service contracts are concluded online. This benefits to the source state by having more room for interpretation. However, it does not provide legal certainty to both taxpayers and tax authorities as it depends on the facts and circumstances. The existence of PE depends heavily on the discretion of the tax authorities and the courts.

Although, there is no requirement of ‘fixed place of business’ to be met, the scope of this threshold is limited on two consecutive conditions: the physical presence of the agent; and the activity of the conclusion of contracts. If there is no agent in the source state or there is no conclusion of contracts, there is no PE to exist as well.

The main problem of this threshold in term of ‘effective enforcement’ is that it is difficult to prove that the activities of the agent lead to the conclusion of contracts. It is subject to the controversy between taxpayers and the tax authorities which creates a burden of compliance to both sides.

Furthermore, the PE threshold extension might not be sufficient to ensure the taxing rights for the source state in term of ‘Profit Attribution’. Generally, if there is a PE in the source state, the taxable income is only the profits that are attributable to the PE.¹⁹² Therefore, ‘Profit Attribution’ is how much the profits can be attributed to a PE in the source state, the calculation is based on the ‘functions performed, assets used and risks assumed’ by the non-resident enterprise through a PE as it is a ‘separate and independent enterprise’.¹⁹³

To illustrate the problem, if the dependent agent is a subsidiary of the non-resident company, the source state can tax it separately: (i) as a resident of the source state and (ii) as a PE of the non-resident enterprise under Art.7 and Art.9 of the OECD Model.¹⁹⁴ However, as both are a ‘single taxpayer’ in reality, the amount of tax would be the same as it is the same profits on the same enterprise. Hence, there are no additional profits to be attributable to the PE. Consequently, even though the extension of PE threshold creates more PE, the taxation in the source state would be identical.¹⁹⁵

4.1.3 Conclusion

As it stands today, the PE threshold may be insufficient to ensure the sourced-base taxation on income from cross-border business services.

¹⁹² Art. 7 OECD Model (2017).

¹⁹³ Para. 2 OECD Model: Commentary on Article 7 (2017).

¹⁹⁴ Arts. 7, 9 OECD Model (2017); Piotr Drobnik, ‘The Attribution of Profits to a Dependent Agent PE – If the Dependent Agent Is a Commissionaire (Wholly Owned Subsidiary) of the Principal 4’ [2018] 25(3) International Transfer Pricing Journal chap. 2, 7.

¹⁹⁵ Shee Boon Law, ‘Profit Attribution to Permanent Establishments – A Tax Treaty Perspective on the “Single Taxpayer” Approach’ [2018] 72(3) Bulletin for International Taxation chap. 2.

Although the revision of the PE definition is resulting in a lower threshold, it is inadequate to provide ‘legal certainty’ and ‘effective enforcement’ to the source state due to the following reasons:

- (i) The revision of Art. 5 creates new wording which is hard to define and understand as there is no meaning in legal or economic terms, e.g. the term ‘effective power’ or ‘plays the principal role’. Due to the lack of clarity, it can lead to extensive interpretation and application of the terms which can result in the unforeseeable outcome to taxpayers.
- (ii) Most of the revision was made to the Commentary, rather than to the text in Art.5(1) of the Model. The scope of application of PE was extended by the wording in the Commentary, it goes beyond the mere clarification. It causes more uncertainty as the text should be clear and precise.
- (iii) Due to the requirement of physical presence either the fixed place of business or the dependent agent, it is burdensome to levy tax on service income from the modern business without the intervention from tax authorities or national courts. As the modern business does not need a physical presence in the source state, it is difficult to prove that there is a participation of economic life in the source state. Therefore, it depends on the interpretation of tax authorities or the courts whether there is a sufficient physical presence to constitute a PE.

