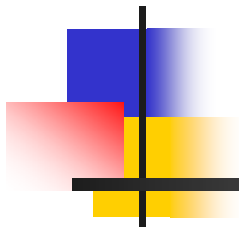


Imposing Domestic Tax Rules on PEs of Foreign Taxpayers¹



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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
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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-subsubsidiary

- 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-subsubsidiary

- Example

State A

Parent

State B

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-subsubsidiary

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



IIIC. Parent-subsubsidiary

- 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



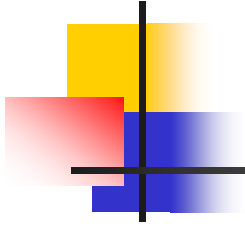
IIID. Tax administration

- 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!

