Symposium: Summary of the Proceedings of an Invitational Seminar on the Taxation of Business Profits Under Tax Treaties

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INTRODUCTION

From October 24 to 26, 2002, an invitational seminar on the taxation of business profits under tax treaties was held at Harvard Law School in Cambridge, Massachusetts. The seminar was a followup to the invitational seminar on the future of tax treaties in the 21st century held in 2001 in Amsterdam. Both seminars were jointly sponsored by the Canadian Tax Foundation, Harvard Law School's International Tax Program and Fund for Tax Research, the International Bureau of Fiscal Documentation, Maisto e Associati, Milan, and the Organisation for Economic Co-operation and Development (OECD).

Seminar participants included treaty negotiators and other government officials, representatives of international organizations, academics, and tax practitioners from around the world. A complete list is provided in appendix 1. The participants attended the seminar in their personal capacities rather than as representatives of their organizations.

The 2001 seminar examined tax treaties from a broad theoretical perspective, dealing with such issues as the role of tax treaties, the possibility of a multilateral tax convention, and the interaction of tax and non-tax treaties.[1] In contrast, the 2002 seminar focused on a specific area of treaty taxation and was intended to be less theoretical.

The taxation of business profits was selected as the topic for the seminar both because of its importance, as a central feature of bilateral tax treaties, and because of its timeliness. In recent years, the provisions of tax treaties, and in particular the concept of permanent establishment (PE), have come under increasing scrutiny as a

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result of the growing importance of service businesses and electronic commerce. Technical issues arise concerning the operation of the existing treaty provisions, and on a more fundamental level, there is a continuing debate over the respective merits of the arm's-length principle and formulary apportionment as mechanisms for the allocation of business profits. The OECD has recently issued draft changes to the commentary on the OECD model convention[2] dealing with PEs, both in general and in connection with electronic commerce in particular.[3] The OECD is also currently working on the application of its transfer-pricing guidelines to PEs.[4] These concerns and developments are reflected in the issues addressed at the seminar.

This article summarizes the seminar discussions. Comments made during the discussions have not been attributed to specific participants. The authors of this summary are solely responsible for its content; however, an earlier draft was made available to the participants for their comments.

The agenda for the seminar, reproduced in appendix 2, attempted to arrange the discussions of the topic in a logical sequence reflecting the issues that must be addressed by source countries in taxing the business profits of non-residents. These steps involve the determination of

- the nexus required between the business profits derived by a non-resident and a country in order for the country to exercise its taxation rights;
- a minimum threshold requirement for the taxation of a non-resident's business profits;
- geographic source rules to determine what revenue and expenses are properly attributable to a country;
- rules for computing the business profits of a non-resident; and
- rules with respect to the enforcement of tax payable by a non-resident, including information-gathering and tax-collection mechanisms.

It is clear that these steps are intimately connected, and some participants expressed dissatisfaction with the order set out in the agenda.

To provide some focus for the discussions, papers were prepared for each session and distributed in advance to the participants. These papers are not reproduced here but will be published in due course. The titles of the papers and their authors are set out in appendix 3. Although the discussions were not limited to the content of the papers, the papers provided the foundation for the discussions. Accordingly, this summary includes brief references to the papers.

TAX TREATIES AND THE TAXATION OF BUSINESS PROFITS: OBJECTIVES AND ISSUES

The paper by Eric Zolt and Jennifer Kowal introduced a series of questions to be considered in discussing alternative regimes for the allocation of taxing rights and revenue from business activity among competing jurisdictions. The paper also discussed several concepts and criteria that might be helpful in evaluating reform proposals and the limitations of these concepts and criteria in the global setting. Zolt and Kowal suggested that the seminar participants consider the strengths and weaknesses of the current system for taxing business profits, decide which aspects of the existing regime work well, and identify the most significant problems. They questioned recent predictions for the decline of the corporate income tax, but they also suggested that the relative robustness of tax revenues from corporate profits over the last 10 years may reflect the high level of corporate profits during the 1990s more than the soundness of the current tax regime. Recent changes in the economic environment may expose the increasing inability of many countries to tax the business profits of non-resident taxpayers effectively.

Zolt and Kowal provided a list of topics to be covered during the seminar and suggested that for each of the topics a range of approaches exists. There is often a choice between making incremental changes to the existing system to cope with the immediate problems and designing and adopting a fundamentally new approach. There also exists a range of possible actions, such as unilateral changes to internal law, bilateral changes to tax treaties, regional approaches, such as the European Union proposals,[5] and multilateral proposals.

Zolt and Kowal noted that the current system for allocating taxing rights and revenue from business activity among competing jurisdictions was designed in the 1920s in the context of a very different global economic climate. Given the extent of the changes in the economic and political environment since then, reform of the original framework to accommodate these changes would be very challenging.

In their paper, Zolt and Kowal posed the following questions:

- Are criteria such as fairness, economic efficiency, and administrative feasibility, which are generally applicable in evaluating domestic tax reform proposals, easily transferable from a national setting into a global context?
- Do concepts such as capital import neutrality, capital export neutrality, and national neutrality provide much guidance in designing reform proposals?
- Are the "benefit," "entitlement," and "market access" theories, which justify source-country taxation, useful in the consideration of the rights of a country to tax and the amount of tax revenue to be allocated to a particular country?

Zolt and Kowal also suggested that it was necessary to have an understanding of the goals of reform proposals. Possible objectives include

- a better matching of economic and tax income within a particular jurisdiction;
- a fairer allocation of the revenues from cross-border business activity; and
- improvement of global economic efficiency by minimization of tax distortions.

Zolt and Kowal also questioned why the current treaty rules for taxing business profits accord so much respect to the legal form of entities and transactions, especially in contrast to the approach based on economic substance taken by many countries for domestic tax purposes. In particular, the treatment of wholly owned foreign subsidiaries as separate taxable entities effectively allows taxpayers to elect the tax regime applicable to their foreign business operations.

Zolt and Kowal questioned why it has been so difficult to come up with good alternatives to the current system. They identified four reasons:

1. the lack of sound criteria or theory for evaluating proposals;
2. the difficulty of deciding where to begin in the process for changing or improving the current tax regimes;
3. the technical difficulty of coordinating the many components involved in any major reform proposal; and
4. the fact that many of the hard questions are more political than technical.

Zolt and Kowal speculated on what could be done to make the task of reforming the tax system for business profits easier, and they noted some encouraging developments. First, there is an increasing convergence of tax systems and tax rates, although harmonization remains elusive. Second, the return of schedular taxation of income from capital may change current thinking about the taxation of income from cross-border transactions. Finally, there is a growing body of relatively recent experience with regional and multilateral tax initiatives, including the European Union tax coordination proposals, the evolution of transfer-pricing provisions, and the effort to address harmful tax competition.

The discussion first focused on perceived weaknesses of the current regime for taxing business profits. One participant questioned whether the threats to the corporate tax base are actually as great as is generally claimed and suggested that the present regime, although flawed, works relatively well in the vast majority of cases. Another participant asserted that the magnitude of the problem is overstated because income taxes from business profits constitute a small percentage of total tax revenues. Other participants disagreed, noting that for many countries, corporate tax revenues are a very important component of total tax revenues. It was noted that the decline in revenues from trade taxes because of the globalization of trade has increased the importance of corporate tax revenues, especially for developing countries. Corporate tax revenues often represent 20 to 30 percent of total tax revenues for these countries, and a large proportion comes from non-resident taxpayers and cross-border transactions. Another participant noted that several countries have decided voluntarily to offer tax concessions to corporate taxpayers and asked why there is so little political will to collect corporate taxes in these countries.

The participants disagreed on whether multinational companies support efforts to reform the current tax treaty regime governing the taxation of business profits. Some participants claimed that multinationals favour changes, and perhaps even the adoption of some type of formulary apportionment, as a way to reduce their overall tax compliance costs. Other participants thought that multinational companies have devised effective tax minimization strategies within the context of the current regime and would not support efforts for major reforms that might increase their tax burden.

A few participants raised the issue of how an international consensus on the taxation of business profits under tax treaties would intersect with countries' differing internal tax laws. One participant noted that any major change in tax treaties would require changes in internal laws as well, and that this relationship exacerbates the difficulty of adopting major reforms.

The discussion then moved to the situation within the European Union. One participant questioned how any changes to the international tax regime would work given the activist role of the European Court of Justice. Tax treaties might apply to all countries in the European Union (either formally or through the actions of the Court of Justice) rather than on an individual country basis. It was suggested that tax experts should lead reform efforts so that the European Court of Justice will not make tax law without considering tax policy. Another participant criticized the European Court of Justice for regarding the European Union as a single market entity in deciding tax cases. The difficulty is that, while the member states must adapt their tax systems to a single market, they cannot agree on a single system.

The group then discussed the function of tax treaties, and whether any reform efforts should focus on the narrow rules of treaties and their effects on the treaty partners or, more broadly, on the interaction of the internal tax rules of a country and treaty provisions. One participant reminded the group that treaties are "bilateral deals" between governments pursuing their own national interests; they are not necessarily driven by a grand view of the optimal division of revenues from cross-border business activity on a global basis. Another participant noted that basing treaties on a normative idea of what countries should do is not sound policy, because sovereign nations may have a different view of what can be agreed in bilateral arrangements with different countries.

Turning to the various goals of tax treaties, some participants noted that one purpose of tax treaties is to permit source-based taxation without causing double taxation. One participant noted that, despite any economic inefficiency or potential for double taxation, a country may choose to impose source-based taxes in order to meet its revenue needs, to protect the residence tax base, and to avoid more favourable treatment for non-residents as compared with resident taxpayers.

The group also discussed the process of reform and the objectives of a new treaty regime for taxing business profits. It was generally agreed that the lack of an overarching economic theory and the absence of clear criteria contribute to the difficulty of reaching agreement on reform proposals. Nevertheless, several participants noted the importance of identifying some guiding principles as a general framework for treaty negotiations, so as to provide negotiators with a "compass" in drafting individual bilateral treaties. While some participants cautioned against "reinventing the wheel" in devising a new system, others questioned why change should proceed incrementally from the compromises of the current system.

Participants also raised concerns that any changes to the current treaty rules for taxing business profits should not disadvantage developing countries. One participant noted that a formulary apportionment approach with significant weight given to a sales factor may provide developing countries with a greater share of tax revenues from business activity than the current arm's-length approach.[6] Participants also noted that although different types of taxes share common economic features (for example, similarities between a value-added tax and a corporate income tax or a consumption tax and a tax on labour), the rights to revenues from such taxes among countries vary greatly. The allocation of corporate tax revenue among countries based on where productive activities occur or value is added, with no recognition for the country in which the consumption of goods or services occurs, likely works against developing countries.

Some participants suggested that the lack of an overriding theory for reform makes it easy for countries to oppose reform proposals, particularly if a country may risk losing tax revenues because of the changes. Accordingly, any multilateral solution may rest on a common perception that total tax revenues from cross-border business activity will increase under the proposed alternative. Thus, those countries losing tax revenue under a reform proposal may be compensated from an increase in total tax revenues.

