**Papers on Selected Topics in Administration of Tax Treaties for Developing Countries**

**Paper No. 5-A**

May 2013

# Taxation of Non-residents on Business Profits

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# Taxation of Non-residents on Business Profits

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## 1. Introduction

The taxation of non-residents on business profits is important to developing countries in terms of raising revenue and encouraging foreign investment and trade. The source country has the legitimate right to tax business profits arising in its jurisdiction. Tax treaties impose no limits on such taxing rights, other than the obligation to tax net profits in some situations, once the threshold for taxation is satisfied. As such, this source of tax revenue belongs to the source country. There is generally little expectation of the residence country of a non-resident taxpayer in sharing the tax revenue. If the residence country provides a credit for taxes paid to the source country, the non-collection of the taxes owed to the source country is a fiscal transfer to the residence country, with no benefit to the taxpayer.[1]

The threshold for source country to tax the business profits of non-resident taxpayers is the existence of a permanent establishment (PE) through which the business of the non-resident taxpayer is carried on. Ineffective taxation of business profits earned through a PE may lead not only to the loss of revenue from the taxation of a PE, but also potentially the loss of revenue from the taxation of subsidiaries of foreign companies. In cases where a PE and a subsidiary are interchangeable in carrying on business activities in the source country, the foreign companies would presumably be encouraged to use a PE as opposed to a subsidiary when the profits attributable to a PE are not taxed as effectively as profits of a subsidiary.

The manner in which taxes on business profits are collected and enforced, and the actual or perceived efficiency and fairness in dealing with non-residents may affect the business environment. To non-resident taxpayers, taxes are part of the cost of doing business. Certainty and predictability in tax are perhaps as important as the amount of tax. Therefore, competent tax administration can not only collect the taxes due, but also contribute to a positive business environment for foreign investment. On the other hand, if the tax administration is inefficient or incompetent, causing

[1] However, if the residence country is an "exemption" country, that is, business profits earned in the source country are exempt from taxation, the non-taxation of the business profits in the source country would amount to double non-taxation, which is not intended by tax treaties.

uncertainty, confusion or aggravation for taxpayers, it may discourage foreign companies from doing business or making investment in the source country.

The taxation of non-residents on business profits presents many difficult administrative issues because different types of business profits are subject to different thresholds for taxation, different sourcing rules, different methods of computation and collection. Unlike source-country taxes on investment income and employment income which are normally collected through withholding, business profits are generally taxed on a net basis, based on self-assessment. Effective tax administration requires adequate resources and procedures. Unfortunately, many developing countries face difficult challenges in this regard.

This paper discusses five important aspects of the taxation of business profits derived by non-residents in the source country:

(1) the identification of the non-resident taxpayer carrying on business in the source country, and the country in which the particular non-resident taxpayer is resident;
(2) the tax treaty framework for taxing business profits;
(3) whether the non-resident taxpayer is carrying on business in the source country through a PE in the source country;
(4) the attribution of profits to the PE; and
(5) the collection and enforcement of taxes.

This paper focuses on Articles 5 and 7 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] ("UN Model Convention") and the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital[3] ("OECD Model Convention").[4] A thorough discussion of the taxation of services (including the services of artistes and sportspersons) and investment income, which are important types of business profits, is covered under separate papers.[5] The taxation of other types of business

[2] United Nations, Department of Economic and Social Affairs, Model Double Taxation Convention between Developed and Developing Countries (New York: United Nations, 2011).

[3] Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

[4] Unless specified otherwise, any references to Articles in this paper are references to the Articles of the UN and OECD Model Conventions.

[5] See Ariane Pickering, Taxation of Non-resident Service Providers; and Jan de Goede, Taxation of Investment Income and Capital Gains, Papers 6-A and 7-A of this collection respectively.

profits, such as transport and immovable property, is mentioned in this paper to the extent that it is relevant to the understanding of Articles 5 and 7.

## 2. Tax information

Good information is the key to effective taxation of non-residents' business profits in the source country. The tax authorities of the source country need to know which non-residents are carrying on business in their country and whether the business is carried on through a PE. Such determination is highly factual and requires the tax authorities to have good information about the non-resident taxpayer's activities in the source country. Obtaining information from the non-resident or about the non-resident is often challenging. In many developing countries, there may be a serious information deficit.[6] This section briefly discusses ways of addressing such deficit.