It can be assumed that the lowering of PE threshold from the actual physical presence to the abstract contractual relationship is a compromise between two objectives: (i) the reinforcement of taxation without changing the existing international tax principle; and (ii) the need to prevent tax base erosion from tax avoidance.¹⁹⁶ These two aims seem to be conflicted, and thus it must be admitted that the PE threshold might no longer be the ‘the greatest clarity and the easiest to administer’ in order to tax income from business activities.¹⁹⁷

4.2 Current development

Almost a century from the first tax model in 1928, the PE notion is now facing the issue of its validity. Despite that the OECD Model has been revised to keep up to date with the current issues of globalisation, it may not be sufficient. This Chapter aims to provide the overview of the development with regard to the PE as of today.

¹⁹⁶ OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (n 18) p. 11.

¹⁹⁷ Para. 5 OECD Model: Commentary on Article 5 (1963).

4.2.1 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

As of 22 March 2018, 78 jurisdictions signed the MLI, and another 6 jurisdictions expressed their intention to sign the MLI.¹⁹⁸ Under the MLI, all signatory parties must meet the minimum standards of the BEPS project, but the parties can choose tax treaties to be covered under the MLI and make a reservation (opt-out) for certain provisions.¹⁹⁹

However, it is questionable of the legitimacy of the MLI to amend the existing tax treaties. This is because many countries revered the right not to apply specific provisions. For example, 43 of 78 jurisdictions opted out for the amendment of agency PE relating to Art. 5(5)(6) of the OECD Model.²⁰⁰ This mean that more than a half of the signatory countries will not adopt the new text of agency PE under Art. 5(5)(6), these countries included Australia and the UK that implemented unilateral approach on DPT.²⁰¹ The MLI may not be an answer for the state to tackle the tax base erosion problem. Many countries made reservation under the MLI which complicates the development of the consensus rule and makes it more difficult to bring the harmonization in taxation among states.²⁰²

4.2.2 Unilateral measures

Many countries have adopted the unilateral measures to tackle to the problem of PE avoidance and the base erosion from cross-border services, the examples are as follows:

On 1 April 2015, the UK enacted the DPT or the ‘Google Taxes’ to levy 25 per cent on diverted profits. The aim was to counter the artificial arrangement in two situations: (i) a non-UK resident which avoids the PE in the UK; and (ii) a UK resident which performs transactions with lack of economic substance.²⁰³ The DPT is the new tax which does not fall into any types of income under the existing tax treaties, and the purpose of anti-tax avoidance is not eligible for treaty benefits and tax reliefs.²⁰⁴

On 1 July 2017, Australia introduced the DPT to impose tax at 40 per cent on diverted profits of transactions with ‘insufficient economic substance’.²⁰⁵

¹⁹⁸ OECD, ‘Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting’ (n 76).

¹⁹⁹ OECD, ‘Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting’ (n 20) p. 3.

²⁰⁰ OECD, ‘MLI Database - Matrix of options and reservations (Status as of 22 March 2018)’ <www.oecd.org/tax/treaties/mli-database-matrix-options-and-reservations.htm> accessed 15 May 2018.

²⁰¹ Hattingh (n 91) p. 239.

²⁰² David Kleist, ‘A Multilateral Instrument for Implementing Changes to Double Tax Treaties: Problems and Prospects’ [2016] 44(11) Intertax p. 830.

²⁰³ HM Revenue & Customs, ‘Diverted Profits tax’ <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf> accessed 31 May 2018.

²⁰⁴ Yasin Uslu, ‘An Analysis of “Google Taxes” in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative’ [2018] 72(4a) Bulletin for International Taxation chap. 4.2.3.1.