The discussion concluded with a few members urging the group to think creatively about reform proposals and in particular to consider the economic connections between types of income classified under different labels in the current system, in order to uncover some guiding principles. Some participants noted the importance of developing concrete proposals so that a framework for reform will be available in the event that the political conditions occur to permit implementation.

IDENTIFYING BUSINESS INCOME AND DIFFERENT TYPES OF BUSINESS INCOME

John Avery Jones argued in his paper that countries identify a business and business profits in different ways. In general, civil law countries tend to treat all of the income of business entities as business income. In contrast, common law countries tend to use a schedular system that distinguishes between business income and passive investment-type income. These different approaches to the identification of business profits are incorporated into tax treaties because the definition of the term "business" in article 3 of the OECD model convention is inclusive and paragraph 10.2 of the commentary indicates that the term "business" has the meaning that it has under domestic law.

Avery Jones considered whether the different approaches of civil law and common law countries made any real difference in terms of the result obtained in particular cases under tax treaties. The analysis of this point raises the relationship between article 7 (business profits) and the other distributive articles of the treaty. In many cases, both civil law and common law countries will reach the same result. Common law countries will apply the relevant article if they determine that the activity does not amount to a business. In contrast, civil law countries will initially apply article 7; however, paragraph 7 of article 7 will then require the application of the other relevant distributive article. The difference in approach can be significant, according to Avery Jones, in the case of dividends, interest, and royalties because those items are taxable under article 7 if they are attributable to a PE. For example, if a common law country considers amounts derived by a non-resident to be dividends, interest, or royalties and not business profits, the existence of a fixed place of business (PE) in the country is irrelevant; as a result, the country may apply withholding tax to the dividends, interest, or royalties received by the non-resident. In contrast, if the taxpayer is resident in a civil law country, the civil law country may exempt the income derived from a common law country because it considers the taxpayer's fixed place of business in the common law country to be a PE and considers the dividends, interest, or royalties to be attributable to the PE.

One possible solution explored by Avery Jones is to have a definition of business profits for purposes of tax treaties. He concluded that this solution would not be effective even if a meaningful definition could be agreed on. First, if the treaty definition were broader than the definition under domestic law, the country in which the PE was located would not be able to tax the income attributable to the PE under its domestic law, but the residence country would exempt the income within the treaty definition. Second, if the definition in the treaty were narrower than the domestic law meaning, other problems would likely result for civil law countries, since they would have to apply a treaty categorization of an amount that was different from their domestic law categorization.

Avery Jones considered a number of specific situations in order to determine where real problems arise and then to fashion solutions for those problems. According to Avery Jones, the only serious problem arises where dividends, interest, or royalties are attributable to a PE in the source country—in which case, article 7 applies. One possible solution raised by Avery Jones to deal with the relationship between article 7 and the articles dealing with dividends, interest, and royalties is to make the application of article 7 conditional on the actual imposition of tax by the country in which the PE is located on the income attributable to the PE.

The discussion commenced with consideration of a further problem that arises where a bank earns interest income from a country in which it does not have a PE. In this case, article 11 (interest) will apply to allow the source country to impose a gross basis withholding tax. Since the interest represents business profits to the bank, a gross basis withholding tax will often be excessive. It was argued that, at a fundamental level, the problem is that interest derived by a bank may be characterized as either interest or business profits. Items of income may be characterized by reference to the objective nature of the income (income derived from property, such as interest, dividends, or royalties) or by reference to the nature of the taxpayer deriving the income (such as a bank or a passive investor). Tax treaties do not deal adequately with this fundamental issue; they simply leave it to be dealt with by domestic law. Some participants thought that this is not an appropriate result and that tax treaties should define the terms "business" and "business profits." Other participants suggested that it would not make sense to define "business" and "business profits" for treaty purposes because tax officials would interpret these terms narrowly. Another view expressed was that, because the term "permanent establishment" is defined, the context of the treaty requires that the term "business" should be given a common treaty meaning, and the statement in the commentary requiring the use of the domestic law meaning of the term should be ignored. Another participant suggested that taxpayers could engage in self-help to avoid the difficulty by ensuring that the bank had a PE in the source country so that any business profits would be taxable on a net basis in accordance with article 7. Another participant suggested that the appropriate solution is to eliminate the withholding tax on interest received by banks and on royalties, on the basis of the assumption that these amounts are business profits and should be taxed once in either the source country or the residence country; they should not qualify for exemption in both countries. Another participant suggested that a subsidiary should be treated as the PE of its parent corporation so that royalties paid by the subsidiary to the parent would be subject to source-country taxation.

The discussion focused substantially on the issue of double non-taxation. Some participants thought that, at least in some circumstances, it is acceptable for income not to be taxed in either the source country or the residence country. Other participants were of the view that, in general, source countries give up their right to impose tax on the assumption that the residence country will tax the income. It was suggested that there should be a distinction between intentional and unintentional double non-taxation, and that only the latter is problematic. If both countries decide as a matter of policy not to tax a particular item of income, double non-taxation is clearly acceptable. Some participants suggested that this problem could be solved in the bilateral negotiation of particular treaties and that, as a result, new provisions in the OECD model convention, such as subject-to-tax clauses, would not be necessary. Other participants argued that ensuring at least a single level of taxation is a serious problem for tax treaties. It was pointed out that even for countries taxing on a worldwide basis with a foreign tax credit, it cannot be assumed that foreign-source income is actually subject to tax. Well-advised taxpayers can often secure a result virtually equivalent to exemption through foreign tax credit planning.

According to a number of participants, the key issue is neither double taxation nor double non-taxation of business profits, but rather the overtaxation of business profits derived in the form of interest and royalties. Such amounts should be taxed on a net basis rather than on a gross basis, which often results in overtaxation. There seemed to be general agreement on this point, although one participant argued that undertaxation is the main problem with respect to royalties. Another participant questioned whether tax treaties have any role to play in preventing excessive source-country taxation. The level of source-country taxation is simply a matter for each source country to determine. One participant suggested that the rate of withholding tax could be adjusted in order to reflect more closely a tax on net profits. Source-country withholding tax rates are often set at a relatively high level as a bargaining device to induce other countries to enter into tax treaties. Another reason for a country to have high withholding rates and broad source rules is to ensure that residents of non-treaty countries, especially tax havens, are taxable on their income earned from sources in the country. As a result, tax treaties are essential in order to provide relief for residents of countries imposing tax on their residents on a worldwide basis. Moreover, it was argued strongly that tax treaties serve as models for domestic law and have an important role to play in limiting excessive source-country taxation. As noted earlier, the difficulty in this regard is to distinguish between investment income, which represents pure profit, and business income derived in the same form as investment income, but with respect to which the taxpayer has incurred substantial expenses.

It was argued that if the effect of tax treaties is to eliminate source-country taxation of certain types of income, double non-taxation is a serious concern. One way to deal with this problem is for an exemption country to shift to the credit method for any income that is not taxable in the source country. However, another participant argued that one of the purposes of tax treaties is to allow domestic tax policy to function without undue limitations; therefore, treaties should not contain any general subject-to-tax clause. This point led to a discussion of the role of tax treaties at a more fundamental level. Some participants argued that tax treaties cannot anticipate and deal with every problem. Others pointed out that adding a general subject-to-tax clause would not detract unduly from the broad general nature of tax treaties. Another suggestion was that countries should have smaller treaty networks to limit the possibility of double non-taxation and other abuses of tax treaties. In response, it was asserted that businesses want tax treaties because they provide certainty and stability, not because of the tax-avoidance possibilities.

Finally, the situation in the European Union was raised. Commencing in 2004, companies established under the European company statutes (Societas Europaea) will be able to shift their residence between member countries without restriction. Accordingly, it was pointed out that for any country negotiating a treaty with an EU member country or a country about to join the European Union, it will be necessary to consider the domestic laws of all of the member countries.

THRESHOLD REQUIREMENTS FOR TAXING BUSINESS PROFITS UNDER TAX TREATIES

Brian Arnold's paper attempted to distinguish threshold requirements from the concepts of nexus, or jurisdiction to tax, and source of income. Nexus involves the circumstances in which a country is justified in taxing non-residents on business profits. Traditionally, countries are considered to exercise their jurisdiction to tax residents on their worldwide income on the basis of their personal connections with a country and non-residents only on their income derived from or in a country on the basis of the connection between the income and the country. Source rules are necessary to determine the geographical location of revenue and expenses so that a source country taxes only income that is geographically connected with it. A country is clearly entitled to tax any income that is sourced in the country according to its source rules.[7] However, countries entering into tax treaties have resolved on a reciprocal basis not to tax domestic-source business profits derived by non-residents unless the non-resident's connections with the country exceed a minimum threshold. The general threshold requirement in tax treaties is the existence of a PE.

Arnold argued that some type of threshold requirement is necessary and desirable primarily because

- it provides certainty for both taxpayers and tax administrators as to the circumstances under which a non-resident will be subject to source-country taxation;
- it reduces the compliance burden on taxpayers and the administrative burden on tax officials with respect to non-residents that derive business profits from occasional and temporary activities; and
- it recognizes the practical difficulties in enforcing source-country taxation of business profits derived by non-residents from occasional and temporary activities.

Arnold identified four generic types of threshold requirements:

1. a fixed place of business,
2. physical presence,
3. nature and level of activity, and
4. a monetary amount, usually based on gross revenue.

He suggested that existing treaties typically use the first three. For example, the PE definition is a fixed place of business threshold, supplemented by a dependent agent rule, which is a combination of a physical presence and a nature of activity (the habitual exercise of authority to conclude contracts) threshold, both of which are subject to the exclusion for preparatory and auxiliary activities (a nature of activity threshold).

In light of the reasons for a threshold requirement, Arnold analyzed the definition of a PE and the other threshold requirements for other types of business profits in the OECD and UN model conventions.[8] He identified several deficiencies in the PE requirement: for example, uncertainty and inconsistency with respect to the time element,[9] the emphasis on the conclusion of contracts in the dependent agent rule, and the exclusion for preparatory and auxiliary activities. The most serious deficiency in the existing PE rule, he suggested, is its application to service businesses. Taxpayers involved in providing services often do not require any fixed place of business or dependent agents in a country. Therefore, in Arnold's view, a physical presence test would be more appropriate for service businesses. Arnold also raised the even more difficult issue of the taxation of remote businesses (that is, businesses that produce income from sources in a country without any significant presence there). The discussion of this issue often centres on electronic commerce; however, it extends to many other types of businesses as well.