### 2.1 What information?

The objective of obtaining information is to enable the tax administration to determine whether a non-resident taxpayer is carrying on business activities, meets the threshold for taxation, has revenues and expenses connected to the PE and whether the prices charged for dealings between the PE and the non-resident enterprise reflect the arm's length principle. Arguably, the utility of information is more important than the comprehensiveness and quantity of information.

The specific information requirements of the source country may depend on business-specific factors (such as, for instance, in case of offshore oil and gas projects, insurance, or technical services) or general legal requirements (such as, for instance, in case all branches must register irrespective of the nature of business activities). If the source country is concerned with the determination of PE threshold, since the threshold differs for different types of business activities, it may demand different information for different thresholds. For example, the ownership of certain categories of property in the source country (e.g., factories, natural resources and assets that may constitute an office), contracts with local agents, or contracts with local customers (such as general contractors with sub-contractors). It is not uncommon for countries to require non-resident taxpayers to provide organizational diagrams and information that will permit an assessment of arm's length prices for related party transactions.

6 Robert Couzin, "Imposing and Collecting Tax" in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation, 2003), at p.171-200.

Several considerations need to be taken into account in designing rules on requesting information. First, both taxpayer compliance and resources of the tax administration should be kept in mind. Non-resident taxpayers will complain about the burden of compliance if they are required to produce and retain information that is perceived to be redundant or cannot be used by the tax administration. In many countries, such information needs to be translated into the official language(s) of the source country, which is another cost of doing business. A "fishing expedition" type of information requirement may backfire on the source country: the information may not be relevant, bad information may crowd out the good, and taxpayers may become "unhappy". As a result, the source country cannot benefit from "information gluttony"[7]

Second, the format of information is as important as the content. Ideally, tax information should be in electronic format that can be manipulated by the tax administration to make comparisons with other years, other taxpayers and other sectors, or to determine the impact of different cost allocations or transfer pricing models that influence the profit attributable to a PE. Standardization of the data sets and format are important in the "high-tech" details as well as the "low-tech" equivalents (standard paper size and colour coding).

## 2.2 Sources of information

The main sources of tax information are the non-resident taxpayer, withholding agents, the competent authority of the other treaty country, and other agencies in the source country. Although the requirements applicable to resident taxpayers should apply equally to non-resident taxpayers liable to tax in the source country, the local regime may be inadequate due to the different information required for assessing the tax liability of non-resident taxpayers and the difficulty in obtaining information from non-residents.

### 2.2.1 Taxpayers

Taxpayers possess the necessary information about their business activities that is relevant for tax purposes. The laws of the source country generally require non-resident taxpayers to provide information in several ways, ranging from tax registration to transactions reporting, tax returns, applications for treaty exemptions, and providing information based on request.

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[7] Couzin, *ibid.*

Tax registration seems to be common in many parts of the world. Under such regime, a non-resident taxpayer is required to register with the tax administration if certain conditions are met, such as carrying on a business activity for a specified period of time (e.g., Russia), or establishing a branch or representative office (e.g. China[8] and Thailand). For example, a foreign company carrying on business in Thailand, whether setting up a branch or an office must apply for a tax identification number from the Revenue Department. The taxpayer must complete an application form[9] and provide some supporting documents, such as a copy of a company's registration license. The application form typically asks information such as the name, address, local agent or representative, type and duration of the business. The registration requirement is not formally connected to the subsequent tax status of the non-resident taxpayer. The tax threshold is determined based on the facts, not merely on the registration. In practice, however, the tax registration may be a strong indication of significant business presence in the source country.

Transaction reporting provides additional evidence that may be relevant to the taxation of non-resident taxpayers on their business profits in the source country. One type of transaction reporting relates to transactions between related enterprises, which is often part of transfer pricing documentation. The report may cover the relationships, the organizational structure of the enterprise group, the type of transactions, etc. Another common type of transaction reporting relates to services rendered by non-residents. Such reporting is often coupled with a tax withholding requirement.

