The OECD Model Convention Part 2

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Lesson 05

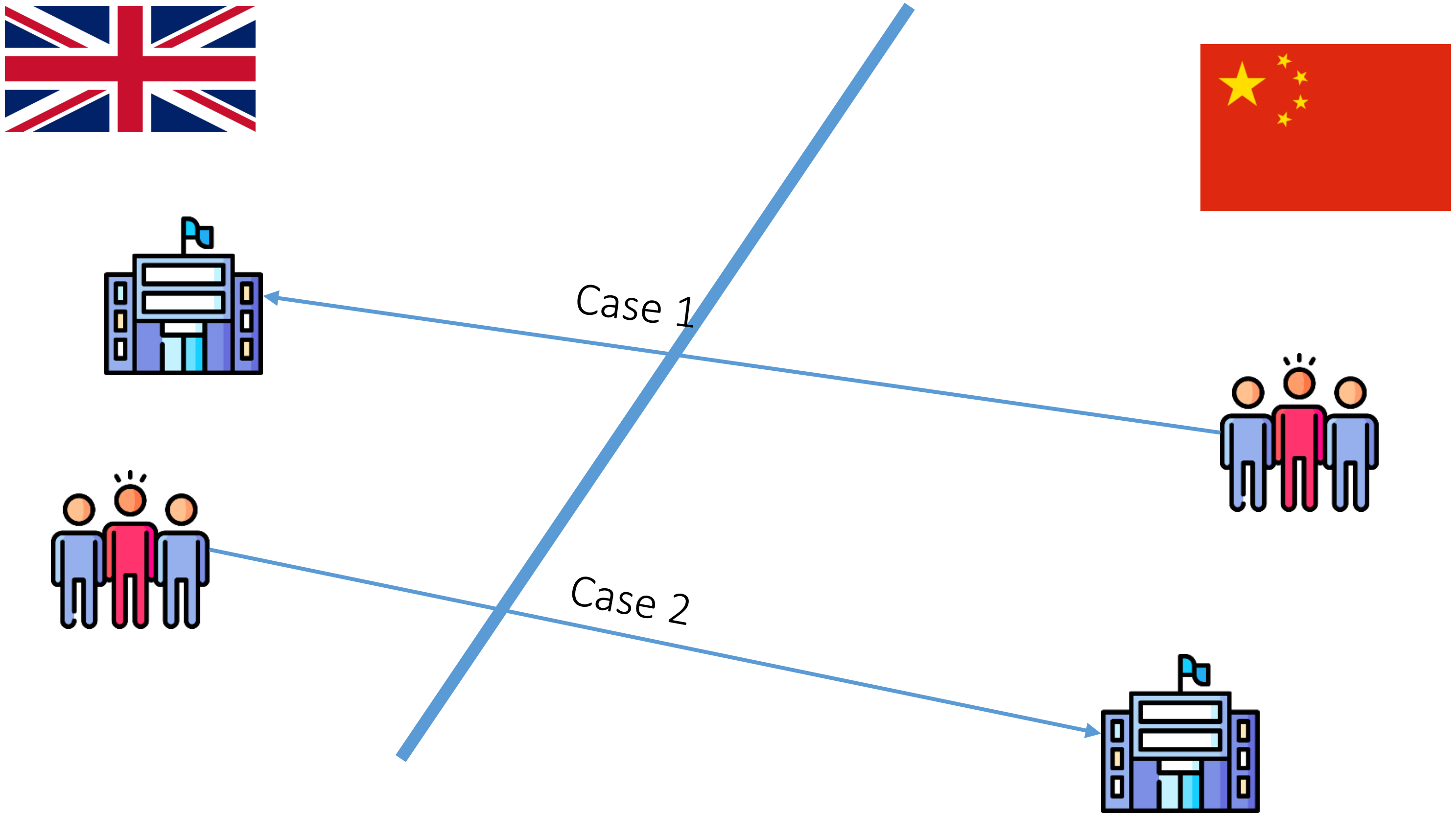
Programme of the Day 05

- Finalise the analysis on the definition of permanent establishment (Article 5);
- Approaching the third part of the OECD Model;
  - That is, the one related to the allocation of the taxing power of the states in the framework of a tax treaty;
- Business income (Article 7) as connected to the permanent establishment;
- Shipping and waterways transportation (Article 8).