The discussion focused primarily on broad policy issues concerning threshold requirements in tax treaties, rather than technical deficiencies in the existing definition of a PE in the OECD model convention. There appeared to be substantial, but not unanimous, agreement that some threshold requirement for source-country taxation is both necessary and desirable. Some participants pointed out that the effect of a threshold requirement is to limit the right of the source country to tax business profits. Accordingly, the threshold should not be set at too high a level in order to give adequate recognition to source-country taxing rights. These participants also expressed concern about tax avoidance and double non-taxation. Hard-to-tax persons should not be exempt from source-country tax purely because of practical concerns about enforcement unless such persons are subject to residence-country tax. These hard-to-tax persons could be subject to some type of presumptive taxation. Other participants, in contrast, considered that the primary purpose of a threshold requirement is to encourage cross-border activities. They argued that the existing PE threshold requirement is not a major source of non-taxation and, further, that the threshold issue is rather unimportant. In many circumstances, multinational enterprises can avoid having a PE in a country by doing business through independent contractors or by establishing a subsidiary corporation in the country. In response, it was suggested, but not discussed in detail, that subsidiary corporations should be treated as PEs of the parent corporation.[10] Further, it was suggested that the threshold requirements should be different for individuals and multinational enterprises.

A vigorous debate took place concerning the relationship between a threshold requirement and practical considerations involving the enforceability of source-country taxation. Several commentators have noted that unless non-residents have a substantial presence in a source country, it will be extremely difficult for the source country to enforce its tax. Some participants argued that this rationale for a threshold requirement is faulty in the context of tax treaties because treaties provide mechanisms, such as exchange of information and assistance in collection, to permit the source country to enforce its tax effectively. It was argued in response that, currently, these mechanisms are seldom very effective and that the relationship between a threshold requirement and enforcement concerns is critical. If a threshold requirement were to be abandoned, it would be necessary for a source country wishing to impose tax on a net basis to attempt to obtain tax returns from all non-residents doing business in the country, and the costs of collection would be disproportionately high relative to the amount of tax to be collected. Source countries, and in particular developing countries, would inevitably look to other mechanisms to enforce their taxes effectively. This might lead to the widespread use of gross basis withholding taxes. Such taxes are often excessive because they do not provide adequate recognition for expenses. Moreover, there is a tendency for such taxes to become final taxes because of the practical difficulties in administering a temporary withholding system with non-residents filing tax returns to claim refunds on a net basis.

It was pointed out that it might be instructive to look at the threshold requirements for purposes of value-added taxes. Value-added taxes often use different threshold requirements for different purposes—for example, registration, information gathering, and collection. Many value-added taxes use a monetary threshold based on sales in a particular country, with no requirement for any physical presence. In general, however, value-added taxes are levied on the basis of the place of supply, which requires some physical location in the country. Accordingly, it was argued, experience with threshold requirements for purposes of value-added taxes does not provide instructive lessons for income taxes as far as the taxation of remote businesses is concerned.[11]

One suggestion that stimulated considerable interest and significant debate was the use of a monetary amount based on gross revenue from sales or services as a general threshold requirement in place of the current PE definition. The problem of enforcement would be addressed by a relatively low rate of withholding on all or most payments made to non-residents, coupled with a requirement for non-residents to file tax returns in order to obtain the benefit of net basis taxation. It was argued that this proposal would permit source countries to tax remote businesses and electronic commerce on the basis of revenue derived from sales or services in the country in excess of a certain amount. As a result, countries where consumption occurs would be given some taxing rights based on their providing non-resident sellers and service providers with access to their markets. This type of taxation already exists with respect to non-resident insurance companies, which are sometimes taxable on the premiums that they collect in a country. The critical problem is how to get non-resident sellers to pay source-country tax when they have no fixed place of business or other physical presence in a country. In this connection, it was noted that the United States requires foreign banks to collect information for purposes of the US taxation of non-residents. It was acknowledged, however, that such a measure is extraordinary and feasible only for the United States. Some participants expressed concern that a monetary limit would be set too low and would not be indexed. Other participants pointed out that experience shows that monetary limits are usually set too high rather than too low, in response to political and business pressure. A few participants argued that a monetary threshold should be used only as a supplement to the fixed place of business threshold and not as a replacement of that test. From a practical perspective, one participant noted that a monetary threshold could be used for business-to-business electronic commerce because the necessary information could be obtained from a non-resident's major clients. However, such a threshold would be impossible for business-to-consumer transactions.

Some participants thought that it is inappropriate for source countries to tax remote businesses if the only productive activity occurring in the country is sales or consumption. They argued that, in this case, the appropriate tax to be levied is a consumption tax rather than an income tax. Other participants argued that there is a difference between using sales revenue as a threshold for imposing a source-country tax on the net income derived by non-resident sellers and a consumption tax on the sales themselves. On the other hand, it was argued that a monetary threshold based on sales would not address the concerns of developing countries that the existing rules do not permit sufficient scope for source-country taxation. The view was also expressed that because some developing countries export more than they import, any shift from the current PE requirement to a monetary threshold applicable to sales might result in a net loss of revenue for these countries.

Several participants argued that there is no meaningful distinction between source-of-income rules and threshold requirements. According to them, source rules function as a threshold requirement. A country is not entitled to tax a non-resident on business profits unless the profits are derived from sources in the country. Therefore, the critical issue is the determination of the source of income. Some participants suggested that economic principles concerning the source of income are, at worst, non-existent or, at best, not very useful in this context. As a result, source-of-income rules are largely arbitrary and devised in the course of treaty negotiations, without reference to any underlying economic principles. Some participants argued that it is essential to have underlying economic principles in order to guide treaty negotiations concerning the relevant source rules. One underlying principle put forward is that income should be sourced in the country or countries where productive activities occur or where value is added. Other participants argued that this approach does not give adequate recognition to the country where consumption occurs. Since income cannot occur without the final sale, it was argued, the country where the sale occurs has a legitimate claim that the income is earned there, at least in part.

Arnold suggested in his paper that the dependent agency rule in paragraph 5 of article 5 of the OECD model convention should be deleted. He argued that a threshold requirement based on the authority to conclude contracts is not effective as a threshold requirement. Although there was not much discussion of this issue, it was pointed out that the reliance on authority to conclude contracts in paragraph 5 of article 5 was based on early case law in the United Kingdom. It was also noted that article 7 provides no guidance with respect to the attribution of income to a dependent agent that constitutes a PE. Some taxpayers are apparently taking the position that, in computing the profits of a dependent agency PE, a deduction must be allowed for an arm's-length agent's fee, even though this results in the elimination of any profits for the non-resident. Participants pointed out that this result is inconsistent with the original intention of the dependent agency rule.

Arnold also suggested in his paper that the exclusion for preparatory and auxiliary activities in paragraph 4 of article 7 should be deleted. Some participants thought that the exclusion for preparatory activities is necessary in order to encourage non-residents to explore cross-border business opportunities. There seemed to be some agreement that if preparatory activities continue for more than a specified temporary period—say, three to five years—then the exclusion should cease to apply. One participant suggested that only paragraphs 4(e) and (f) of article 5 should be deleted.[12] It was suggested that the provisions in paragraph 4(d) of article 5 and paragraph 5 of article 7 relating to purchasing activities can be explained by history. Colonial powers did not want their resident enterprises to have PEs in the colonies as a result of their purchases there. These rules may still be justified today because some source countries may wish to encourage purchasing by non-residents.[13] However, it was pointed out that such countries can introduce exemptions for purchasing activities under their domestic tax laws. It is not necessary for purchasing to be exempt pursuant to bilateral tax treaties.

There was broad consensus that the fixed place of business threshold is inappropriate for service businesses and, further, that some type of physical presence threshold, such as exists in the UN model convention,[14] would be more appropriate. Such a physical presence threshold, it was noted, would not catch services, such as financial services, performed outside the source country. Some participants thought that there should be no distinction between services and other types of businesses. Instead, the threshold for all businesses should be based on the physical presence of employees or agents carrying out activities for a non-resident in the source country. This presence threshold would supplement the fixed place of business threshold.

Arnold argued in his paper that the dichotomy between article 7, which requires a non-resident to have a PE in the source country, and article 17, which requires only that a non-resident perform entertainment or athletic services in the source country, is difficult to justify. In the discussion, it was suggested that entertainment for purposes of article 17 should be broadly defined to include activities such as speaking engagements by celebrities. Others thought that article 17 should apply to any high-value services. Several participants agreed that a de minimis monetary threshold for article 17 is appropriate.

SOURCE RULES FOR TAXING BUSINESS PROFITS UNDER TAX TREATIES

Brian Arnold and Jacques Sasseville asserted in their paper that source rules have a dual role under domestic tax systems and tax treaties:

1. to determine which part of the income of a non-resident is taxable by a country; and
2. to determine which part of a resident's income qualifies for relief of double taxation (through either the credit or the exemption method).

Arnold and Sasseville suggested that source rules can be distinguished from threshold rules and rules for the computation of income, even though there is a close connection (and overlap) between these rules in tax treaties. For example, the PE concept is primarily a threshold requirement for taxing business profits sourced in a country. If a PE is found to exist in a country, the profits attributable to the PE are sourced to that country. As discussed later in the paper, however, one could conceivably separate the issues of threshold and source and use the PE concept solely as a threshold so as to allow a country in which a PE of a non-resident exists to tax any business profits sourced in that country (the "force-of-attraction" approach). The limited force-of-attraction approach of the UN model convention is another alternative.

Arnold and Sasseville argued that source rules are "inherently arbitrary" since they do not attempt to determine the place where the productive activities occur. Accordingly, it is more important to achieve international consensus on source rules than to try to get the rules right. This issue generated considerable discussion during the seminar.

Since different treaty articles may apply depending on the nature of the business profits, the various source rules of these articles were discussed in the paper. The provisions of article 7 provide little guidance as regards the source of business profits. The general rule is that the source country is entitled to tax the profits attributable to the PE. Paragraph 3 of article 7 supplements that rule by providing a source rule for expenses; that is, expenses incurred for the purposes of the PE are sourced in the country and attributed to the PE. The absence of clearer source rules has the following consequences, according to Arnold and Sasseville:

- the source of revenue and expenses for purposes of article 7 appears to be essentially a question of fact;
- there is uncertainty for both taxpayers and tax authorities as to what source rules should be applied; and
- countries have considerable latitude to reach different conclusions about the source of revenues and expenses.

Arnold and Sasseville argued that countries should not automatically apply their domestic source rules in the context of article 7 and, for the purposes of appropriately relieving double taxation under article 23, the amount of business profit attributable to a PE should be the same in both the source and residence countries. They inquired whether article 7 should prescribe more detailed source rules for determining the income attributable to a PE.

Arnold and Sasseville identified a number of technical issues related to source rules under article 7 and other treaty articles (specifically, articles 6, 10, 11, 12, and 21) that may apply to business profits. With respect to income from services, they concluded, on the basis of the OECD and UN model conventions, that a source rule for services that looks to the country where the services are performed seems to be broadly accepted, natural, and practical (even though it may not fully reflect economic principles). They acknowledged that such a rule would not capture services consumed in a country but performed remotely. However, the extension of source taxation to such services might be difficult to enforce and might discourage cross-border trade in services.