Tax returns are required to be filed by non-resident taxpayers in certain circumstances in accordance with domestic tax law. The return is often the same for domestic and foreign enterprises and filed annually. Non-resident taxpayers must also apply for treaty benefits, often in a prescribed manner.[10]

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[8] In China, a foreign company must obtain a business license for its representative office in China pursuant to the "Regulations on Administration of Registration of Resident Offices of Foreign Enterprises", issued by the State Council on November 19, 2010. The English text is available at http://english.mofcom.gov.cn/aarticle/policyrelease/announcement/201012/20101207344274.html (visited on April 30, 2013). Pursuant to the State Administration of Taxation Interim Provisions on the Administration of Taxation of Resident Representative Offices of Foreign Enterprises (Guo Shui Fa [2010] No.18, issued on February 20, 2010, the representative office must register within 30 days of the issuance of the Registration Certificate with the competent local Tax Bureau. The following documents must be submitted: (i) Registration Certificate; (ii) Approval Letter; (iii) Evidence of Bank Account (account book); (iv) Certificate of Enterprise Organization Code; and (v) ID of the individual filing the application. The competent local Tax Bureau will issue (i) a local Tax Registration Certificate and (ii) a State Tax Registration Certificate.

[9] See Thailand, Revenue Department, Income Tax Guide for Foreign Company, at http://www.rd.go.th/publish/20470.0.html (visited on April 30, 2013).

[10] See, for example, Canada Revenue Agency, Schedule 91, Information Concerning Claims for Treaty-Based Exemptions, available at http://www.cra-arc.gc.ca/E/pbg/tf/t2sch91/README.html (visited on

The issue of "double thresholds" is worth mentioning. The threshold for taxing non-resident taxpayers is often lower under domestic law than the PE test. This means that a non-resident taxpayer that meets the domestic threshold may be exempt from taxation if the business activity falls below the PE threshold. Nevertheless, the obligation to file a tax return is based on the domestic threshold. A non-resident taxpayer should disclose its treaty-based return position by declaring that its business activities are insufficient to meet the threshold for taxation in the source country under the applicable treaty. This information may be valuable as it permits the tax administration to examine the validity of the claim of treaty benefit and flags potential targets for audit.[11]

### 2.2.2 Withholding agents

Withholding is particularly effective as a means of collecting income tax on many forms of business profits paid to non-residents (i.e., dividends, interest, royalties and service fees). It is also an effective, and arguably, the only practical, mechanism for gathering information from non-resident taxpayers who do not have a business presence in the source country. This is true whether or not the withholding tax is final or provisional.

Withholding agents often claim a deduction for the payments (other than dividends) in computing their own tax liability. Therefore, in addition to information returns filed by withholding agents regarding the payments to non-residents, the general corporate tax returns of withholding agents may reveal useful information about payments to non-residents in the form of interest and royalties which are deducted in computing the agent's profits.

### 2.2.3 Other government agencies

Other government agencies that administer corporation registration, intellectual property registration, industry regulation, foreign investment, customs, and immigration often have information relevant to the taxation of business profits earned by non-resident taxpayers. For example, in order to carry on business in Canada, a foreign corporation will need to register as an "extra-provincial corporation" in

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April 30, 2013) and China, State Administration of Taxation, Administrative Measures for Non-tax Residents to Enjoy Treaty Benefits (Trail) (the Measures), Guo Shui Fa [2009] No. 124, August 24, 2009, available at www.chinatax.gov.cn (in Chinese) (visited on April 30, 2013). A non-resident must submit the following supporting documents to the tax authorities to obtain a treaty-based tax reduction or exemption: (i) application forms; (ii) a resident certificate issued by the competent authority of the treaty country or region; (iii) documents that evidence the taxpayer's right to the payment, such as property ownership certificate, agreement, payment voucher, or certificate issued by an intermediary or notary agent.

[11] Couzin, supra note 6, at p.183.

all the provinces in which it intends to do business.[12] In completing the registration process, the foreign corporation is required to designate an attorney resident in the province who can accept service of legal documents on behalf of the foreign corporation, and a "head office" of the corporation in the province through which business may or may not be conducted. Registration as an extra-provincial corporation does not, in and of itself, amount to a PE for income tax purposes. Similarly, in Australia, a foreign company must register with the Australian Securities and Investments Commission (ASIC).[13] It must file appropriate documentation, appoint a local agent and maintain a registered office and in certain instances a register of local members in Australia. Once the foreign company has been registered with ASIC, it must comply with various obligations such as reporting its financial results to ASIC. Failure to register a foreign company in Australia is a strict liability offence and could result in fines by ASIC and the courts. There may be registration requirement for certain industries, such as banking, insurance, mining, etc.