²⁰⁵ Australian Taxation Office, ‘Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 Explanatory Memorandum’ (Australian Taxation Office 2015) Available at: http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5549_ems_f2f9c061-45d9-4f1f-b8f9-eb140cdc08ae/upload_pdf/503830.pdf;fileType=application%2Fpdf; Australian Taxation Office, ‘Diverted profits tax’

The transactions that subject to DPT are transactions that are ‘complex, contrived and artificial schemes’ to avoid taxation in Australia.²⁰⁶ It will apply to the ‘significant global entities’ that has an annual global income of more than 1 billion Australian dollars.²⁰⁷ The main goal is to ensure source-based taxation with regard to the economic substance in the country and to prevent tax base erosion from the artificial arrangement to divert the profits between related parties.²⁰⁸

Both laws aim to target the large non-resident enterprise who has no PE in the source state and potentially to avoid taxation by imposing tax in a very high rate as penalty taxes, even more than a normal corporate income tax. This concept of ‘DPT’ has redefined the PE concept under the tax treaty as these rules are anti-tax avoidance rule which overrides the tax treaty.²⁰⁹ This implies that the ‘DPT’ is a new PE definition of the source state to tax more income from the non-resident enterprise which attempts to avoid taxation in the source state, and there is no tax relief under tax treaties which can cause double taxation to taxpayers.

4.2.3 Domestic Case Law

The Court’s interpretation is different depending on the law system, background, and approach of the Court. Recently, many countries approach a broader interpretation to protect their taxable base.

4.2.3.1 Case law in Norway and Spain

These two domestic cases were ruled in Norway (2 December 2011) and Spain (20 June 2016). Although the fact was similar, the judgement was different as the Court used a different approach for interpretation. For the Dell case in Spain, it was based on the ‘broad interpretation’ and ‘substance over form’ approach, while the Court adopted ‘strict interpretation’ for the Dell case in Norway. As a result, the PE existed in Spain even if there was no direct physical presence in the source state.²¹⁰

In the first case of *Dell Norway*,²¹¹ the fact was that Dell Products Europe BV (Dell Products), a Dutch company that has a tax resident in Ireland, was entered into a commissionaire arrangement with Dell Norway to sell the products to customers in Norway. Under this scheme, the Dell Products does not have a PE under Art. 5(5) of the Norway–Ireland Income and

www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected
accessed 29 May 2018.

²⁰⁶ Australian Taxation Office, ‘Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 Explanatory Memorandum’ chap. 3.4, p. 23; Uslu (n 204) chap. 4.3.3.

²⁰⁷ Anton Joseph, ‘BEPS and the Diverted Profits Tax’ [2017] International Transfer Pricing Journal pp. 59-60; Anton Joseph, ‘Diverted Profits Tax: A Multinational Nightmare’ [2018] 25(3) International Transfer Pricing Journal chap. 1.

²⁰⁸ Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017 (Australian Government 2017) para.177H
www.legislation.gov.au/Details/C2017A00027 accessed 29 May 2018; Australian Taxation Office, ‘Diverted profits tax’
www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected
accessed 29 May 2018.

²⁰⁹ Uslu (n 204) chap. 4.2.3.1.

²¹⁰ Ave-Geidi Jallai and Mart van Hulsten, ‘Report on the 2016 Conference Tax Treaty Case Law Around the Globe’ [2016] 44(11) Intertax p. 862.

²¹¹ Case 2011/755 *Dell Products (NUF) v. Tax East* (2 December 2011) Tax Treaty Case Law IBFD.

Capital Tax Treaty in Norway because Dell Norway as an agent did not conclude the contract on behalf of the Dell Products.²¹²

In this case, the tax authority argued that even though the sale contracts did not legally bind Dell Products but based on the ‘functional assessment’ Dell Products was bound in reality. The definition of Art. 5(5) should be interpreted by its aim to protect source-based taxation.²¹³ However, the judgement of the Supreme Court was based on the strict interpretation of the wording in Art. 5(5) that the PE can exist if the contract is legally binding Dell Products. The ‘functional assessment’ based on the economic reality will lead to ‘unnecessary uncertainty’ of the PE existence.²¹⁴ Therefore, Dell Products did not have a PE in Norway.