Summary of the Concepts Addressed so far

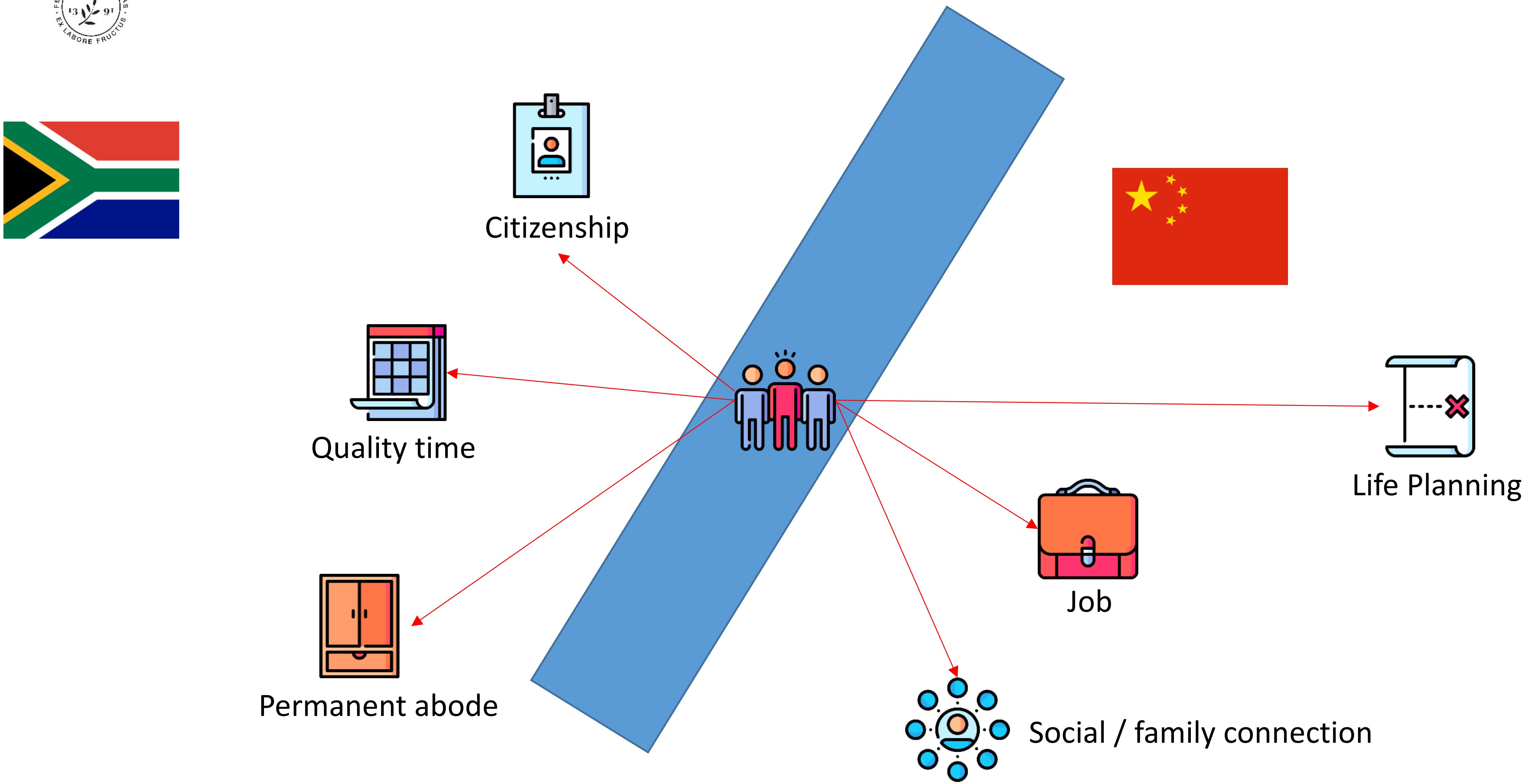
- Tax Treaties are aimed at preventing international double taxation
- Double taxation occurs when a taxpayer (or income / asset) taxed in both states;
- According to customary law a state charges a tax when either the taxpayer <u>or</u> the income (asset) is placed in its territory;
  - Exceptions apply (such as in the US);
- As to achieve this goal a treaty lays down common rules as to decide ex ante (in advance) who is going to tax whom, and under which conditions.