The paper also dealt with a difficulty arising from the application of the source rules for interest and royalties (where the treaty allows source taxation of these payments) in a triangular case where such payments are made by a resident of a contracting state but are related to a PE located in another state. The PE source rule (which sources interest and royalties to the PE country if the payer, whether a resident of a contracting state or not, has in one of the contracting states a PE for which the interest or royalties were incurred) addresses only one side of the triangular case. It does not deal with the situation where the PE is situated in a third country. The solution proposed in the commentary[15] for this problem may give rise to tax-planning opportunities. The paper notes that, interestingly, the PE source rule applicable to interest and royalties has no equivalent in the article on dividends. Thus, a dividend is always sourced in the country in which the paying company is a resident, even though the dividend may relate entirely to equity capital used for the purposes of a PE outside that country. Many countries find that result difficult to justify in policy terms and provide specifically in their treaties for a right to impose a branch tax as a proxy for a dividend withholding tax. While it may be argued that the logic of the provisions of the model convention should lead to the recognition of PE-source taxing rights for dividends, it can also be argued that, unlike interest and royalties, dividends are not base-eroding payments. Therefore, there is no safety check against a source country's attempt to allocate too large a portion of the dividends paid by a company to PE profits derived from its territory.

Another technical difficulty analyzed in the paper arises in the case of a PE that is the recipient of dividends, interest, or royalties. Since PEs do not generally qualify for treaty benefits in their own right, it is the treaty between the source state and the state of residence of the taxpayer that will apply to such income. This does not seem to be a logical result since the treaty between the state of residence and the state where the PE is located will give exclusive taxing rights (where the residence country uses the exemption method) or prior taxing rights (where the residence country uses the credit method) to the country where the PE is located.

The paper concluded with a discussion of the relationship between domestic and treaty source rules. According to Arnold and Sasseville, cases of conflict of source resulting from different domestic source rules should be solved as conflicts of qualification. More important is the practice of many countries to depart from the wording of the OECD model convention and subject their obligation to provide relief of double taxation to the provisions of their domestic law. Arnold and Sasseville argued that treaty source rules should prevail over domestic source rules for purposes of providing relief of double taxation. Since a fundamental feature of tax treaties is that the source country has taxing rights with respect to an item of income, the residence country is obligated to provide relief of double taxation (through credit or exemption) as regards that item of income.

The main issue discussed in this session was the extent to which source rules are, or should be, derived from economic principles. Some participants agreed with the view expressed in the paper that source rules are to a certain extent arbitrary. They argued that, while economic criteria can help design factors for sourcing income, the source of income is essentially a legal concept and not an economic one. One participant expressed the view that income is simply a number and in most cases does not have any geographical link. A number of participants disagreed with these views. For many of them, it was important to rely on economic principles in approaching the issue of source (even though it was not always clear during the discussion whether economic principles were used to justify source-based taxation, to develop source rules, to compute income subject to source taxation, or to determine the level of source taxes). One participant identified two alternative paradigms derived from economic principles as possible bases for justifying source taxing rights or determining the source of income:

1. the place where value is added (which is the basis on which the arm's-length principle is currently applied); and
2. the place where economic resources (including the legal protection of property rights) are used or accessed.

Another possibility would be to determine the source of income in relation to the location of an economic rent.

The second conceptual basis for justifying source taxing rights gave rise to lengthy discussions focusing in large part on the justification for source taxation by the market state (the country in which goods and services are sold). In discussing the claim to tax of the market state, one participant drew a parallel with consumption taxes. It was argued that the distinction between income taxes and consumption taxes is a tenuous one. Consumption taxes are typically destination-based, although that approach is being challenged in theory and practice, as evidenced by the European Union's attempt to move toward an origin-based approach. Therefore, it was asserted, why should the market country have any difficulty justifying source taxing rights in the case of an income tax, when it is generally agreed that it has taxing rights under the destination principle in the case of a consumption tax? Other participants disagreed with this analysis because income taxes and value-added taxes are different taxes based on different principles. A few participants also disagreed that the proposal for an origin-based approach for supplies under the value-added tax within a single EU market provides support for the suggestion that there is a move away from destination-based consumption taxes.

Another participant argued in favour of the second justification for source-country taxing rights based on the notion of economic rent. The justification is clear, it was argued, with respect to activities such as oil extraction. Accordingly, in this participant's view, economic principles can be helpful in determining where the rent arises.

Another participant argued that justification for source taxation based on economic rent is not entirely satisfactory. Taking the example of a person who provides high-value services in a country, the economic rent argument seems to justify the allocation of source taxing rights to the country where that person received education and training rather than, as is widely accepted, the country where the services are performed. Therefore, as several participants agreed, the real practical issue that underlies the discussion of source is the treatment of intangibles transferred abroad. The problem is not really to determine the appropriate source of the income but rather to value the intangibles at the time of transfer. Another participant, however, argued that the problem also involves article 12 of the OECD model convention, which precludes source taxation of royalties, and suggested that this aspect of article 12 can best be explained by historical reasons.

The economic rent paradigm was also challenged by another participant, who suggested that under an economic rent approach, business income would really belong to the country that supplied the capital for the business. The discussion of the economic rationale for source-country taxation led one participant to observe that there may be competing ways of viewing transactions and therefore of identifying the "right" source of income. It is crucial to take account of administrative concerns when designing source rules. The existing source rules of the United States can probably be explained on the basis of such concerns rather than economic principles.

The discussion of source also touched upon the distinction between residence and source. It was noted that residence rules for business entities act as source rules to the extent that they give rights to a country to tax the business profits of entities found to be resident there. While the location of the headquarters of a corporation might justifiably be used as the basis for determining the source of the income attributable to activities taking place in that location, there seems to be less justification for allocating taxing rights on the basis of existing tests of corporate residence, because most multinationals have important connections with many different countries (shareholders, management, employees, business facilities, etc.). One participant also remarked that source rules are closely related to the rules for the computation of income, so that source rules under a formulary apportionment approach would be different from the source rules in treaties, which are based on the arm's-length principle.

The group also discussed some of the technical issues arising from the current treaty rules. One participant argued that the current treaty source/threshold rules have shortcomings that need to be addressed. The following three situations illustrate the point:

1. an independent agent negotiates a very large construction contract but does not have a fixed place of business in the country where the project is to be carried out and does not spend a significant period of time there;
2. a well-known personality earns a very substantial fee for a speech given in a country; and
3. a satellite operator receives payment for satellite broadcasting of television programs on behalf of a country's broadcasting companies.

In these three cases, the current treaty rules do not allow the relevant income to be taxed in the source country. Therefore, it was suggested, the current rules need to be supplemented by rules that may, for example, allow source-country taxation if "substantial economic activity" takes place in a country.

The last part of the discussion on the issue of source dealt with the need for treaty source rules to be independent from the source rules in domestic law. There was general agreement that, in order to obtain effective relief of double taxation, the country of residence needs to take account of the treaty source rules rather than the source rules in its domestic law. It was noted that this practice has been made clear in recent US treaties.[16] One participant emphasized the need for treaty source rules to be comprehensive and not to be based on domestic law. Thus, treaties should expressly indicate that, for purposes of relief of double taxation by the residence country, income should be considered to be sourced in the other country if it may be taxed in that other country in accordance with the provisions of the treaty (as is currently done in some treaties). It was noted, however, that such a provision is necessary only if the article on relief of double taxation is drafted in a way that makes the treaty relief subject to the provisions of domestic law.

The last point on the topic of source provided a link to the session following since it dealt with an apparent inconsistency between treaty source rules in the context of article 7 and those in the context of articles 10, 11, and 12 (in the case of treaties that allow the source taxation of royalties). Under articles 10, 11, and 12, the return earned by a passive investor who contributes capital or intangible property to a business is sourced in the country where the payer is located. The location of the payer typically corresponds to the place where the business using the capital or intangible is carried on. However, where capital or intangible property owned by a non-resident enterprise is used for purposes of a PE located in a country, the income earned from the capital or the intangible property, to the extent that it is recognized at all in computing the profits of the PE, may not be sourced to the country where the business of the PE is carried on.

TAXATION OF BUSINESS PROFITS AND THE ARM'S-LENGTH PRINCIPLE

Richard Vann's paper provided a fascinating perspective on the application of the arm's-length principle in the context of article 7 of the OECD model convention, by reference to the history and underlying policy rationale of the principle. Originally, the arm's-length principle was developed with respect to branches, not subsidiaries. The focus of the principle shifted to subsidiaries in response to the US transfer-pricing regulations issued in 1968, the commensurate-with-income rules adopted in 1986, and the revised transfer-pricing regulations introducing profit-split methods in 1994. Both the 1979 and the 1994 OECD transfer-pricing guidelines[17] substantially follow the US rules. Since 1994, the OECD has been working on the extension of the transfer-pricing guidelines to PEs. According to Vann, a central feature of the 1979 and 1994 OECD transfer-pricing guidelines applicable to associated corporations is acceptance of the actual transactions entered into by the parties. This feature is alien to the application of the arm's-length principle to PEs because there are no actual legal transactions between parts of a single entity. Vann suggested that the functional analysis recognized in the transfer-pricing guidelines (functions performed in the light of assets used and risks assumed) is inherently inconsistent with a transactional analysis. As a result, multinational enterprises can use transactions to allocate functions, assets, and risks. In his view, it would be unwise to impose the transactional requirement in the application of the arm's-length principle under article 9 to PEs under article 7.[18]

Further, Vann argued that the concept of a PE plays an important role in supporting taxation of corporations on the basis of their residence. Because it is so difficult to define corporate residence in a way that is not subject to manipulation, the taxation of non-residents with a PE in a country ensures that taxation cannot be avoided by simply shifting corporate residence without also shifting the business activities. He also argued that the original intention underlying article 7 was that the existence of a PE in a country meant substantial taxing rights for the country. As a result, it should not be possible for a PE to be stripped of its profits, as would be possible under a transactional approach to the computation of the profits of a PE. On this basis, Vann argued, developing countries are right in seeking to expand the PE definition and the scope of source-based taxation.

Vann's paper suggested that article 7 accommodates two different approaches to the computation of the profits of a PE:

1. an accounts-based system, which is typically applied by civil law/exemption countries, and
2. an allocation approach, which is typically used by common law/credit countries.

Under the first approach, transfers of goods and services between the head office and the PE are treated as transactions that enter the calculation of PE profits. (For example, inventory transferred to a PE would be considered to be acquired by the PE for its fair market value.) In contrast, under the second approach, only actual transactions with other persons are taken into account, and then revenue and expenses are allocated between the head office and the PE. According to Vann, the commentary on article 7 is a curious mixture of both approaches. Paragraph 1 of article 7 supports an allocation approach, while paragraph 2 supports an accounts-based approach. Both approaches are acceptable as long as they reach a result that is in accordance with the arm's-length principle. Vann argued that the OECD's *Discussion Draft on the Attribution of Profits to Permanent Establishments*[19] is misguided in attempting to mandate an accounts-based approach in the form of the working hypothesis.

Finally, Vann's paper made the case that one of the fundamental presumptions of the OECD's discussion draft, namely, that PEs and subsidiaries should be treated the same, is flawed. He pointed out that PEs are treated differently from subsidiaries for purposes of other articles of the model convention (for example, no withholding taxes on notional distributions of dividends, interest, or royalties). Ownership of assets and risks are shared by the head office and the PE because the latter are part of the same legal entity, whereas they may be allocated quite differently among related entities. Vann left no doubt about his preference for the current approach to the computation of business profits in article 7 over the OECD's proposed working hypothesis.