### 2.2.4 Exchange of information (EOI)

The exchange of information mechanism in tax treaties is useful to a source country in obtaining information about a non-resident from the non-resident's residence country. The term "exchange of information" has a very broad meaning. It includes "an exchange of documents and an exchange of information unrelated to specific taxpayers and the provision of information by one Contracting State whether or not information is also being provided at that time by the other Contracting State."[14] The obligation to provide requested information is for an "effective" exchange of information, meaning that the requested state may not avoid its obligations under Article 26 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange.[15] The types of requested information are also broad. For example, in computing the taxable profits of a PE that is located in the source country and has its head office in the residence country, the source country may

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[12] See, e.g., Ontario, Application for Extra-Provincial Licence Form 1 Extra-Provincial Corporations Act, available at http://www.forms.ssb.gov.on.ca/mbs/ssb/forms/ssbforms.nsf/FormDetail?openform&ENV=WWE&NO=007-07065 (visited on April 30, 2013).

[13] Australian Securities and Investments Commission, Application for Registration as a Foreign Company, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/402.pdf/$file/402.pdf (visited on April 30, 2013).

[14] Paragraph 5 of the Commentary on Article 26 of the UN Model Convention.

[15] Ibid., para.9.

request information from the residence country about the expenses and profits of the head office and the dealings of the head office with other PEs and associated enterprises.[16]

Developing countries may not be reaping the full benefits of the exchange of information mechanism for several reasons. For example, the source country may not have sufficient information to know the right questions to ask the other country. It may not know if a non-resident enterprise is carrying on business in its country. In the case of automatic or spontaneous exchanges, the exchanged information may not be very useful in the absence of an integrated information system that can accommodate the volume of input and produce useful output. The level of information technology may vary greatly from country to country.

# 3. Treaty framework for taxing business profits

## 3.1 "Business" and "profits"

The terms "business" and "profits" are normally not defined in tax treaties.[17] Pursuant to Article 3(2), undefined terms used in a treaty generally have their meanings in the domestic law of the country applying the treaty. In general, civil law countries tend to characterize all of the income of business enterprises as "business" income. Common law countries tend to distinguish between business income and passive investment-type income.[18] "Profits" generally means net profit under the domestic income tax laws. Cost and expenses incurred for business purposes are generally deductible in computing profit.

The types of business are arguably unlimited as new forms of business constantly emerge and existing businesses undergo transformation. Generally speaking, all business activities involve capital and human efforts. The UN Model Convention recognizes the following forms of businesses:

- Manufacturing and processing (factory, workshop) (Art.5(2))

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[16] Ibid., para.10.1.

[17] Under the OECD Model Convention, Articles 5 and 7 apply to professional and other independent services, whereas the UN Model Convention has a separate provision, Article 14, for the taxation of such services.

[18] John F. Avery Jones, et al, "Treaty Conflicts in Categorizing Income as Business Profits: Differences in Approach Between Common Law and Civil Law Countries" in Arnold, Sasseville and Zolt, supra note 6, at p.25-54.

- Sales and trading (office, branch, Art.5(2))
- Extraction of natural resources (Art.5(2))
- Construction ((Art.5(3)(a))
- Services (including consultancy services) ((Art.5(3)(b); Art.14)
- Insurance (Art.5(6));
- Professional services (Art.14);
- Agriculture and forestry (Art.6)
- Immovable property (Art.6)
- Banking (Art.7(3));
- Transport (Art.8)
- Investment (Arts.10, 11 and 12) (i.e., investment in equity, lending, licensing and leasing).

As summarized in Table 1 below, the UN Model Convention specifies different thresholds for some types of businesses.