Cases You are already Familiar with



Fictitious case: a Tax on the ownership of companies.
Both China and UK can claim their power to tax.

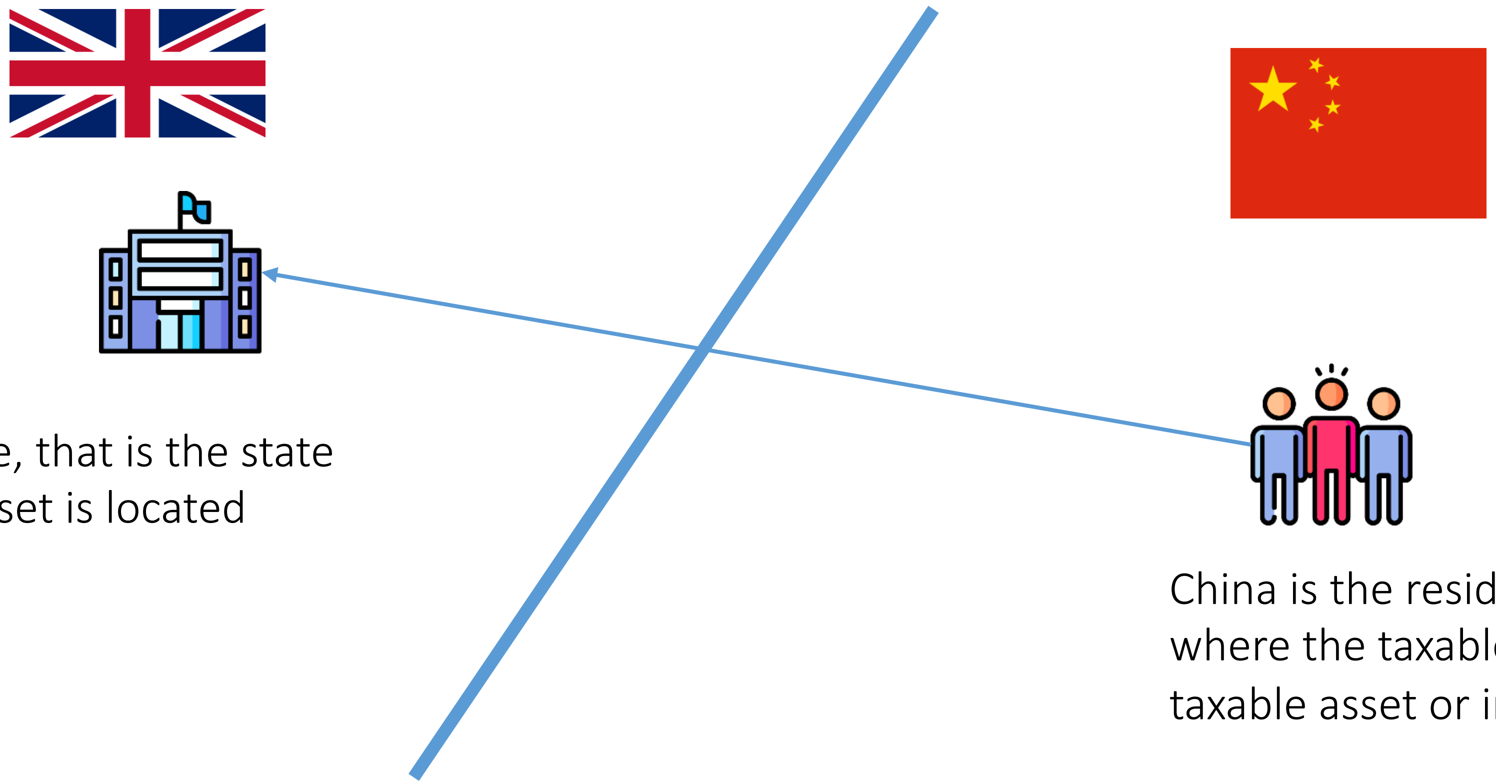
Or else


Citizenship
Quality time
Permanent abode
Life Planning
Job
Social / family connection