There was substantial disagreement among participants about whether branches and subsidiaries should be treated the same. Some participants thought that branches are sufficiently different from subsidiaries to require different tax treatment. Other participants argued that if branches and subsidiaries are treated differently, taxpayers will be able to elect the desired tax treatment; since this is unacceptable, the treatment of branches and subsidiaries should be roughly similar. It was pointed out that in the European Union, EU law requires a member country to treat branches and subsidiaries of residents of other EU member states no less favourably than it treats its own taxpayers. Although the OECD's working hypothesis assumes that branches and subsidiaries should receive the same treatment, it was argued that the working hypothesis does not require the same result for a branch and a subsidiary, and that the different legal positions of a branch and a subsidiary must be taken into account. Although branches and wholly owned subsidiaries might be similar, the treatment of subsidiaries that are not wholly owned was raised as problematic.

The OECD's working hypothesis came in for serious criticism from some participants. Other participants, however, noted that article 7 of the OECD model convention is currently deficient in not providing principles to guide the attribution of profit to PEs. In the absence of such principles, treaty negotiations could degenerate into opportunistic bilateral deals. It was argued that the working hypothesis represents an attempt to provide a principled framework for attributing profits to PEs based on transfer-pricing guidelines.

Participants engaged in a vigorous debate of Vann's argument that the modern trend of treating a group of related corporations as a single taxpayer (and, as a result, ignoring intragroup transactions) is inconsistent with the respect for taxpayer's transactions in the application of the OECD's transfer-pricing guidelines. The debate went well beyond the attribution of profit to PEs. According to some participants, the transactional approach is unable to capture the residual profits generated by the intangibles of multinational enterprises. In effect, multinationals can choose to allocate residual profits by way of either non-arm's-length royalties or a residual profit split. According to Vann, profit-split methods of transfer pricing ignore transactions, and the onus should be on the taxpayer to establish that transactions should be respected. The allocation of profit to a PE under article 7 is essentially a profit-split method. Some participants argued that controlled foreign corporation rules and thin capitalization rules do not disregard transactions. The former are concerned with determining who is the proper taxpayer, the parent or the foreign subsidiary, and the latter is an example of the application of the economic substance over legal form doctrine. Another participant suggested that respecting the legal form of a corporation (the separate-entity principle of paragraph 2 of article 7) permits taxpayers to manipulate the geographical source of income because source rules are often based on the separate-entity principle. Consolidation is not inconsistent with the arm's-length principle, it was argued, but the question was raised whether bilateral treaties can effectively take account of multinational corporate groups.

There was a brief debate of Vann's argument that the PE concept is intended as support for residence-country taxation. One participant expressed the view that the PE concept plays the dual role of supporting residence-country taxation and establishing source-country taxing rights; moreover, there is no inconsistency between these two roles.

Vann's paper suggested that the residual profits of multinational enterprises should be allocated on the basis of a combination of functional analysis and profit split. In his view, part of the residual profit should be allocated to the country in which goods are sold (the country supplying the market) even though no functions are performed and no value is added in that country. Some participants agreed that the allocation of residual profits should not be governed by arm's-length transactional analysis. Others argued that no profit should be allocated to the market country if no functions are performed or value added there. They suggested, however, that in most cases marketing and sales activities will occur in any market country. It was argued that a country providing writeoffs for research and development has a legitimate claim to tax some of the residual profits. The discussion foreshadowed part of the topic of the last two sessions of the seminar: the allocation of profits by way of formulary apportionment. If the amount of sales is one of the factors in the formula, as is customary, the country supplying the market should be entitled to tax a portion of the profits.

There seemed to be general agreement that the OECD's transfer-pricing guidelines afford considerable scope for multinational corporations to strip profits out of high-tax source countries into tax havens. Captive insurance, thin capitalization, hedging, and commissionaire arrangements were referred to as some of the common methods for stripping profits. On this basis, some participants argued that functional analysis with adherence to legal transactions is not the proper way to allocate profits.

There was some discussion, but no agreement, about two PE cases in which US courts held that treaties overrode the application of US domestic rules.[20] In his paper, Vann argued that these cases are wrong because they require acceptance of the financial accounts of a PE, which is typical of a civil law/exemption system rather than a common law/credit system such as that of the United States. It was pointed out in response that civil law countries typically rely on the accounts for the taxation of entities, not for the allocation of profits between parts of a single entity. It was argued that the *Natl. Westminster Bank* case, in which a US PE of a UK bank was entitled to deduct interest expense in respect of notional loans between the PE and the head office, was more difficult than the *North West Life* case, in which taxation of a PE of an insurance company by reference to a formula based on premiums was rejected. The treaty rules for allocating deductions are unclear—in particular, the meaning of paragraph 2 of article 7, which requires profits to be allocated to a PE as if it were a separate entity dealing independently with the other parts of the enterprise. As a result, it was unclear how profits were to be attributed to the PE in the *Natl. Westminster Bank* case. It was suggested that perhaps the reference to article 7 in paragraph 7 of the commentary on article 15 provided some assistance in this regard. This point led to a discussion of the Canadian *Cudd Pressure* case,[21] in which the deduction of notional rent in computing the profits of a Canadian PE of a US company was denied. It was suggested that the word "incurred" in paragraph 3 of article 7 provides a basis for denying the deduction of notional expenses. It was also pointed out that tax treaties do not permit withholding taxes on notional payments. As a result, if notional expenses were deductible, countries would need to adopt branch-level interest and royalty taxes.

Finally, there was a brief discussion of paragraph 4 of article 7. Paragraph 4 allows profits to be attributed to a PE on the basis of apportionment as long as that method has been customarily applied. The result of the application of the apportionment method, however, must be in accordance with the principles of article 7. Some participants thought that this caveat could be satisfied rarely, if ever, because the arm's-length principle in article 7 is inconsistent with any apportionment method. Others argued that article 7 accommodates different methods for attributing profits to PEs. Reference was made to paragraph 24 of the commentary on article 7, which indicates that in situations in which it is impractical to construct accounts for a PE, it is acceptable to use other methods to estimate the arm's-length profits of the PE. It was also pointed out that paragraph 4 of article 7 deals with the apportionment of the worldwide profits of an enterprise, whereas paragraph 2 of the article deals only with the profits of a PE from dealings with the head office and other PEs.

TECHNIQUES FOR EFFECTIVELY COLLECTING TAXES ON BUSINESS PROFITS: WITHHOLDING TAXES AND OTHER ALTERNATIVES FOR GROSS AND NET BASIS TAXATION

The paper by Robert Couzin examined how a country can assess and collect taxes on business profits from non-resident taxpayers. It addressed two specific questions: first, how will the taxing authorities get the information they need to identify taxpayers and determine tax liability; and second, how will they assess and collect the tax? The paper assumed that a consensus had been reached regarding such issues as the threshold for taxation, the determination of source rules for different types of income, the method for computing income from business activities, and the allocation of taxing rights among competing jurisdictions.

The paper began with the proposition that the tax administration and compliance regime applicable to non-resident taxpayers should differ from the regime applicable to domestic taxpayers only to the extent necessary to provide equivalent protection to the country's revenue authorities. Couzin noted two primary differences in obtaining compliance of domestic and non-resident taxpayers: first, it is more difficult for local taxing authorities to determine the existence and amount of the tax liability of non-resident taxpayers; and second, the cost-benefit ratio for collection activity may be quite different for non-resident as compared with domestic taxpayers.

Couzin examined the information-collection problem by focusing first on the nature of the information that tax authorities need to obtain and then on the practical difficulty of gathering such information. He noted that for information to be useful, it must be susceptible to being understood, manipulated, stored, and retrieved. Couzin added that taxing authorities should collect only information that is necessary to the tax-collection function. According to Couzin, tax authorities sometimes tend to request large quantities of information because they do not know what information they need. However, difficulties exist in collecting too much information, because taxpayers can obscure useful information by giving it along with much other useless information. He argued that the information requirements will depend on such factors as the details of a country's tax regime applicable to non-resident taxpayers, the nature of the business activities of non-resident taxpayers, and the quality and scope of a country's tax administration. Attention to issues of information overload, relevance, manipulability, and connectivity will contribute to improving the design of information-collection regimes.

Couzin examined information reporting for non-resident taxpayers from unilateral, bilateral, and multilateral perspectives. Clear limitations exist as to what countries can do unilaterally in obtaining information. Non-resident taxpayers differ from domestic taxpayers in two key respects: first, the type of information required from non-resident taxpayers may differ in both nature and scope from the information required from domestic taxpayers; and second, it may be more difficult to obtain and process information from non-resident taxpayers. Challenges exist in obtaining information from non-resident taxpayers concerning transaction reporting and foreign-based documentation. Couzin suggested that it might be advantageous to use two business activity thresholds: first, a minimal one for requiring information reporting; and second, a higher threshold for subjecting the taxpayer to tax liability.

Couzin also examined how exchange-of-information procedures between taxing authorities could assist more effectively in the collection of information about non-resident taxpayers. Article 26 of the OECD model convention provides the basic framework for information exchanges. Couzin suggested that the article may need to be modified to de-emphasize its bilateralism and facilitate exchanges in triangular or more complex situations. Finally, although multilateral exchanges of information have been explored in the European Union, among Nordic countries, and even through the OECD, the practice is not yet well developed. Furthermore, it is unclear how helpful or necessary multilateral exchange-of-information provisions are, especially for countries that are already partners in bilateral treaties.

With respect to enforcement issues, Couzin challenged the commonly accepted notion that the physical presence of a taxpayer in a taxing jurisdiction is a precondition for enforcement of tax liability by that jurisdiction. He argued that physical presence without the presence of valuable assets is of little assistance in the collection of taxes. Also, a taxpayer may have valuable assets in a jurisdiction without a traditional physical presence. Tax authorities typically do not have problems enforcing tax claims against non-resident taxpayers with significant assets in the jurisdiction. The real challenge for the source state is to collect tax from non-residents whose assets are located for the most part outside the source state. As discussed in the paper, administrations typically do not have the experience or the resources to chase assets around the world.

Couzin explained that there are two important differences between a tax administration with a claim against a remote taxpayer and a trade creditor with such a claim. First, national tax administrations are often inexperienced in collecting debts, especially from foreigners. Second, the existence of the "revenue rule,"[22] under which domestic courts commonly refuse to recognize or enforce foreign revenue laws, constitutes a very significant obstacle to collection.

Couzin examined possible solutions to these problems from a unilateral, a bilateral, and a multilateral perspective. He suggested that a state might decide to allow its courts to be used to enforce foreign tax laws, probably on a reciprocal basis. He noted that bilateral and multilateral solutions are often based on assistance-in-collection provisions, such as new article 27 of the OECD model convention, and that such solutions are most appropriate and effective when the contracting states have similar or at least compatible tax systems. He observed that many of the countries most in need of assistance in collection are least likely to meet the qualifications for article 27. (For example, the requesting state must have pursued all reasonable methods of collection.) Furthermore, the limitations in article 27 (for example, no assistance will be provided if it is "contrary to public policy") may limit its utility.

