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Nexus Requirements for Taxation of Non-Residents' Business Income

S. Gadžo

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Reviewed by: Christiana HJI Panayi Professor in Tax Law, Queen Mary University of London, Centre for Commercial Law Studies.

**B.T.R. 426* This book ¹ is based on the award winning ² doctoral thesis of the author and explores a very important issue in international tax law: the different nexus requirements used by countries to tax non-resident business income and whether they are fit for purpose in the new economic environment. The author examines the principles set out under the existing international tax framework, as enshrined in the bilateral tax treaty model, with much focus on the concept of the permanent establishment. As explained in the beginning, the main research question is what the appropriate nexus norms for taxing non-residents' business income should be in light of developments in the contemporary global economy. ³ He proposes his own very interesting approach to deal with his question.

There are eight chapters to this book. The first chapter provides a very useful introduction to the issues to be analysed, the hypotheses and methodology of the research. The second chapter reviews the customary principles of jurisdiction to tax. In this chapter, the author goes beyond the traditional exposition of the League of Nations reports and investigates the issues also from the perspective of general international law: more specifically, the status of the nexus requirement as a norm of international law. **B.T.R. 427*

The following chapters examine the different approaches that countries take in dealing with the nexus issue domestically (Chapter 3) or under tax treaties (Chapter 4), with a focus on the permanent establishment concept. Whilst Chapter 4 sets out a more traditional analysis of the tax treaty rules in this area, Chapter 3 contains a very interesting comparative analysis of the permanent establishment concept from the perspective of Croatian tax law, German tax law, French tax law, US tax law, Indian and Brazil tax law. Four basic approaches are identified: using the PE concept as defined in tax treaties (model 1—Croatian approach); using the PE concept in a substantially different manner than under tax treaties (model 2—German approach); using a broader approach than the PE concept that is not restricted to a fixed place of business (model 3—French, US and Indian approach); and reliance on withholding tax imposed on income derived by non-residents (Brazilian approach).

Chapter 5 examines the framework for normative analysis of the nexus norms. The author reviews some abstract tax policy principles (equity, efficiency and administrability) and considers how these are adapted to address the research question. This sets the background to analyse the appropriateness of different nexus norms used by states in the taxation of non-resident business income and in particular in the context of the global economic environment (Chapter 6). Particular attention is drawn to developments associated with the introduction and expansion of e-commerce and the rise in cross-border services trade. The analysis in these chapters is masterful, blending in established principles, the challenges shown through the BEPS Project and the new digital environment.

In the next chapter, Chapter 7, the author evaluates the traditional forms of finding PE nexus in light of this new environment and concludes that they are inappropriate. This is because the traditional forms of PE nexus do not recognise the taxing claims of market states and, as such, they are very restrictive. The main reform proposals are considered such as the modest BEPS

proposals in this area and the more ambitious proposals for broader use of PE-deeming rules. The latter encompasses the introduction of a virtual PE and a proposal for a PE based on significant economic presence.

The author's own proposal is very interesting. He advocates the preservation of the PE nexus in tax treaties but with a new deeming rule as its supplement. Under this evolutionary approach

"a new nexus based on a de minimis revenue threshold should be added to tax treaties, supplementing two basic PE concepts, namely the 'fixed place PE' and the 'agency PE'".⁴

The exact threshold amount is not determined and it is admitted that "it is hard to draw the line and specify the threshold amount".⁵ As a rule of thumb, US\$1 million is proposed, aligned with proposals from other scholars.⁶

In the last chapter, Chapter 8, there is an overview of the contents of each chapter to this book. The proposal for a new PE-deeming rule based on de minimis revenue threshold is reiterated and nicely summarised. The author argues that **B.T.R. 428*

"such a rule would allow a state to tax the business income of a non-resident taxpayer as soon as he has derived an ex ante specified amount of gross revenue from catering customers located in that state, irrespective of his physical presence therein".⁷

This rule would be aligned with the principle of tax equity as it recognises significant benefits that non-resident taxpayers receive from market countries. Such a rule would also be tax efficient, as the revenue threshold would be prone to less manipulation by taxpayers compared to the traditional PE concept. The proposal also suggests that the administrative concerns surrounding the application of such a rule can be resolved in a comprehensive manner; for example, by relying on an interim withholding regime in respect of business-to-business payments.

Overall, this book provides an impressive analysis of some of the important issues relating to jurisdiction to tax a non-resident's business income and especially the PE concept. The author's proposal is very well argued and quite convincing. Whilst it appears to precede the European Commission's⁸ and the OECD's⁹ 2018 proposals on the taxation of digital economy, it provides an excellent benchmark for further research and a solid alternative if the existing proposals do not gain consensus.

Christiana HJI Panayi

Footnotes

- 1 *S. Gadžo, Nexus Requirements for Taxation of Non-Residents' Business Income (the Netherlands: IBFD, 2019).*
- 2 Winner of the 2017 European Academic Tax Thesis Award, jointly awarded by the European Association of Tax Law Professors (EATLP) and the European Commission.
- 3 Gadžo, above fn.1, 7.
- 4 Gadžo, above fn.1, 320.
- 5 Gadžo, above fn.1, 321.
- 6 Namely, R.S. Avi-Yonah and O. Halabi, "A Model Treaty for the Age of BEPS" (2014) Law & Economics Working Paper 103, available at: http://repository.law.umich.edu/law_econ_current/103 [Accessed 11 June 2019].
- 7 Gadžo, above fn.1, 337.
- 8 *European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (Brussels: 21.3.2018, COM (2018) 147 final); European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (Brussels: 21.3.2018, COM(2018) 148 final).*
- 9 *OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from Digitalisation—Interim Report 2018: Inclusive Framework on BEPS (Paris: OECD Publishing, 2018),* available at: <http://dx.doi.org/10.1787/9789264293083-en> [Accessed 11 June 2019].