Second Part of the Summary

- Once the agreement is effective, one states surrenders entirely (or partially) it power to tax if conditions are met;
- In this way international taxation is:
  1. Removed or
  2. Mitigated
- Who is the winner ?
  - Depends on the cases: it could be the source state or the residence state;
- Unresolved problem: conflict of qualification
  - Definition of assets or income is anything but clear (see the class on the Interpretation)

Lexicon



UK is the source state, that is the state where the taxable asset is located

China is the residence state, that is the state where the taxable person (owning the taxable asset or income) is located

Fictitious case: a Tax on the ownership of companies.
Both China and UK can claim their power to tax.

The Theory and the Practice

- Deciding who is the winner: the OECD approach with Income taxation;
- Every kind of income has its own nexus:
  - Real estate;
    - Where the immovable is;
  - Business;
    - Where the resident is, unless a Permanent establishment does exist;
  - Passive income;
    - Where the resident / recipient is;
  - Labour income;
    - Where the worker is resident (source state may concur)
  - Other kind of income;
    - …

The Case for Business Income

- OECD Model Convention, Article 7:
- Profits of an enterprise of a Contracting State shall be taxable only in that State **unless the enterprise carries on business in the other Contracting State through a Permanent establishment** situated therein.
- If the enterprise carries on business as aforesaid, the profits that are attributable to the Permanent establishment in accordance with the provisions of § 2 may be taxed in that other State.

Permanent Establishment: Preliminary Definition

- OECD Model, Article 5 § 1:
  - For the purposes of this Convention, the term “Permanent establishment” means a <u>fixed place of business through which the business of an enterprise is wholly or partly carried on</u>.

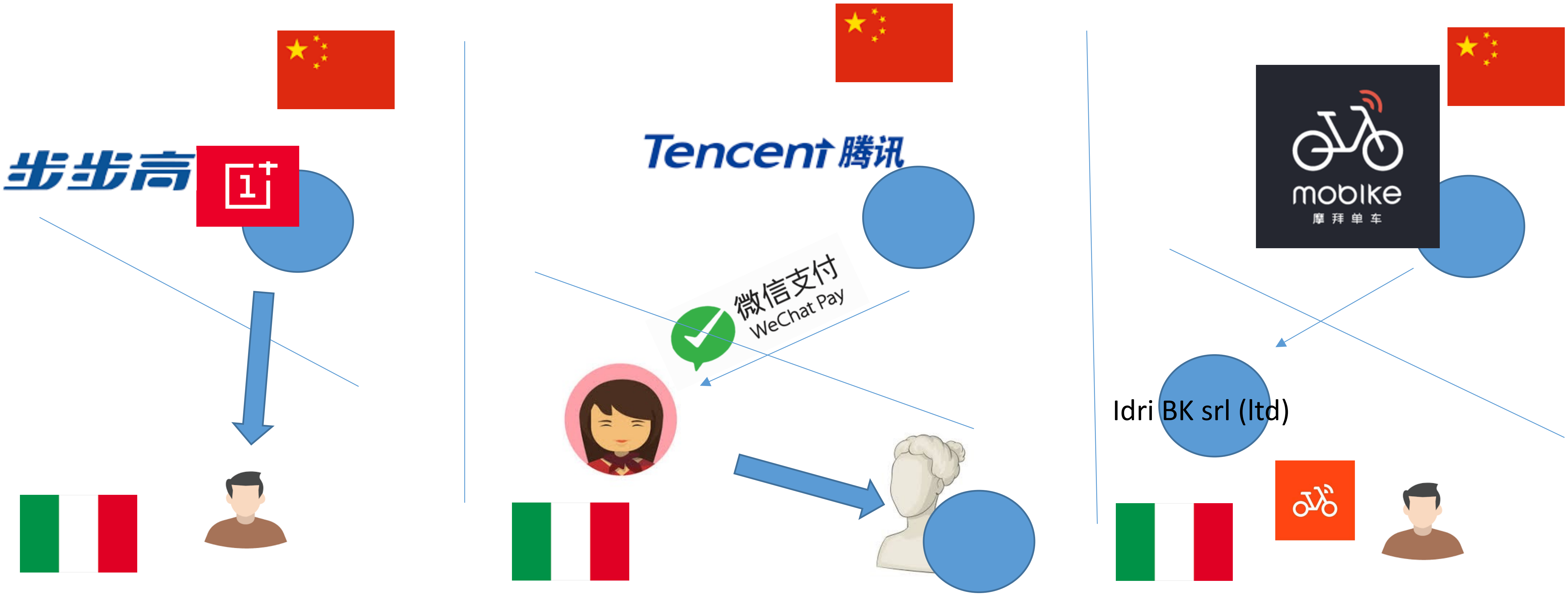
Examples with a descriptive purpose: do not confuse a permanent establishment with a subsidiary