In the second case of *Dell Spain*,²¹⁵ the business structure was similar to the previous case of Dell Products in Norway. Dell Spain was appointed by Dell Products under a commissionaire arrangement to sell products and provide services, e.g. logistics, marketing, after-sales services and administration of an online store to customers in Spain. Dell Spain sold products under its name, but the products belonged to Dell Products. Dell Products had no employees or facilities in Spain. In this case, the Supreme Court ruled that Dell Products had a PE based on both ‘fixed place of business’ and ‘dependent agent’. The reasons were:

(i) Fixed place of business – The term ‘fixed place of business’ should not be interpreted strictly, ‘it must adapt to the circumstances, the commercial and geographical coherence of the activity, and the objective of Art. 5(1) that is to determine the taxing rights of the states when there is a ‘certain degree of economic activities’.²¹⁶ The term ‘at the disposal’ is a ‘factual concept’ which does not require a formal legal right.²¹⁷ Therefore, the office of Dell Spain was at the disposal of Dell Products as it was made available for Dell Products to perform business activities. The exceptions under Art. 5(4) were not applicable as the activities were not merely of a preparatory or auxiliary nature.

(ii) Dependent agent – The term ‘acting on behalf of an enterprise’ under Art.5 (5) did not require a direct relationship or legal agreement between the principle and the clients. The contracts were binding Dell Products, although the contracts were concluded under the name of Dell Spain. Dell Spain was not an independent agent under Art. 5(6) as the activities were performed exclusively for Dell Products.

²¹² Joachim M. Bjerke and Simen S. Sjøgaard, ‘Dell Wins Important Agency Permanent Establishment Case’ [2012] International Transfer Pricing Journal p. 176.

²¹³ Bjerke and Sjøgaard (n 202) p. 176; Thor Leegaard, ‘Supreme Court Holds That Commissionaire Structure Does Not Amount to a Permanent Establishment’ European Taxation p. 319.

²¹⁴ Bjerke and Sjøgaard (n 202) p. 177.

²¹⁵ Case 2555/2015 *Dell Products v. Agencia Estatal de Administración Tributaria* (20 June 2016) Tax Treaty Case Law IBFD.

²¹⁶ Adolfo J. Martín Jiménez, ‘The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, beyond BEPS or Simply a Wrong Interpretation of Article 5 of the OECD Model?’ [2016] Bulletin for International Taxation p. 463.

²¹⁷ Aleksandra Bal, ‘The Spanish Dell Case – Do We Need Anti-BEPS Measures If the Existing Rules Are Broad Enough?’ European Taxation’ [2016] 56(12) European Taxation p. 575.

4.2.3.2 Case law in South Africa

This case law,²¹⁸ the Court used the ‘objective interpretation’ that it should consider the purpose, the words, the meaning as regard to the object and purpose.²¹⁹ The fact was that the US companies sent their employees to provide advisory services on a rotation basis at the exclusive room in the customer’s premise in South Africa. The South African Tax Court ruled that there was a PE in South Africa as the employees performed work exceeding 183 days in a calendar year. The Service PE under Art. 5(2)(k) of the South Africa-United States Income Tax Treaty (1997) was extended the definition of Art. 5(1), the PE exists without satisfying the requirement of the ‘fixed place of business’.²²⁰ The Court chose to interpret in a broader way that it is an extension of the basic rule.²²¹

4.2.3.3 Case law in India

In 2017, the Court of India ruled in two cases by using the ‘broad interpretation’ that there was a PE in the source state and it can be considered that the Court disregarded the concept of physical presence in the source state. The summarized are as follows:

On 24 April 2017, the Supreme Court of India ruled in *Formula One* case²²² that the PE under Art. 5(1) existed although the employee was presented to provide an international circuit in India for a short period. The reason was that the UK company (i) has authorities to organize and control the event which can be considered that the commercial activity was carried out in the circuit; and (ii) has an exclusive right to access to the area of circuit during the event which can be considered that there is a control over the circuit area. Thus, the circuit was regarded as a ‘fixed place of business’ under Art.5(1) of India and the UK Double Taxation Avoidance Agreement.