From a multilateral perspective, Couzin suggested that a multilateral agreement concerning assistance in collection will be most successful within closely connected groups of states such as the Nordic countries and the European Union. Even if securing such a broad multilateral agreement is not possible, states might agree multilaterally to repeal the revenue rule.

Couzin pointed out that the use of withholding as a collection mechanism with respect to business profits is particularly difficult because gross income and net income differ greatly, depending on the business sector and the particular circumstances. Consequently, it is difficult to fashion a collection mechanism that advances the legitimate interests of the collecting state without imposing an undue burden on the taxpayer. It is particularly difficult to set an appropriate withholding rate. Couzin suggested that a schedular provisional withholding system might be a solution. Coordinated collection by the source and residence states is likely desirable, but probably feasible only in very limited circumstances.

Finally, Couzin asserted that a final withholding tax is not an income tax but a substitute tax imposed because of the difficulty of computing and collecting an income tax. He argued that, because the rate set for final withholding will be either too high or too low in some circumstances, it is a poor collection mechanism. According to Couzin, the only justification for a final withholding tax on business profits is that taxing authorities lack the necessary information to impose a tax on net income.

The discussion began with a question as to the use of withholding as an information-gathering device and what alternatives may exist to the withholding approach. It was suggested that while countries use withholding to collect information, withholding probably does not add much to the information-gathering function. However, taxing authorities are more likely to enforce information-reporting requirements that are tied to the collection of tax revenue.

The discussion then focused on the experience of the European Union. One participant noted that multinational corporations do not favour systems with high compliance costs, even if those systems are closely coordinated among countries. There is a need for the electronic transmission of information in a standard format to reduce costs and a need especially to expand information-exchange mechanisms within the European Union. The European Union's efforts have increasingly focused on tax sharing among EU countries, particularly in the context of mutual assistance in collection. It was suggested that information exchange could be improved by following the EU proposal to give the country providing the information a percentage of the tax collected by the other country.

The US experience was also discussed. One participant explained that during the 1990s the US Government Accounting Office advocated information reporting on any transactions between businesses exceeding a small monetary threshold. While this idea was ultimately rejected owing to high compliance costs, the demand for such a burdensome system arose from the extensive lack of compliance in the current system. Another participant noted that the burden of designing and complying with the US information-reporting system is largely tied to the implementation of exceptions to withholding to make sure that these exceptions are not wrongly applied and that no US persons escape taxation. This participant also commented that the difficult issue for information collection seems to be identification of taxpayers who are carrying on business in the source country with very little physical presence. The group was urged to consider how to identify these people, whether or not they meet the PE threshold or any alternative threshold requirement.

The use of different sources of information for different purposes was then discussed. One participant suggested that while Couzin's paper examined the use of information reporting by the source country, information reporting also helps the residence country to identify income that its residents might be hiding. This is especially true if source countries can identify non-resident taxpayers conducting business in the source country through information provided in connection with other legal requirements for conducting business in that jurisdiction, such as commercial law requirements. It was noted, however, that this information is often not available to taxing authorities for legal or practical reasons.

A question was raised about whether the transactional reporting provided for value-added tax systems could be effectively used as an information source for the enforcement of direct taxes, either to identify taxpayers or to check the accuracy of amounts reported by taxpayers. In both the United Kingdom and Australia, taxpayer information acquired through value-added taxes is used in confirming a taxpayer's income tax liability. One participant noted that using sales as a threshold for income taxation would create additional reporting burdens unless this information were already provided for value-added tax purposes.

The discussion then turned to the issue of cooperation among taxing authorities in collecting information. One participant noted that the major challenge is who collects the tax when income is global but taxing authorities are local. The possibility was raised that taxing authorities might cooperate in constructing a standard taxpayer registry, perhaps restricted to taxpayers or transactions exceeding a monetary threshold. Another participant pointed out that an effective multilateral agreement regarding exchange of information may not be possible unless cultural differences and expectations can be overcome. While some countries, such as the United States, have a well-established tradition of information reporting, other countries do not.

The usefulness and effects of exchange-of-information agreements were discussed. One participant noted that while the European Union's exchange-of-information system may be effective, it has very high compliance costs and imposes a heavy burden on the economy. Moreover, developing countries do not have the resources to meet the very high costs of information exchange. The critical questions for information collection and tax enforcement are, what information does the tax administration need to do its job, and how can the taxing authorities make it attractive for people to provide that information?

Another participant questioned why source countries do not get useful information from residence countries, and why residence countries do not tell their treaty partners when residents are carrying on business in the source country. Another asked why more treaty-partner administrations do not conduct simultaneous examinations of taxpayers. Some participants expressed serious doubts that exchange of information with other countries provides an effective response to enforcement problems. The information is costly to compile and send to treaty partners.

Some participants also argued strongly that agreements for mutual assistance in tax collection do not eliminate the need for withholding at source. Some concern was expressed that mutual assistance in the European Union might lead to calls for the elimination of withholding.

The extent of the enforcement problem was discussed. One participant inquired whether the revenue rule has any practical effect and whether any countries are really having problems with collecting taxes. This participant suggested that the real problem was identifying and assessing non-resident taxpayers, rather than collecting tax owing. Another participant offered a possible defence of the revenue rule, explaining that a country may not want its courts to get involved in determining the merit or validity of another country's tax laws.

One participant reminded the group that artists and athletes are generally the most mistreated groups under tax treaties. They are usually subject to gross withholding with no net basis election, resulting in excessive taxation.

The necessity for final and provisional withholding on gross income was discussed. One participant explained that developing countries often have to use final withholding in order to collect any tax revenues and that the final withholding rate was rarely set too high, and often set too low. Provisional withholding inevitably increases the costs of tax administration because taxpayers will file on a net basis only if doing so saves them money. Moreover, taxpayers may report their net income inaccurately because they know that the tax administration of a developing country does not have the resources to verify their tax returns. As a result, developing countries are often unwilling to allow non-residents to elect to file on a net basis.

ANOTHER APPROACH TO THE TAXATION OF BUSINESS PROFITS: FORMULARY APPORTIONMENT

The last session of the seminar dealt with formulary apportionment as a possible alternative to the current treaty rules for the taxation of business profits. Two papers, by Malcolm Gammie and Michael McIntyre, were prepared for that session.[23]

In his paper "Arm's Length or Formulary Apportionment? A European Union Perspective," Malcolm Gammie argued that Europe, like the rest of the world, has to address the issue of the allocation of business profits between taxing jurisdictions, even though there is no correct method (or formula) for dividing profit and no correct way to define the unitary entity (company or group) whose profit is measured and divided. For him, therefore, the issue is one of practical rather than principled methodology.

Gammie discussed the distinction between the two competing approaches of separate accounting and formulary apportionment. In his view, the boundary between the two is not clearcut, as shown by the adoption of the profit-split and the transactional net margin methods in the OECD transfer-pricing guidelines. While separate accounting has been preferred since the 1930s, it is susceptible to manipulation and may also result in double taxation where countries do not agree on transfer-pricing adjustments. Other difficulties arise because it is increasingly difficult to apply separate accounting to integrated enterprises (since transactions occur within an integrated enterprise for which there is no comparable uncontrolled third-party price), arm's-length prices may not exist at all, or there may be no single arm's-length price for a commodity. Despite these difficulties, the main reason why separate accounting remains the preferred method is that, if arm's-length prices can be accurately computed, separate accounting is superior in the sense that it reveals accurately where profits arise.

Using the example of the development of formulary apportionment for purposes of US state taxation, Gammie argues that a single market compounds the problems of separate accounting. A single market provides the basic conditions (in particular, the absence of overriding external constraints) that allow enterprises to integrate to the fullest possible extent. According to Gammie, the factors that led to the adoption of separate-entity accounting at the international level have disappeared among the member states of the European Union. He therefore argued that the adoption of formulary apportionment within the European Union seems only a matter of time.

After examining the current problems facing corporate taxation in Europe, Gammie concluded that there are two ideal solutions:

1. countries could abolish their corporate income taxes, or
2. countries could impose a single tax at a uniform rate on corporate profits measured according to a common set of rules, with the tax revenues being used collectively or shared among member states on an agreed basis.

The first option has obviously not been adopted, and the current EU political institutions are insufficiently developed to implement the second solution at the Community level. For Gammie, however, it remains an option for member states to agree on a common corporate tax system that each could adopt at a national level. This would involve agreement on several key issues, which are all examined in the paper:

- clear rules for determining each member state's jurisdiction to tax;
- a definition of profits to be apportioned;
- the apportionment formula itself and a definition of the factors that it comprises;

- the method for measuring the factors in the formula; and
- a definition of a unitary business.

According to Gammie, differences between EU member states concerning the tax base are not large, and it would be possible for them to agree on a common measure of profits if they had the political will to do so. One particular issue that would need to be addressed, however, would be third-country income (which would probably have to be allocated to a particular member state).

The choice of formula would clearly be important. Factors such as the firm's inputs and outputs would have to be used and should reflect where income is earned. The composition of the formula would affect decisions as to which countries are entitled to receive a share of tax revenues: countries in which none of the components of the formula are found would receive nothing. Gammie suggested that the test of whether a company has a PE in a country is an appropriate starting point to decide whether that country should get a share of the tax on the profits of that company.

Formulary apportionment aims to allocate profits to the jurisdictions where they are earned. To that end, the most common components of apportionment formulas are sales, labour, and capital. (The formulas used by Canadian provinces and US states use all or some of these factors in different combinations.) While profits are generally thought of as returns to capital and the use of capital as a factor to allocate profits seems therefore obvious, no formula is based on this single factor, probably because capital is difficult to measure accurately. The use of two or more factors raises the issue of how to assign weight to the factors (if at all). Currently, the sales factor is usually given the highest weighting.[24] As regards administrative issues, Gammie noted that the most problematic of the three main factors is capital stock because there is no generally agreed measure for it.

Gammie discussed the difficulty that intangibles present, in terms of both valuation and attribution. He did not endorse the approach of many US states, which assign a nil value to intangibles. For him, the essential problem is not so much the valuation of the intangible but rather the determination of the appropriate location of the intangible. The country in which the intangible is developed (if it can be ascertained) may have a claim for research and development; but in cases where the intangible is attributable to reputation, advertising, or monopoly power and longer-term development, the determination of the location of the intangible is likely to prove more difficult.

In Gammie's view, the use of a uniform formula is more important than the factors used in the formula. He considered that unilateral changes by one member state, which has been a problem in the United States, would likely be less of a problem in the European Union, since the agreement would take effect as an EU measure.