**Table 1: Taxation of Business Profits under the UN Model Convention**

| **Type of business profits** | **UN Model** | **Threshold for taxation in Source country** | **Taxable Amount** |
|---|---|---|---|
| General | Art.7 | PE | Net profit |
| Immovable property | Art.6 | Situs of property | Net profit (gross-basis withholding on rent is allowed in some cases) |
| Transport | Art.8 | N/A (taxable exclusively in the country in which the place of effective management is situated) | |
| Dividends, interest, and royalties | Art.10<br>Art.11<br>Art.12 | - Residency of payer, or<br>- PE or fixed base that bears the cost of the interest/ royalties | -Gross amount under Arts.10,11 and 12<br>-Net basis under Art.7 and Art.14 |
| Alienation of movable property forming part of a PE or fixed base | Art.13 | PE or fixed base | Net basis |
| Alienation of shares of a company if the property of the company consists “principally” (more than 50%) of immovable property | Art.13 | Situs of the property | Net basis |

| Independent personal services | Art.14 | - fixed base, or<br>- physical presence of 183 days or more in any 12-month period | Net basis |
|---|---|---|---|
| Artistes and sportspersons | Art.17 | - place of activities/ performance | Net basis (generally) |

## 3.2 Application of Article 7

Business profits derived by non-residents in the source country are potentially taxable under several provisions of a tax treaty, depending on the type of business activity. For example, profits from immovable property are taxable under Article 6; profits from international shipping and transportation are taxable under Article 8, and profits from holding investments or licensing or leasing property are taxable under Articles 10, 11 and 12, and profits from services may be taxable under Article 14 (UN Model Convention, independent personal services) and Article 17 (artistes and sportspersons). These other provisions prevail over Article 7 subject to the throwback rules in Arts 10(4), 11(4), 12(4) of the UN Model Convention and 12(3) of the OECD Model Convention. Each provision contains its own threshold for source country taxation.

The source country is prohibited from discriminating against PEs of non-resident enterprises (Article 24(3) of both the UN and the OECD Model Conventions). Similar businesses conducted by local residents and non-residents should, therefore, be treated similarly. This is likely one of the reasons why Article 7 prescribes only general principles for the determination of the amount of profit taxable in the source country. The general rules of accounting and source rules under domestic law generally apply to attributing profits to a PE. Similarly, the general rules of tax reporting and payments are presumably the same or similar for domestic enterprises and non-resident taxpayers.

# 4. Permanent establishment

## 4.1 General threshold and the "effectively connected" rule

Article 7(1) of both the UN and the OECD Model Conventions provides that the business profits of an enterprise resident in one country cannot be taxed in the other country unless the business is carried on through a PE in that other country (or source country). The existence of a PE is thus a threshold for taxation by the source country. Furthermore, once a non-resident taxpayer has a PE in

the source country, not only business profits attributable to the PE are taxable in the source country, so are dividends, interest and royalties if the holding of the shares, debts or property is effectively connected with such PE.[19] The UN Model Convention further allows the source country to tax profits derived from sales in the source country of goods and merchandise of the same or similar kind as those sold through that PE, or other business activities carried on in the source country of the same or similar kind as those effected through that PE. Tax treaties define the meaning of a PE in different ways, depending on the type of activities.[20]

## 4.2 Fixed place of business without specific time requirement

Article 5(1) of both the UN and the OECD Model Conventions defines the term permanent establishment to mean "a fixed place of business through which the business of an enterprise is wholly or partly carried on". A fixed place of business is thus clearly the core of the concept of PE. It generally refers to a specific geographical location that is used to carry on business for a certain period of time. Each geographical location is treated separately unless the places constitute a "coherent whole commercially and geographically"[21]. The place of business must have a "certain degree of permanency, i.e., if it is not of a purely temporary nature".[22]

Article 5(2) lists the following examples of fixed places of business: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

## 4.3 Building site, project or supervisory activity lasting more than 6 months

The nature of a construction business is service. When a non-resident corporation builds buildings, roads, bridges or canals or lays pipe-lines, etc., the non-resident taxpayer is rendering a service to its clients who own the building, road, etc. Article 5(3) of the UN Model Convention provides that a PE

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[19] Articles 10(4), 11(4) and Article 12(4), respectively, of the UN Model Convention.

[20] For further discussion, see Brian J. Arnold, "Threshold Requirements for Taxing Business Profits under Tax Treaties," in Arnold, Sasseville and Zolt, supra note 6, at p. 55-108.

[21] Paragraph 3 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 5.1 of the Commentary on Article 5 of the OECD Model Convention.

[22] Paragraph 3 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 6 of the Commentary on Article 5 of the OECD Model Convention.

encompasses a building site, a construction, assembly or installation project or supervisory activities in connection therewith,[23] but only if such site, project or activities last more than six months (12 months under the OECD Model Convention).