On 21 June 2017, the Bengaluru bench of the Indian Income Tax Appellate Tribunal (Tribunal) ruled in *ABB FZ – LLC* case²²³ that existence of the Service PE does not require a physical presence of the employee in the source state. The fact was that a UAE company provided regional services to a company in India remotely via the internet. The Tribunal ruled that Service PE under Art. 5(2) of the India - United Arab Emirates Income Tax Treaty (1992) does not subject to ‘fixed place of business’ under Art. 5(1) of the same treaty. Therefore, the fact that the services were rendered via a virtual mode for an exceeding period was satisfied to constitute a PE without a physical presence of the employees in India.²²⁴ The interpretation

²¹⁸ Case 13276 *Company, name undisclosed v. South African Revenue Service* (15 May 2015) Tax Treaty Case Law IBFD.

²¹⁹ Ernest Mazansky, ‘South African Tax Court Departs from Commentary on Article 5 of the OECD Model in Finding a Permanent Establishment’ Bulletin for International Taxation p. 495.

²²⁰ Mazansky (n 219) p. 495.

²²¹ Ibid.

²²² Civil Appeal No. 3849 of 2017 *Formula One World Championship Ltd. Vs. Commissioner of Income Tax* (24 April 2017) Tax Treaty Case Law IBFD.

²²³ Case IT(TP)A Nos. 1103/Bang/2013 and 304/Bang/2015 *ABB FZ – LLC v. Deputy Commissioner of Income Tax* (21 June 2017) Tax Treaty Case Law IBFD.

²²⁴ PWC, ‘The fact of rendering services for a specified period is relevant and not the stay of employees for determining a Service Permanent Establishment; rendering of services which tantamounts to provision of information is taxable as Royalty’ <

of the Tribunal is based on the length of the provision of services, rather than the physical presence of the employee.

4.2.4 Tax model

Apart from the OECD Model and the UN Model, there is also another tax model which is used in many countries. A well-known tax model is the ‘U.S. Model Income Tax Convention and Model Technical Explanation’ (US Model), which was issued in 2006 by the Treasury Department of the US.²²⁵ The US Model is adopted by the US as a baseline for treaty negotiation. The latest revision was on 17 February 2016, the aim was to prevent double taxation without creating a gap for tax evasion or tax avoidance.²²⁶ The definition of the PE did not change, rather the US included a rule to deny or reduce the treaty benefit in the case of profits shifting to a related enterprise in low or no taxation jurisdiction, and also improved the existing anti-abuse rule to prevent the treaty shopping.²²⁷ Hence, the PE definition is generally similar to the 2014 OECD Model, for example, the US did not adopt the words of ‘agency PE’ under Art.5(5) of the 2017 OECD Model.²²⁸

In 2016, the African Tax Administration Forum launched the ‘ATAF Model Tax Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income’ (AFTA Model) for 38 member countries in Africa.²²⁹ The AFTA Model is generally similar to the UN Model and the OECD Model.²³⁰ As stated in the aim, the AFTA model is more favourable to the source state, and it also adopts the provisions in Action 7 of the BEPS project. The PE definition in Art.5 of the AFTA Model is similar to Art. 5 in the 2017 OECD Model, especially, ‘specific activity exemptions’, ‘anti-fragmentation rule’ and ‘dependent agent’, as well as, the Service PE clause under Art. 5(3)(b) of the UN Model.²³¹

4.2.5 Conclusion

Based on these recent developments around the globe, the application of the PE has deviated from the original objective in the OECD Model to provide the same standard of the international tax law. The application of the MLI to

https://www.pwc.in/assets/pdfs/news-alert-tax/2017/pwc_news_alert_10_july_2017_the_fact_of_rendering_services_for_a_specified_period_is_relevant.pdf> accessed 31 May 2018; IBFD, ‘Indian Income Tax Appellate Tribunal holds solar days relevant for service PE determination, rejects virtual PE claim’ < <https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Taxsutra-Indian-Income-Tax-Appellate-Tribunal-holds-solar-days-relevant-for-service-PE-determination-rejects-virtual-PE-claim.pdf>> accessed 31 May 2018.