With respect to the determination of the unit to which the common base and formula would apply, Gammie argued that the case for using unitary combination in Europe is compelling given the desire to improve the cross-border offset of profits and losses and the need to avoid giving companies the choice between which of their units they want to consolidate (by choosing to set up some of them as branches and others as subsidiaries). Unlike the US states, which have very different approaches for defining the unitary business, each member state would probably apply the same definitions since the rules would likely be determined at the EU level. Gammie added, however, that the rules for defining the group would have to be more complicated than mere ownership of a majority of capital and would have to take into account ownership, integration, and control.

Gammie also discussed how formulary apportionment could coexist with separate-entity accounting, which would continue to apply for non-participating EU countries or, at a minimum, countries outside the European Union. He noted that the problem with that approach is that companies could end up being undertaxed or overtaxed.

In conclusion, Gammie claimed that the development of the single market should lead to the adoption of formulary apportionment as the only administratively practical method of allocating corporate profits within the single market, but that the failure of member states to agree to corporate tax measures over many years raises the question whether member states will be able to agree on the elements needed for such an outcome. Supposing there is no agreement on a common tax base on which formulary apportionment can rest, Gammie queried whether countries will begin to make greater use of formulary approaches, either explicitly or under arm's-length methodology. He also questioned whether an EU move toward formulary apportionment would result in the major regional blocs—Europe and the United States—agreeing to allocate profits in different ways.

Michael McIntyre's paper, "The Use of Combined Reporting by Nation States," vigorously advocated combined reporting with formulary apportionment (referred to as "combined reporting"). The paper described the basic elements of combined reporting as used by a number of US states, the most important being California. For McIntyre, the current rules for taxing business profits have proven to be difficult to implement, and the problems of implementation appear to be getting worse rather than better. He also claimed that serious theoretical issues have been raised against the use of the current arm's-length method when the income being apportioned has been derived in substantial part through the exploitation of intangible property. He therefore recommended replacing the existing rules for the allocation of business profits by a system of combined reporting.

The first part of the paper gave a general description of how combined reporting works. In a worldwide combined reporting system, the members of a related group of corporations ("combined group") engaged in a common enterprise ("unitary business") are required to file a combined report. The combined report is an accounting document prepared on behalf of the group. It contains a tabulation of the aggregate taxable income derived by the members of the group from the common enterprise. In the computation of that aggregate taxable income, transactions between members of the group are generally eliminated. The combined report also includes a tabulation of each group member's apportionment factors (property, payroll, and sales) used in the apportionment formula. On the basis of the report, the amount of the group's overall income is apportioned to a state by applying the formula applicable to that state. However, the tax is not imposed on the combined group itself. Rather, each member of the group having nexus with the state is taxable on its assigned share of the combined income apportioned to the state under the apportionment formula.

McIntyre discussed the various design aspects of a combined reporting system: the rules for determining the members of a combined group, the definition of a common enterprise, the nature of the combined report, the apportionment formula and each of the constituent factors, and the territorial limitation to combined reporting (referred to as the "water's-edge" approach). He also examined the policy justification for combined reporting and compared that system with the arm's-length/source method currently used for the international allocation of business profits. For McIntyre, combined reporting rests on a theoretical foundation that is entirely different from that of the arm's-length/source system. The purpose of combined reporting is not to achieve some rough approximation of the results achieved under the arm's-length/source approach but, rather, to obtain for the taxing jurisdiction some reasonable share of the income earned by a group of related corporations from a common enterprise, based on the level of relevant economic activity conducted in that jurisdiction. The basic theory of combined reporting is that the income earned by a group of related corporations engaged in a common enterprise is, in substance, the income of the enterprise, not the income of the various members that make up the enterprise.

McIntyre was critical of the four basic sets of rules underlying the arm's-length/source system—residency rules, source rules, accounting rules, and transfer-pricing rules. While most corporate residence rules are simple, they are also easily manipulated. Source rules are sometimes simple and sometimes quite complex; some are difficult to manipulate, whereas others invite manipulation. Accounting rules are not really rules, in the legal sense. In many important situations, they are no more than loose guidelines, subject to substantial manipulation by the taxpayer. Transfer-pricing rules are extremely complex, to the point, perhaps, of being incapable of fair administration. They are also easy to manipulate, for their operation depends on factual matters typically under the control of the taxpayer; in addition, the rules are not uniform. Little wonder, then, according to McIntyre, that countries have encountered major difficulties in operating the arm's-length/source-rule system:

- Taxpayers have substantial control over the transfer-pricing, source, branch accounting, and residency rules.
- Many of the rules used to implement the arm's-length/source system have major design flaws.
- The source rules, transfer-pricing rules, and occasionally branch accounting rules elevate form over substance.
- The model embodied in the transfer-pricing rules implicitly assumes that the members of a multinational enterprise, operating in concert, earn the same

amount of income as would a group of unrelated entities operating in their own self-interest. This assumption is unsustainable. Multinational firms did not come to dominate international markets by earning the same profits as their local competitors.

- The transfer-pricing rules are not really rules of law that provide definite answers to legal questions but instead are mere guidelines. This problem of indefiniteness is nearly impossible to remedy because prices in a market economy are set through the negotiations of the parties.
- The arm's-length/source system is buttressed by treaties and other agreements that have institutionalized some of the major techniques used by multinational businesses to avoid taxes.
- Finally, the transfer-pricing, source, branch accounting, and residency rules interact with each other to increase significantly the complexity of an arm's-length/source system.

McIntyre acknowledged that neither combined reporting nor the arm's-length/source system is close to perfect. For him, however, the flaws in a combined reporting system are largely technical, and the solutions to those problems are relatively easy to identify. In contrast, the problems with the arm's-length/source system result from the complex interplay of many seemingly unrelated sets of tax rules and can be addressed effectively only through the coordination and major reform of each of these sets of rules. Moreover, the reforms needed for the arm's-length/source system to operate effectively are at best uncertain.

McIntyre concluded that the successful use of combined reporting by California and other US states shows that most of the important technical issues arising from that system have been confronted and resolved. While using combined reporting at the international level would present new challenges, the experience of California, which is one of the biggest economies of the world, provides a basis for optimism. According to McIntyre, the success of combined reporting is dependent on three key elements:

1. multinationals need to report their worldwide income and be taxed on an amount computed by reference to that income;
2. income should be attributed only to jurisdictions where substantial activities take place on the basis of easily measured indicators of the amount of activity that is clearly located in those jurisdictions; and
3. the form of legal organization of the multinational and the intragroup contractual arrangements should be given little or no weight.

At the same time, the case for continuing to use the arm's-length/source system, according to McIntyre, is difficult to make. He challenged supporters of that system to provide answers to a number of questions related to what, in his opinion, are the main flaws of the system (for example, the recognition for tax purposes of the legal form of the organization of the multinational and the intragroup contractual arrangements; the fact that the system allows tax avoidance; and the system's overwhelming complexity). In McIntyre's opinion, unless the corporate tax is abandoned, the only alternatives are the adoption of combined reporting or a major overhaul of the current system. While he argued that combined reporting would be a better alternative, he observed that its key features could conceivably be adopted by analogy under the arm's-length/source system if the following changes were made to the current system:

- moving to worldwide taxation of resident corporations with no deferral (or adopting a functionally equivalent system of controlled foreign corporation rules);
- changing corporate residency rules so that they are no longer subject to manipulation; and
- revising source rules, branch accounting rules, and transfer-pricing rules so that they operate more like formulary apportionment rules in the case of income from intangibles.

At the beginning of the session, Malcolm Gammie introduced the topic of formulary apportionment by commenting on the prospects for corporate tax reform within the European Union. While the timetable for reform is still uncertain, the direction of the likely changes is clearer: ultimately, for the European Union, what are currently considered international tax issues would be restricted to relations with countries outside the European Union, while domestic issues would be linked to relations between EU countries. This is the basis for the proposal for an origin-based value-added tax. Although the system would remain destination-based for supplies to and from non-EU countries, supplies within the European Union would simply be dealt with as domestic supplies. According to Gammie, the same approach is needed for direct taxes, and that is the direction in which the jurisprudence of the European Court of Justice is moving.

With that perspective, he discussed two aspects of the taxation of business profits in the European Union. First, he found imputation systems as currently applied in Europe to be discriminatory within the meaning of the EC treaty and indicated that the solution currently applied by EU countries is a move toward classical systems (although it would be possible, but more difficult, for countries to address the discrimination issue by taking account of taxes paid in other countries). Second, the sharing of taxing rights between source and residence states should be based on the location at which the productive activities are carried on (that is, where value is added), with the exception of the normal return on capital (which should be taxed without any distinction between debt or equity). Residence is generally a meaningless concept for companies. Therefore, controlled foreign corporation rules are discriminatory within the European Union, and the appropriate system for relief of double taxation is the exemption method.

For Gammie, however, the real question was, how would EU countries move to a "domestic" approach for the taxation of EU business activities? Would these countries make the necessary changes unilaterally, or would there be a collective move in that direction? It would certainly be possible for each country to make the above-mentioned changes, but it would also be possible for a proposal like common base taxation or home state taxation to be adopted. Either choice, however, would leave open the "international" dimension (that is, the relationship with non-EU countries). Gammie argued that while the European Court of Justice is able to distinguish single-market issues from those involving non-EU countries, the real difficulty in this area arises from the non-discrimination provisions of tax treaties.

In conclusion, Gammie expressed the view that EU countries will gradually, and maybe reluctantly, be required to adopt a "subnational" approach to taxation within the EU area. The consequence for tax treaties is that the whole of the European Union should be seen as the contracting party for any bilateral treaty involving an EU country. This arrangement could be achieved either by having a single treaty binding each EU country or by having the benefits of any treaty concluded by an EU country extended to all other EU countries.

One of the main topics addressed during the discussion was whether and how corporate taxes should be harmonized within the European Union. One participant expressed doubts as to whether a greater convergence of European tax systems is needed without a similar convergence in public services and, therefore, spending. Several participants questioned the process through which formulary apportionment could be introduced within Europe and suggested that it would be unfortunate if the reform process were left to the bargaining skills of politicians rather than based on sound principles of tax policy.

The discussion then shifted to the process through which corporate taxation is changing within the European Union. One participant expressed the view that a country's decisions on how it should finance its chosen level of expenses are a manifestation of sovereignty. Consequently, European countries can hardly be blamed for not having adapted their corporate tax systems to the single-market requirements, since it is difficult to understand how the EC treaty is being interpreted with respect to direct taxes. The example of a recent case on Germany's thin capitalization rules[25] was raised to make the point that the decisions of the European Court of Justice have focused on what the tax rules should not be, but those decisions provide little guidance as to what the rules should be (which is inherent in the judicial process). Countries cannot be expected to find immediate substitutes for rules that have been invalidated by the European Court of Justice. There is no guidance, for instance, concerning how each European country should move from having a network of bilateral treaties with each of its European partners to a system of one single treaty applicable to all these partners. There is a clear need for a different approach to tax policy development within the European Union.