In determining how long the site, project or activity has existed, no account is taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. In other words, a non-resident taxpayer may spend five months on each unconnected building site without having a PE.[24] On the other hand, the very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously (e.g., building roads or canals) as the project progresses. In this case, the activities performed at each spot are treated as part of a single project and the project is regarded as a PE if, as a whole, it lasts for more than six months.[25]

## 4.4 Physical presence

The UN Model Convention uses a physical presence threshold for professional services (Article 14) and other services (Article 5(3)(b)). For example, Article 5(3)(b) provides that a PE encompasses "the furnishing of services, including consultancy services, by an enterprise, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period". A similar physical presence test applies to independent personal services under Article 14 of the UN Model Convention.[26]

In the case of entertainers and sportspersons, however, there is no specific time requirement (Article 17). Therefore, any performance of entertainment or athletic activities in the source country is sufficient to give the source country the right to tax.

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[23] The OECD Model Convention does not mention assembly and supervisory activities. For further discussion of the differences between the UN and OECD Model Conventions, see paragraph7 of the Commentary on Article 5 of the UN Model Convention.

[24] Paragraph 11 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph18 of the Commentary on Article 5 of the OECD Model Convention.

[25] Paragraph 11 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 20 of the Commentary on Article 5 of the OECD Model Convention.

[26] For further discussion of Article 14, See Ariane Pickering, Taxation of Non-resident Service Providers, Paper 6-A of this collection.

## 4.5 Collection of insurance premiums or insurance of risks

Article 5(6) of the UN Model Convention deems a non-resident enterprise to have a PE if it collects insurance premiums in the source country or insures risks situated in the source country through a person other than an independent agent. The activity of collecting premiums or the location of the risks alone gives rise to a PE. There is no requirement of a fixed place of business or any time requirement.

This deeming rule and Article 17 are the most significant deviations from the core notion of PE as they require neither "a place of business" nor "any degree of permanence" in the source country.

## 4.6 The nature and level of activity of agents

Instead of carrying on business in the source country directly, a non-resident enterprise may carry on business activities through an agent. Article 5(5) of the UN Model Convention provides that a dependent agent constitutes a PE if the agent has the authority to conclude contracts on behalf of the non-resident enterprise and habitually exercises that authority in the source country[27], or if the agent has no authority to conclude contracts, but habitually maintains in the source country a stock of goods or merchandise from which he/she regularly delivers goods or merchandise on behalf of the non-resident enterprise[28]. Merely having employees or agents present in the source country does not give rise to a PE.

Activities of an independent agent do not constitute a PE. However, the independent status is not available when the activities of an agent are carried out wholly or almost wholly on behalf of the non-resident enterprise, and there is no arm's–length relationship between the agent and the non-resident enterprise[29].

In general, even if a non-resident enterprise has a fixed place of business or dependent agents in the source country, no PE exists if the business activities are of "preparatory or auxiliary nature" (Article 5(4)).

[27] Article 5(5) (a) of the UN Model Convention.

[28] Article 5(5) (b) of the UN Model Convention.

[29] Article 5(7) of the UN Model Convention.

## 4.7 Subsidiary versus PE

Very often business activities in the source country can be carried on by a non-resident enterprise through a local company or a PE. A subsidiary company is a separate entity and taxable on its income. Technically, the source country is the residence country of the subsidiary. Economically speaking, however, the subsidiary's income may be derived exclusively from business activities in the source country in the same way as a PE.

Article 5(8) of the UN Model Convention is clear that a subsidiary company should not of itself constitute a PE of the parent. However, if the subsidiary acts as an agent on the parent's behalf, or the parent uses subsidiary's place of business to conduct its own business activities, the subsidiary may be deemed to be a PE of the parent. In such cases, the subsidiary's income and the parent's income must be separated for source country tax purposes. The non-resident parent is taxable in the source country on business profits attributable to the PE. The subsidiary is taxable on its income. Transfer pricing issues must be considered in examining the transactions between the subsidiary and the parent, irrespective of the status of the subsidiary as a separate company or a PE.

## 4.8 Remote businesses

The existing PE threshold relies on the existence of a fixed place of business and/or physical presence of the non-resident enterprise in the source country. When a non-resident enterprise sells goods or services to customers in the source country without using a place of business or being physically present there, irrespective of the volume of business, the source country has no jurisdiction to tax the business profits under the treaty for lack of a PE. The only exception is the taxation of technical fees.