²²⁵ Internal Revenue Service, ‘The U.S. Model Income Tax Convention and Model Technical Explanation’ <www.irs.gov/individuals/international-taxpayers/the-us-model-income-tax-convention-and-model-technical-explanation> accessed 29 May 2018.

²²⁶ U.S. Department of the Treasury, ‘Treasury Announces Release of 2016 U.S. Model Income Tax Treaty’ <www.treasury.gov/press-center/press-releases/Pages/jl0356.aspx> accessed 29 May 2018.

²²⁷ Para. 2 and 3 US Model: Preamble to 2016 U.S. Model Income Tax Convention (2016).

²²⁸ Art. 5 US Model (2016).

²²⁹ African Tax Administration Forum, ‘Overview’ <www.ataftax.org/en/about/overview> accessed 29 May 2018.

²³⁰ African Tax Administration Forum, ‘Commentary on the ATAF Model Tax Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income’ <www.ataftax.org/en/component/jdownloads/send/56-technical-assistance/117-commentary-on-model-tax-agreement-for-the-avoidance-of-double-taxation-and-the-prevention-of-fiscal-evasion-with-respect-to-taxes-on-income> accessed 29 May 2018.

²³¹ African Tax Administration Forum, ‘Comparison of tax treaty model’ <<https://www.ataftax.org/en/component/jdownloads/send/56-technical-assistance/118-comparison-of-tax-treaty-model>> accessed 29 May 2018.

amend the existing tax treaties is in doubt in for its legitimacy to implement the change of the PE definition. As the current rule is not sufficient to ensure the source-based taxation, many states chose not to apply the new PE definition in the 2017 OECD Model and adopt their unilateral measures to tackle the problem of base erosion. The obvious case is the UK and Australia, who both opted out from the agency PE clause under the MLI and instead adopted their anti-tax avoidance measures to tax large enterprises who avoid having a PE in the source state. Those unilateral measures give rise to the taxing power of the source state, but it is only one source state which applies the measure. If a state adopts its own rules to expand their taxable base and disregard the common rule under the tax treaty, it is likely that those unilateral measures will increase the non-harmonization in international taxation and the goal of the OECD to coherent the international standard is challenging to be achieved.

5. Final remarks

5.1 Conclusion

As it stands today, the change of the OECD Model to lower the PE threshold may not be sufficient to solve the problem of tax base erosion and ensure source-based taxation on cross-border business services. The PE remains the only threshold to determine the taxing right of business services, although the nature of services and the criterion of the PE threshold are in contrast. Now there is legal uncertainty stemming from the extension of PE threshold and the current PE definition also possibly creates more non-harmonization in the field of international taxation.

In Chapter 2, it was established that the OECD is favouring residence-based taxation, the source state is allowed to tax business profits only if there is sufficient ‘economic presence’ in the source state.²³² The concept of PE threshold was invented as a ‘legal convention’ to determine a sufficient taxable connection between source state and tax object based on the ‘physical presence’.²³³ In addition, the lack of physical presence in the modern business services and tax avoidance by the multinational enterprises causes tax base erosion in the source state. The PE as a threshold for allocation of taxing rights has become an instrument of tax avoidance.²³⁴

The OECD aims to prevent the base erosion and profit shifting problem coming from that multinational enterprises avoid taxation in the source state by circumventing the existence of the PE in the source state. The BEPS project was launched and the result in Action 7 was to amend the PE

²³² Skaar (n 14) p.72, p.559.

²³³ López (n 34) p. 8; Klaus Vogel. “‘State of Residence’ may as well be ‘State of Source’ – There is no Contradiction’ (n 83) p. 422.