Permanent Establishment vs Subsidiary

Place of business owned by a foreign legal entity.
The permanent establishment has no legal entity status

Company (Ltd.) with legal personality under the control of the foreign parent.
The subsidiary is a different legal entity.

Real Life Cases



Going back to definitions …

- OECD Model, Article 5 § 1:
  - For the purposes of this Convention, the term "Permanent establishment" means a <u>fixed place of business through which the business of an enterprise is wholly or partly carried on</u>.
- OECD Model, Article 5 § 2:
- The term "permanent establishment" includes especially:
  A. Place of management;
  B. Branch;
  C. Office;
  D. Factory;
  E. Workshop, and
  F. Mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

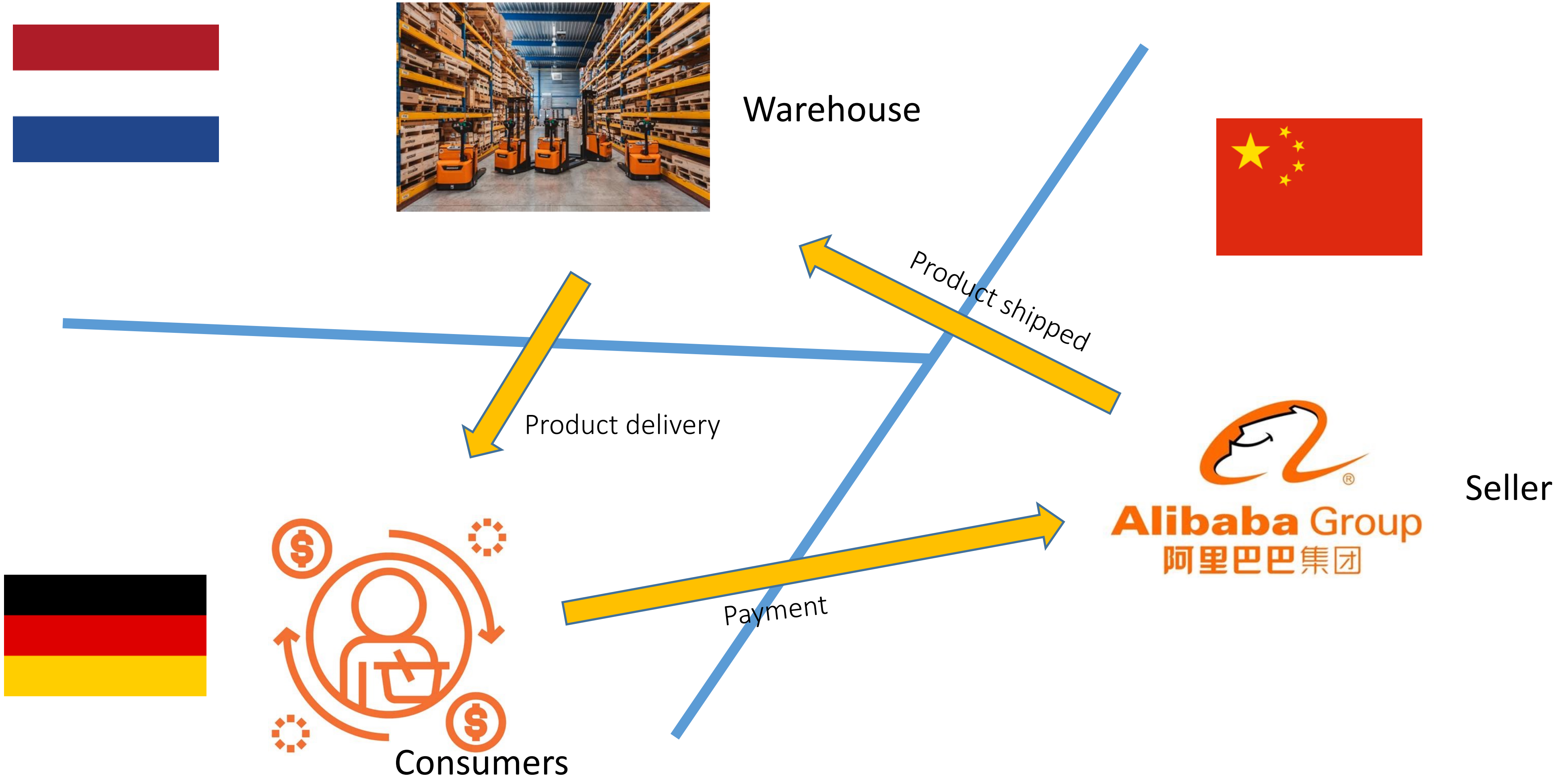
Continued …

- OECD Model, Article 5 § 4:
- Notwithstanding the preceding provisions of this Article, the term "Permanent establishment" shall be deemed <u>**not to include**</u>:
  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**; …

Continued …

- …
  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.

