Imposing Domestic Tax Rules on PEs of Foreign Taxpayers[1]

Yoshihiro MASUI
The University of Tokyo
masui@j.u-tokyo.ac.jp

1 The views expressed in this paper are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank (ADB) or its Board of Directors or the governments they represent. ADB makes no representation concerning and does not guarantee the source originality, accuracy, completeness, or reliability of any statement, information, data, finding, advice, opinion, or views presented.

Outline

- Setting the Scene
- Present Rule in a Nutshell
- Some Structural Issues
- Conclusion

I. Setting the Scene

- Analysis of the topic
- “Imposing Domestic Tax Rules on the Permanent Establishments of Foreign Taxpayers”

I. Setting the Scene

- Domestic Tax Rules
  - Focus on Income Taxes
  - Not VAT, indirect taxes, and customs duties

I. Setting the Scene

- Permanent Establishments (PEs)
  - Fixed place of business
  - Through which the business of an enterprise is carried on
  - Example: branch, factory, construction site…

I. Setting the Scene

- Foreign Taxpayers
  - Individuals, Corporations, and other business entities
  - Domestic or foreign?
  - Example: A Delaware Corporation setting up a building site in your jurisdiction

I. Setting the Scene

- Aim of the presentation
  - Understand the present rule that is internationally agreed upon
  - Discuss some structural issues that are inherent in the present rule

II. Present Rule in a Nutshell

- A threshold requirement for the source state
  - Regarding business income
  - No taxation without a PE
  - Profits attributable to the PE
  - Net income taxation

II. Present Rule in a Nutshell

State S State R

PE HO

II. Present Rule in a Nutshell

- Internal law
- Treaty law
  - OECD Model Tax Convention on Income and on Capital (MTC) Article 7
  - UN Model Article 7
  - US Model Article 7

II. Present Rule in a Nutshell

- Definition of a PE: OECD MTC Article 5
  - Fixed place of business
  - Typical examples
  - Building sites more than 12 months
  - Excluded: preparatory or auxiliary
  - Dependent agent PE

II. Present Rule in a Nutshell

- Profits attributable to the PE: OECD MTC Article 7
  - Attributable profits, not all domestically sourced income
  - Arm’s length principle
  - Deduction of costs
  - Priority of other Articles

II. Present Rule in a Nutshell

- Threshold requirements in other Articles
  - Immovable property: no threshold
  - Shipping, air transport etc.: no taxation by State S in the first place
  - Dividends, interest, and royalty: Again, PE threshold if attributable to the PE
  - Capital gains: no taxation by State S but for immovable property

III. Some Structural Issues

- Is physical presence necessary?
- Arm’s length principle vs. Formulary apportionment
- Parent-subsidiary relationship
- Tax Administration

IIIA. Physical presence

- PE notion focuses on the physical presence in State S
- From the “brick and mortar” environment to the electronic commerce environment
- Is source-based taxation eroding?

IIIA. Physical presence

- OECD projects on e-commerce
  - 1998 Ottawa Ministerial meeting
  - 2003 update of the OECD MTC Commentary
  - PE definition: Commentary on Article 5, Paragraphs 42.1- 42.10.
  - Classification issues
  - Attribution issues

IIIA. Physical presence

- Long term agenda
  - Same rule, different result
  - Lowering the threshold?
  - Withholding on all deductible payments?
  - Administration: feasible?

IIIB. Arm's length principle

- Revenue division based upon the arm's length principle
  - Distinct and separate enterprise
  - Transaction-oriented approach
  - Deduction of costs
  - Comparison with Article 9 (Associated Enterprise)

IIIB. Arm's length principle

- Theoretical alternatives
  - Formulary apportionment
  - Looks at worldwide profits
  - Apportionment by some key factors: sales, wages and capital
  - Seemingly simple, but difficult to agree upon

IIIB. Arm's length principle

- OECD's current work on Article 7
  - Authorized OECD Approach (AOA)
  - Discussion drafts
  - Banks, global trading, and insurance

IIIB. Arm’s length principle

- Discussion at the IFA Congress September 2006
  - State R double tax relief: outside the scope
  - EC law implications
  - A more closely targeted approach?

IIIC. Parent-subsidiary

- When is a subsidiary PE of the parent?
  - OECD MTC Article 5(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.

IIIC. Parent-subsidiary

- Example

State A State B

| Parent |

| Subsidiary |

IIIC. Parent-subsidiary

- OECD Commentary on Article 5(7)
  - General rule (Paragraph 40):
    - The existence of a subsidiary does not, of itself, make that subsidiary a PE of the parent.
  - Exceptions (Paragraph 41)
    - Parent may have a PE if it has premises at its disposal which belong to the subsidiary.
    - Subsidiary may be a dependent agent of the parent.

IIIC. Parent-subsidiary

- Different opinions
  - Italian Supreme Court on Phillip Morris Case (2002)
  - Brian Arnold (2003)

IIIC. Parent-subsidiary

- Does it matter?
  - Revenue more than just transfer pricing adjustments?
  - Dividends, interests and royalties subject to tax?

IIID. Tax administration

- The most crucial aspect
  - And the most challenging!
  - Because the taxpayer is foreign
- Gathering information
- Collection of taxes

IIID. Tax administration

- Information
  - Ask for relevant information
    - Potentially limitless
    - Unnecessary paperwork: waste of resources
  - Utilizing information available in the non-tax field:
    - The role of corporation act
    - Banking and other financial regulations
    - Business secrets

IIID. Tax administration

- Information
  - Information reporting: legislative backup
  - Auditing: effective personnel
  - Information exchange through treaty network

IIID. Tax administration

- Collection
  - Commercial reputation: penetration into the domestic markets
  - Seizing the domestic assets
  - Mutual assistance

IIID. Tax administration

- Why physical presence considered as necessary
  - Bookkeeping necessary for net basis taxation
  - Cannot physically impose rules on those who are not present
- Challenges ahead:
  - Imposing domestic rules on foreign taxpayers

IV. Conclusion

- What have we learned?
- Striking the right balance
  - Revenue
  - Administrative costs
  - Compliance costs
  - Behavioral effects on the inbound investment

Thank you!