²³⁴ Skaar (n 17) p. 559.

definition in the 2017 OECD Model. The MLI was also launched in order to revise the PE definition in the existing tax treaties. The revised PE definition aimed to not change the existing standard of taxing rights between source and residence states.

In Chapter 3, it was developed that the ‘income from cross-border services’ is business profits from provision of services internationally, which is subject to the PE threshold as there are no specific provisions in the OECD Model. The PE thresholds under Art. 5 are (i) fixed place of business; and (ii) dependent agent, there is no Service PE in Art. 5. The 2017 UN Model revised the Service PE under Art. 5(3)(b) clause to be broader and introduced the new provision of the technical fee under Art. 12A, allowing the source state to levy tax on technical services without the existence of a PE.

In Chapter 4, the focus was put on the evaluation of the PE threshold by demonstrating the upcoming consequences, and the result is the concept possibly lacked clarity, increased uncertainty and provided ineffective enforcement in the source state. The current development around the globe is deviating from the consensus in the field of international tax. An obsolete PE concept is unable to ensure a balanced allocation of taxing rights between states, and this leads to situations which suggest non-harmonization of direct taxation. The situations are, for example, the legitimacy of the MLI as a consensus in the international tax, the unilateral measures adopted in many countries, the different interpretation of domestic courts and the departure of the suggested tax treatment in the model tax treaties.

5.2 Recommendation

For future consideration, a review should be made of the ‘all or nothing’ approach of the PE as the taxing right is assigned to either the source state or the residence state. If there is a PE, all income attributable to the PE will be taxed at source, if there is no PE then there is no income in the source state.²³⁵

The world economy has been developed from the past, and businesses are no longer located in only one place or even one country. The OECD’s concept that the service income should fall under exclusively residence-based taxation is obsolete.²³⁶ Taxation on income from cross-border business services should be allocated to both residence and source states with the simpler application of the law and with less tax authority discretion.

It is difficult to have a universal threshold which can cover all service income and lead to taxation in the source state. The PE threshold should not

²³⁵ Fernando Souza de Man, *Taxation of Services in Treaties between Developed and Developing Countries: A Proposal for New Guidelines* (IBFD 2017) p. 182.

²³⁶ Para. 132, 135, 139 OECD Model: Commentary on Article 5 (2017).

be abandoned at all, but it should be developed by adding more criteria into the existing threshold and a new threshold should be created for modern services. For existing threshold, the time-threshold may be added to the ‘fixed place of business’ and ‘dependent agent’ for counting the days of the presence or working in the source state.²³⁷

With regard to the new threshold, the OECD proposed that ‘the profits should be taxed where economic activities deriving the profits are performed and where the value is created’.²³⁸ It is possible that the new nexus can be the ‘destination principle’, which is similar to VAT system in the EU that withholding tax on gross payment in the market destination (the recipient of services’ country).²³⁹ This could be related to the concept of ‘significant economic presence’, which suggested the threshold of:

- (i) have a strong relationship with the customers and a physical presence;
- (ii) sale of goods or provision of services via the website and have local facilities; and
- (iii) provision of goods and services via ‘systematic data-gathering.’²⁴⁰

At the moment, there is no widely accepted solution which can provide a consensus in the tax treaties. Nevertheless, a minimum threshold is necessary so long as it can satisfy source-based taxation on income from cross-border business services. The further step is a consideration of whether the PE should evolve itself from a threshold for allocation of taxing rights into being an instrument of ‘anti-avoidance’ rule in order to safeguard source-based taxation.

²³⁷ Brian J. Arnold, ‘Threshold Requirements for Taxing Business Profits under Tax Treaties’ (n 74) pp. 491-492.

²³⁸ OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (n 55) p. 10.

²³⁹ de Wilde, ‘Tax Jurisdiction in a Digitalizing Economy; Why ‘Online Profits’ are so Hard to Pin Down’ (n 5) p. 798.