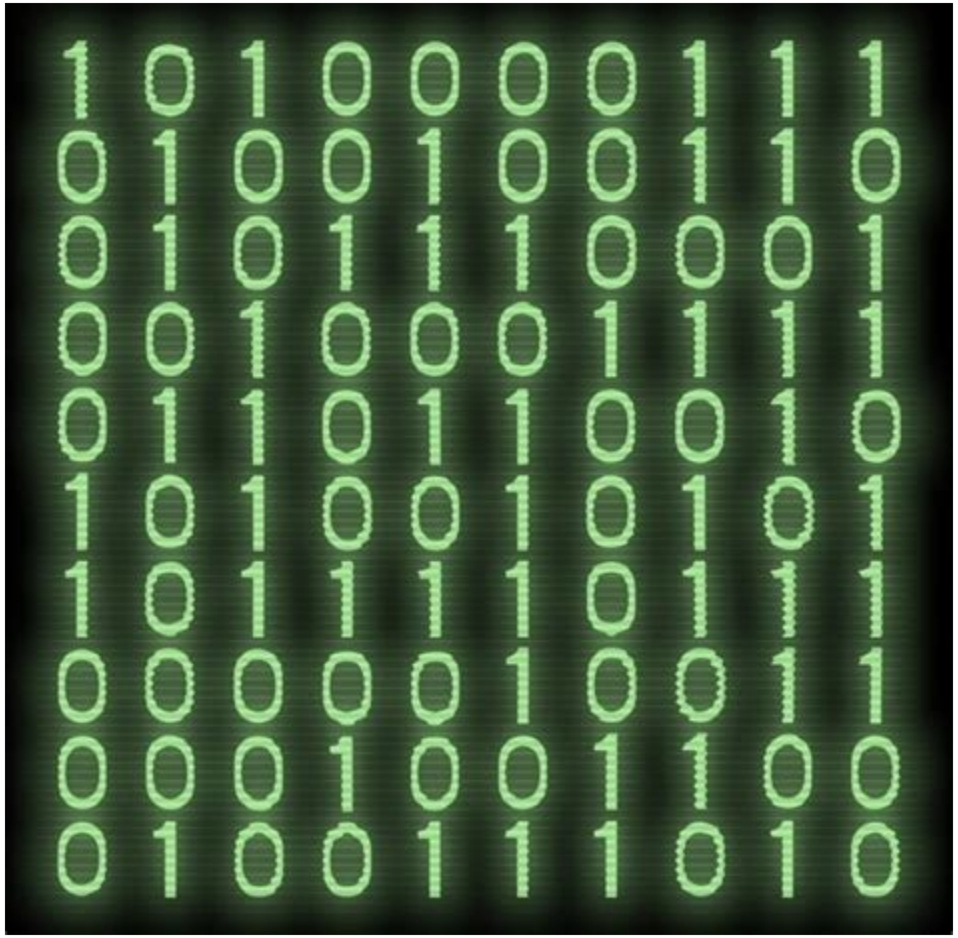
Another Case



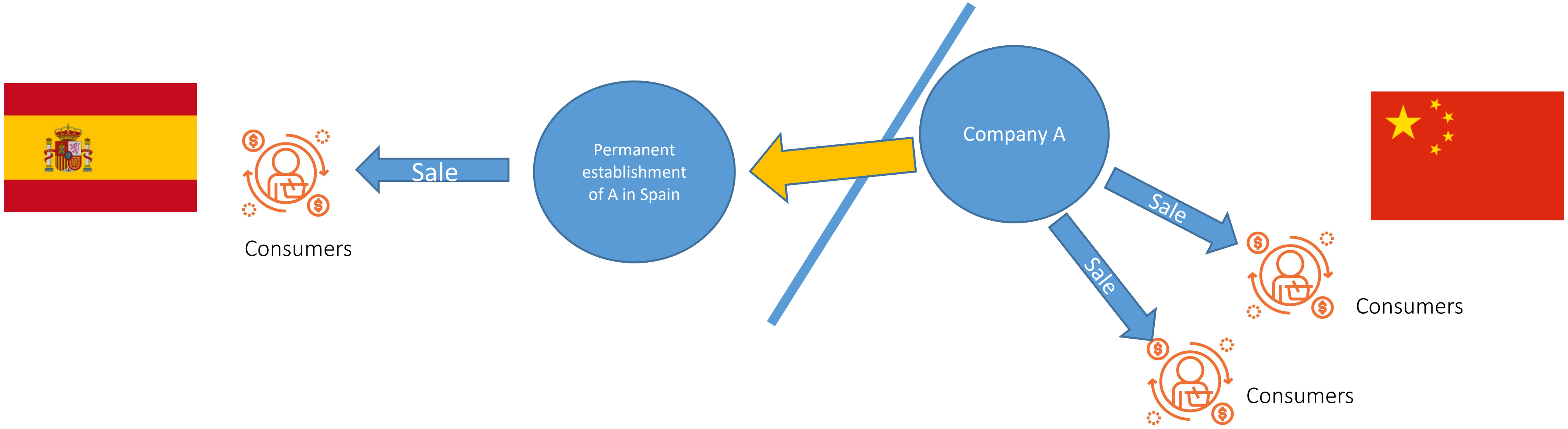
Fictitious example

Summary of the Relevant Findings

- Taxation of Business income follows a "Digital" approach;
- **With no Permanent establishment in the source state**
  - Source state can not tax;
- **With Permanent establishment in the source state;**
  - Source state can tax the profits originated from there;
  - The residence state should grant relief to this situation (normally it does)



More to the Point …



a) Company A income in China 1000

b) Permanent establishment (PE) income in Spain 100

c) Taxes paid in Spain on (b): 20 (assuming 20%)

d) Tax base in China (subject to taxation): (a) + (b) = 1100

e) Taxes to be paid in China on (d): 220 (assuming 20 %)

f) Taxes actually paid in China: (e) – (c) = 200

Warning: <u>oversimplification</u> of real life situation. Rates might diverge, credit [- (c)] might not be entirely granted …

Special provisions: Shipping and Air Transport

- Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of head office or the place of effective management of the enterprise is situated;
- …
- The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or in an international operating agency.

Fictitious Example

Companies Potentially under Article 8

- **Tax Issues:**
- Where do they pay taxes ?
- Are they exposed to Double taxation ?

End of Lesson 05

- Suggested readings (B, elective): Greggi, Marco, *The Concept of 'Permanent Establishment of a Group of Companies' in a Recent Case of the Italian Supreme Court (Corte di Cassazione)* (December 30, 2008). Available at SSRN: https://ssrn.com/abstract=1321799 or http://dx.doi.org/10.2139/ssrn.1321799