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# Taxation of Business Profits in the 21st Century

Selected Issues under Tax Treaties

Essays in Commemoration  
of IBFD's 75th Anniversary

75

# Taxation of Business Profits in the 21st Century - Selected Issues under Tax Treaties

## Why this book?

The taxation of business profits derived from cross-border activities is one of the core issues in international tax law. This book sheds light on a selection of issues from a practical as well as from an academic perspective. The first part is dedicated to issues relating to the application of article 5 of the OECD Model and the problem of determining the existence of a permanent establishment in a state. The second part of the book relates to issues arising from article 7 of the OECD Model and the attribution of profits to a permanent establishment

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## Introduction

The taxation of business profits derived from cross-border activities is one of the core issues in international tax law. The key principle for the allocation of taxing rights between countries, as laid down in article 7 of the OECD and the UN Models, has been widely adopted in most tax treaties. This principle provides that profits of a resident enterprise of a state shall be taxable only in that state, unless the enterprise carries on business in another state through a permanent establishment situated in that other state. Where the business is so carried on through a permanent establishment, the state in which that permanent establishment is situated is permitted to tax, but only those profits which are attributable to the permanent establishment. Of utmost relevance, therefore, is the question of how to determine the correct amount of profits to be attributed to a permanent establishment.

Consequently, there are two basic questions. First, one must determine whether a permanent establishment (as defined in the relevant treaty) actually does exist. Second, having determined the existence of a permanent establishment, one must ascertain the profits attributable to that permanent establishment.

The respective discourses concerning these two questions have a long-standing history. One needs to go as far back as the 19th century to discover the emergence of the concept of a permanent establishment acting as a threshold to grant taxing rights to the source state. Similarly, the origins of the underlying principles of article 7 of the OECD and the UN Models, which attributes profits to permanent establishments, can be found in the late 1920s and in the work of the League of Nations. The two basic questions described above have been subject to extensive debate among scholars, practitioners and tax authorities ever since, becoming even more vigorous in the past two decades as innovations in the fields of technology and telecommunications have allowed for increasingly mobile business activities. Thus, the present business environment has placed pressure on traditional concepts and principles concerning the rules to determine the existence (or not) of a permanent establishment, and the attribution of profits to permanent establishments.

This book sheds light on a selection of issues surrounding the essential questions described above. The first part is dedicated to issues relating to the application of article 5 of the OECD Model, and the problem of determining the existence of a permanent establishment in a state. The second part of the book relates to issues arising from the application of article 7 of the OECD Model, namely the attribution of profits to a permanent establishment.

## Introduction

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Part One places particular emphasis on the difficulties arising in interpreting the definition of permanent establishment. Chapters 1 to 3 deal with specific aspects of the permanent establishment concept. In today's business environment, where the sharing of business facilities and premises is far more common than it had been in the previous century and where businesses can derive income quickly and without having substantial premises or equipment at their disposal in the source state, the concept of "at the disposal of" (Chapter 1) and the time requirement regarding the concept of permanence (Chapter 2) under the definition of article 5(1) of the OECD Model are of crucial importance. Another phenomenon of the late 1990s is the restructuring of business models, including the trend of moving from fully fledged distributor arrangements towards commissionaire arrangements. Chapter 3 addresses issues arising from this trend, taking into account recent developments in international tax law.

Chapters 4 and 5 highlight particular challenges that modern business models and technology pose to the traditional permanent establishment concept, and set out alternative approaches for the taxation of business profits. Chapter 4 highlights particular issues concerning the telecommunications industry. Chapter 5 focuses on business profits derived from the performance of services, with a discussion on the practical aspects of taxing this income.

Part Two deals with the attribution of profits to permanent establishments. The first three chapters of this Part deal exclusively with the authorized OECD approach (AOA). Chapter 6 provides an analytical overview of the main elements of the AOA, and the following two chapters give a detailed treatment of two main aspects of this approach: Chapter 7 on the funding of permanent establishments through the allocation of free capital and debt, and Chapter 8 on the treatment of intangibles. Chapter 9 examines the possibility of a consistent application of the separate and independent entity approach throughout the OECD Model (i.e. not only within the confines of article 7), a scenario that would result in equal treatment of permanent establishments and resident enterprises.

The final three chapters deal with the issue of implementing the authorized OECD approach. Chapter 10 considers matters involving treaty interpretation, particularly in respect of treaties concluded before the adoption of the AOA. The other two chapters provide an overview of current country practice. Chapter 11 examines the rather limited implementation of the AOA by OECD member countries. Finally, Chapter 12 takes a look at the approach adopted in the revised 2011 UN Model, and also the policy stance

of the BRICS countries concerning the attribution of profits to permanent establishments.

This book highlights the controversies concerning the concept of permanent establishment as the threshold for granting source taxation, contributing to the discussion on whether the time has come for this concept to undergo a substantial overhaul that takes into consideration today's altered business environment. Similarly, the book highlights the problems of implementing the AOA in tax treaties and domestic law, which is essential for its success. We hope this book will further stimulate academic discussion and be of use to practitioners and students.

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