²⁴⁰ López (n26) 12; Luc Hinnekens. ‘Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-first Century’ [1998] 26(6/7) Intertax pp. 192–200; Reuven S. Avi-Yonah, ‘A Model Treaty for the Age of BEPS’ [2014] law and Economics Research Papers University of Michigan.

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Appendix

Appendix I – Changes to Article 5 of the OECD Model Tax Convention on Income and Capital (21 November 2017)

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term “permanent establishment” includes especially:

- a) a place of management;
- b) a branch;
- c) an office;
- d) a factory;
- e) a workshop, and
- f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- 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,~~

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1 *Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and*

- a) *that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or*

- b) *the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,*

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6*, where a person ~~other than an agent of an independent status to whom paragraph 6 applies~~ is acting in a Contracting State on behalf of an enterprise and ~~has, and habitually exercises, in a Contracting State, an authority to conclude contracts, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are~~

- a) *in the name of the enterprise, or*
b) *for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
c) *for the provision of services by that enterprise,*

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (*other than a fixed place of business to which paragraph 4.1 would apply*), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. ~~An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.~~

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

8. *For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.*

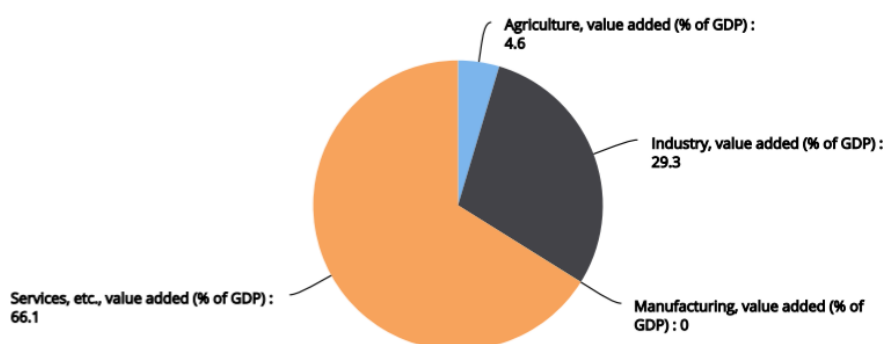
Appendix II – Economic data of International Trade in Services

Introduction

According to the CIA,²⁴¹ services accounted for 63 per cent of the world GDP in 2017.²⁴² It is in accordance with the World Bank data in 2016 which states that services represent 66 per cent of the world GDP as compared to the industry, agriculture and manufacturing sectors.²⁴³

In term of the growth, the WTO's data presents that the value of exports of commercial services have accelerated by 64 per cent since 2006, totalling to USD 4.77 trillion in 2016. The fastest growth in the service sectors is travel and other commercial services (including financial and businesses services), and in the other commercial categories, the ICT is the one which is the fastest-growing category.²⁴⁴

Diagram: Percentage of the world GDP in the industry, agriculture and manufacturing sectors²⁴⁵



²⁴¹ GDP - composition, by sector of origin: This entry shows where production takes place in an economy. The distribution gives the per centage contribution of agriculture, industry, and services to total GDP, and will total 100 per cent of GDP if the data are complete. Agriculture includes farming, fishing, and forestry. Industry includes mining, manufacturing, energy production, and construction. Services cover government activities, communications, transportation, finance, and all other private economic activities that do not produce material goods.

²⁴² Central Intelligence Agency, 'The World Factbook' <www.cia.gov/library/publications/the-world-factbook/fields/2012.html#xx> accessed 4 May 2018.

²⁴³ World bank, 'World Development Indicators: Structure of output' <<http://wdi.worldbank.org/table/4.2>> accessed 1 May 2018.

²⁴⁴ World Trade Organization, 'World Trade Statistical Review 2017' (World Trade Organization, 15 May 2017) 11.

²⁴⁵ World bank, 'World Development Indicators: Structure of output' <<http://wdi.worldbank.org/table/4.2>> accessed 1 May 2018.