In some tax treaties concluded by developing countries, technical fees are treated like royalties and are subject to a final withholding tax in the source country even when the technical services are provided outside the source country, as long as the payer is a resident of the source country. The taxation of remote business activities in this case is administratively feasible because the amount of payments tends to be significant and bundled with royalties in technology transfer agreements. Since royalties are subject to withholding tax, there is little additional compliance burden on the withholding agent in respect of withholding from technical fees.

# 5. Attribution of profits

## 5.1 Introduction

Once a PE exists in the source country, Article 7 allows the source country to tax the profits attributable to the PE as long as these profits are not taxable under other provisions of the treaty. The determination of the amount of profits attributable to the PE is governed by Article 7 as well as domestic law. The main issues in applying Article 7 include the scope of force of attraction doctrine, transfer pricing issues, deductibility of expenses, and source rules. A related issue is the relationship between Article 7 and the non-discrimination provision in Article 24. There are also administrative issues related to trading accounts, books and records, and burden of proof.

## 5.2 Force of attraction

A general principle in Article 7 is that the source country's right to tax the non-resident enterprise's business profits does not extend to profits which are derived by the enterprise from that country but that are not attributable to the PE. This means that the tax authorities of the source country should look at the separate sources of profits that the enterprise derives from its country and apply to each the PE test. For example, an enterprise may set up a PE in the source country to carry on manufacturing or processing activities and also sells different products in the source country through an independent agent. Only the profits of the PE are taxable in the source country. As such, Article 7 rejects the "force of attraction" principle, which would allow the source country to tax not only the profits attributable to the PE, but also other profits (such as the sales of different products through an independent agent), dividends, interest and royalties arising from sources in the source country.

The UN Model Convention adopts a limited force of attraction rule which allows the source country to tax profits attributable to sales in the source country of goods or merchandise of the same or similar kind as those sold through the PE or other business activities carried on in the source country of the same or similar kind as those effected through the PE. This functions as a limited anti-avoidance rule.

## 5.3 Transfer pricing issues

The profits of the PE are to be determined as if the PE were a distinct and separate enterprise dealing at arm's length with the non-resident enterprise and other parts of the enterprise. If the enterprise has

multiple PEs, the income attributable to each PE must be determined separately. If domestic enterprises are not required to compute the income of each branch separately, a potential tax discrimination issue arises under Article 24.

It is beyond the scope of this paper to discuss the transfer pricing rules. It suffices to note that there are additional challenges in applying the transfer pricing rules to the PE. For example, the "transactions" between the PE and the enterprise are based on internal agreements, not legally binding contracts. Some enterprises may not keep separate or accurate accounts for each PE. If available accounts do not represent the "real" facts, then "new accounts will have to be constructed, or the original ones rewritten and for this purpose the figures to be used will be those prevailing in the open market."[30]

## 5.4 Deductibility of expenses

The deductibility of expenses is generally governed by domestic law. Expenses incurred for the purpose of earning business income are generally deductible. The amount of deduction may be limited to the reasonable amount.[31]

Only actual expenses incurred for the purposes of the business of the PE are deductible. Payments of royalties, fees for services and interest (other than a banking enterprise) between the PE and the non-resident enterprise are not recognized under Article 7(3) of the UN Model Convention. The ban does not apply to interest, royalties and fees actually incurred and paid to third parties. In the case of internal debts (other than in case of banks), because money is fungible, it may be difficult to determine the portion of interest payable on internal loans and the portion on loans from third parties. The Commentary on Article 7 of the UN Model Convention suggests a practical solution: the determination "would take into account a capital structure appropriate to both the organization and the functions performed taking into account the need to recognize that a distinct, separate and independent enterprise should be expected to have adequate funding".[32]

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[30] Paragraph 15 of the Commentary on Article 7 of the UN Model Convention, quoting paragraph 14 of the Commentary on Article 7 of the 2005 OECD Model Convention.

[31] E.g., section 67 of the Canadian Income Tax Act limits the amount of deductible expense to the reasonable amount.

[32] Paragraph 18 of the Commentary on Article 7 of the UN Model Convention.

## 5.5 Source rules

In applying Article 7, a question of geographical source may arise. Does the phrase "profits attributable to a PE" mean profits resulting from transactions and activities in the PE country or profits from transactions and activities connected with the PE, irrespective of whether they are located in the PE country or not? The latter meaning is considered more appropriate.[33] In attributing profits to a PE, it is the nexus of a revenue or expense with the business activity of the PE that is important, not necessarily the geographical source of the revenue or expense in the source country. The key is whether the revenue or expense is related to the activities carried on by the PE in earning the income that is considered taxable in the source country.

The above point is confirmed by the effectively connected principle underlying Articles 10, 11 and 12: dividends, interest, royalties and other income that is effectively connected with a PE are attributable to the PE and taxable under Article 7. However, the force of attraction rules under Article 7(1) (b) (c) capture only the profits from sales and other business activities carried on in the source country.

## 5.6 Non-discrimination

Specific rules or administrative practices that seek to determine the profits attributable to a PE, even if they are different from those applicable to branches of domestic companies, are generally not discriminatory within the meaning of Article 24(3) of the UN Model Convention. The key test is whether the differential treatment results in more burdensome taxation for the PE. Article 24(3) states that the taxation of a PE shall not be less favorably levied in the source country than the taxation levied on enterprises of that state carrying on the same activities.

## 5.7 Trading accounts, books and records, and apportionment

The computation of profits attributable to a PE often starts with the "real facts of the situation as they appear from the business records of the PE and to adjust as may be shown to be necessary the profit figures which those facts produce".[34] The business records may include trading accounts of the PE or

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[33] Brian J. Arnold and Jacques Sasseville, "Source Rules for Taxing Business Profits under Tax Treaties," in Arnold, Sasseville and Zolt, supra note 6, 109-131, at p.117-124.

[34] Paragraph 15 of the Commentary on Article 7 of the UN Model Convention, , quoting paragraph 12 of the Commentary on Article 7 of the OECD Model Convention.

even separate accounts of the PE. The accounts may need to be rectified by the tax authorities in accordance with the arm's length principle discussed above.

Apportioning of the non-resident enterprise's profits to the PE on the basis of some formulae is allowed as long as it has been customary in the source country to use this method and the result is in accordance with the principles of Article 7. The method of attributing profits to a PE should be the same year by year unless there is good and sufficient reason to the contrary.

### 5.8 Time limits and burden of proof

Article 7 does not deal with time limits or the burden of proof. These issues are governed by domestic law. In countries that implement a self-assessment system, non-resident enterprises are normally required to file annual tax returns in the same manner as residents in the source country. In the case of disputes, generally the taxpayer bears the burden of proof of facts.

## 6. Tax collection and enforcement

Enforcement of tax liabilities of non-resident taxpayers generally depends on the physical presence of a PE, assets within the source country, and withholding. One of the reasons for using the PE threshold in tax treaties is the practical difficulty in tax collection without it. If a non-resident taxpayer has a factory, a mine or other fixed places of business in the source country, it is generally easier for the tax authorities to seize the assets attached to the PE. If the value of those assets is sufficient to satisfy the tax claim, enforcement is not a problem. Even if the assets are not attached to a PE but are located within the source country, they may be subject to domestic collection measures.

Difficulties arise when the taxpayer's assets are located abroad. In the absence of a tax treaty, the source country's tax claims are generally not recognized or enforced in foreign countries on the ground of the "revenue rule" in international law.[35] This rule is overruled by Article 27 of both the UN and the OECD Model Conventions, which provides for mutual assistance in tax collection. It is unclear how many developing countries actually include this provision in their tax treaties and if this provision has been used in practice.

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[35] More discussion of the revenue rule can be found in Maria Amparo Grau Ruiz, Mutual Assistance for the Recovery of Tax Claims (The Hague: Kluwer Law International, 2003), at p. 16-40.

## 7. Conclusions

Effective taxation of non-residents' business profits by the source country requires thoughtful provisions in domestic law and tax treaties that define and measure the non-residents' tax liability as well as an efficient and workable system of reporting, verification and collection.

Through strengthening the capacity to administer the taxation of non-residents on business profits, the tax authorities in developing countries may be able to adopt some good practices in other countries or international norms and use them as a catalyst to improve tax administration in general. It is true that the administration of domestic taxation is different from the administration of international taxation. But, the procedures and measures put in place to effectively collect taxes from non-residents may be used to collect taxes from domestic enterprises. This is particularly true in countries that are at the early stage of developing capacity in administering income taxation.