Other participants expressed the view that although European institutional arrangements are unclear, Europe never decided to adopt a federal model. Further, although the EC treaty does not expressly provide for the harmonization of direct taxes, it is clear that direct taxes could constitute obstacles to the single market. Member countries will not be willing to remove these obstacles as long as harmful tax competition remains. This situation explains the need for the so-called tax package: agreement on measures to combat harmful tax competition allows progress on issues such as the deduction of losses incurred in another EU state. The European Commission is currently considering solutions to particular problems with the current system (the "minor fixes") as well as more comprehensive solutions, recognizing, however, that the implementation of the latter will probably take a long time. According to some participants, what is really needed are new instruments to force change in this area. The European Court of Justice plays a crucial role in this respect, and countries have been asked to debate with the Commission areas where infringement of national sovereignty has been claimed. At the same time, however, work is carried on in other areas, including the pilot testing of home state taxation for small enterprises and of some elements of a common base taxation approach, as well as the examination of possible factors for apportionment and the effect of the harmonization of accounting standards.

In discussing whether the European Union should move to formulary apportionment, some participants referred to the experience of US states with this approach. A considerable level of tax planning already exists at the state level, even though the amount of tax at stake is typically between 5 percent and 10 percent (the real effect is even lower since state corporate taxes are deductible in calculating federal tax liability). Since the stakes would be considerably higher if the entire amount of a country's corporate taxes depended on formulary apportionment, tax avoidance could prove to be even more problematic for EU countries under formulary apportionment than under the current rules. While other participants acknowledged that there was substantial tax planning around state taxes, it was pointed out that a lot of that planning is directed at differences between the various states' tax bases, differences that would not arise in the European context if corporate tax bases were harmonized. (Similarly, planning based on differences in the states' allocation formulas would not arise if the same formula were used by the EU countries.) It was also argued that the absence of significant tax avoidance with respect to the allocation of income among Canadian provinces is attributable to the use of a common base and the same formula, although the absence of combined reporting (since the Canadian formula applies only to allocate profits between branches of the same legal entity) may actually reduce the need for planning since it is possible (at least in principle) to use separately incorporated entities, along with transfer-pricing and debt strategies, to shift income among the provinces.

Extensive discussion took place on the effect of the adoption of formulary apportionment by the European Union on relations with the rest of the world. One participant questioned how existing bilateral agreements with non-EU countries, which are based on separate-entity reporting and the arm's-length principle, could interact with the use of formulary apportionment within the European Union. The question was raised (but not answered) whether the United States and other credit countries would allow a foreign tax credit for tax payable in an EU country based on formulary apportionment, not on the arm's-length principle. There appeared to be considerable concern that ignoring the residence of entities within the European

Union while maintaining it for relations with non-EU countries would create serious difficulties. In response to these comments, one participant expressed the opinion that the problem would be addressed by the fact that the EU would apply its formulary approach only to EU profits (in a manner that would correspond to the water-edge's limitation for US state tax purposes). It was also argued, however, that a more accurate answer would be that the EU treaties would probably need to be adapted to ensure the coexistence of an intra-EU formulary apportionment with an extra-EU arm's-length/separate-entity approach.

The likelihood of an international move toward formulary apportionment was also discussed. Several participants expressed skepticism about the ability of formulary apportionment to solve the problems arising from the current rules. The view was also expressed that while formulary apportionment could conceivably work at the EU level, which is a regional grouping, it is not a practical model for the world since global harmonization of the corporate tax base seems impossible. Concerns were raised about the various factors that could be used in a formulary apportionment system. The different valuation and depreciation methods applied by countries would make it very difficult to reach an agreement as to the value of assets. Similarly, sales would be influenced by differences in domestic markets (for example, whether or not a firm is in a monopolistic position). Further, a country's wage levels would not necessarily reflect the real contribution of that country's workers to the overall profitability of a multinational. For these reasons, some participants doubted that such factors could be used to measure a country's share of the income of a multinational enterprise.

Expanding on the comment that formulary apportionment could be as vulnerable to tax avoidance as the current rules, one participant expressed the view that countries would also try to manipulate formulary apportionment to their advantage. In the context of the European Union, however, it was noted that the European Union would have the institutional means of enforcing agreement on a common tax base and making sure that each country's tax rules were acceptable to the other countries.

Given the difficulties experienced in trying to apply an asset factor in the context of a mutual agreement, one participant made the point that a formulary apportionment method would not necessarily be simpler to design and administer. The view was also expressed that the burden should be on those arguing in favour of formulary apportionment to prove that there is a real need for such a change.

Several participants expressed the idea (which had already been put forward during another session) that formulary apportionment represents one end of the spectrum of methods that can be used to allocate business profits between jurisdictions, and that it is not significantly different from the profit-split method under the arm's-length principle, except for the focus on transactions under that principle.

Many participants voiced strong views on the merits of formulary apportionment. For instance, a proponent of the method dismissed the argument that formulary apportionment would entail a loss of a country's sovereignty, suggesting that, under the current rules, countries are losing part of their sovereignty to multinationals and need to reclaim it through collective action. Another participant observed cynically that proposals for formulary apportionment seem to come and go every 10 years. This individual cited an example of how the tax burden under formulary apportionment could be influenced by merely having a company enter or leave the unitary group, and expressed the opinion that this was a very strange result.

Various issues related to the design of a formulary apportionment system were also discussed. Some participants noted that what is commonly referred to as formulary apportionment consists of three distinct and separable elements:

1. a common tax base;
2. combined reporting (as opposed to separate-entity accounting, which is the basis for the current rules); and
3. the use of a formula to allocate the common tax base of corporate groups among jurisdictions.

For one participant, the most important change among these three elements is the adoption of a common tax base and, in that respect, the convergence of accounting standards is a key development. For this participant, the adoption of combined reporting is problematic: while combined reporting recognizes that the corporate group corresponds to economic reality, the composition of a corporate group may be constantly changing, making it extremely difficult to identify the corporate group over a long period. The adoption of a common tax base is the least dramatic and most feasible change (especially if, as was suggested by a number of participants, the application of the arm's-length principle moves in that direction through greater use of profit-based methods).

According to several participants, however, the biggest change would not be moving from the arm's-length principle to a common tax base, but moving from separate-entity accounting to combined reporting. It was suggested that if tax systems were to move away from separate-entity accounting, it would be difficult not to move to some type of formula for the allocation of profits, or at least to more "formulary" methods of applying the arm's-length principle.

It was generally agreed that a common tax base is a necessary ingredient of a formulary apportionment method because it would be very difficult to rely on each country's base in taxing a multinational group. One participant, however, referred to the home state taxation proposal in the European Union to clarify that this does not mean that the base must be the same for all multinationals. All that is really required is a common base for the various parts of a particular corporate group and a uniform formula, which is not susceptible of manipulation, for allocating that base among jurisdictions. For example, it was noted that this approach is already being applied by Germany and the Netherlands in the case of branch activities near the border.

For one participant, the idea of moving toward combined reporting was attractive since it would avoid many of the current issues related to entity classification. This participant also welcomed a move toward source rules that would be less subject to manipulation. Since it is unlikely, however, that the United States will agree to an international formulary apportionment system, this participant wondered whether these two aspects could be adopted in tax treaties. Several participants expressed the view that combined reporting would probably not work in the context of bilateral treaties.

The issue of formulary apportionment was linked to the previous discussion of source rules. There was general agreement that the factors that would be used for the formulary apportionment of income would have the same effect as source rules, which ultimately determine where income is allocated for tax purposes. As a result, as one participant observed, formulary apportionment does not in itself address a number of other questions, such as whether there should be concurrent source and residence taxation, and if so, whether double taxation should be relieved through the credit or the exemption method. Another participant expressed the view that while formulary apportionment factors would act as substitutes for the current source rules, they would likely be less firmly anchored on economic principles. The reply from a proponent of formulary apportionment, who had previously observed that economic concepts are more useful in justifying particular source rules than in designing them, was that allocating half of the income to the production state and half to the market state, which is the approach of the US states, makes some sense. Although it may be difficult to identify the production and market states in some circumstances, the place where workers are paid and where assets are located are adequate proxies for identifying the production state. Another participant, however, argued that it is possible to identify the economic source of some types of income, and that could help in the design of tax rules. As an example, a claim to tax by the market state could be justified if marketing intangibles existed in that state.

Another participant suggested a theoretical framework for sourcing income based on economic principles against which both the arm's-length and the formulary apportionment methods could be assessed. Under this theoretical framework, the source of income should be based on where activities giving rise to taxable income take place. Accordingly, the cost of intangibles should be capitalized and income derived from these intangibles should be allocated to the location where they were developed. This would leave a very small residual profit, which should be attributed to the location where the economic rent is realized. Using the same approach, however, another participant expressed the view that the income attributable to economic rent should be larger, even after taking into account the development costs of intangibles. Economic rent should probably be taxed where realized. Although this could be seen as introducing an element of formulary apportionment into the current rules, arguably this is already being done in some advance pricing agreements. According to this participant, the key to taxation in accordance with these economic principles is to move away from the transactional basis for functional analysis under the transfer-pricing guidelines. Support for this view was provided by another participant, who suggested that transfer-pricing disputes are solved mostly through profit-based methods rather than transaction-based methods.

APPENDIX 1 PARTICIPANTS

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APPENDIX 2 AGENDA: TAX TREATIES AND THE TAXATION OF BUSINESS PROFITS

An invitational seminar jointly sponsored by the Canadian Tax Foundation, the Harvard Law School International Tax Program and Fund for Tax Research, the International Bureau of Fiscal Documentation, Maisto e Associati, Milan, and the Organisation for Economic Co-operation and Development, held at Harvard Law School, Cambridge, Massachusetts, October 24-26, 2002.

Thursday, October 24

Chair: Guglielmo Maisto

9:00-9:15 Welcome and introduction—Eric Zolt

9:15-10:00 Tax treaties and the taxation of business profits: objectives and issues

Discussion leader: Eric Zolt

- Which attributes of the current treaty regime for taxing business profits work well? What are its most significant problems?
- How helpful are the traditional criteria of fairness, efficiency, and administrative feasibility for evaluating tax regimes and tax reform proposals in the global context?
- What alternatives exist to the current approach of allocating taxing rights based on source and residence concepts?
- When should a country have the right to tax non-residents on business profits?
- Is it possible to devise rules that achieve a closer correspondence than the current regime between the economic income earned in a jurisdiction and income allocated under the domestic laws and applicable tax treaties?
- What would the model treaty look like if we disregarded the separate existence of related corporations and the independent significance of intercompany transactions?
- What can we learn as to both substance and process from the various European Union proposals for coordinating tax regimes?

10:30-12:30 Identifying business income and different types of business income

Discussion leader: John Avery Jones

- Introduction
- What is the relationship between domestic law and treaties with respect to the identification of business profits?
  —different approaches to identifying business profits in the domestic law of civil law and common law countries
- Is a treaty definition of business profits necessary or desirable?
- What is the relationship between article 7 and other treaty articles dealing with business profits?

Chair: Robin MacKnight

13:30-15:00 Threshold requirements for taxing business income—I: permanent establishment

Discussion leader: Brian Arnold

- Introduction
- Is a threshold requirement necessary or desirable?
- What are the deficiencies in the existing PE threshold?
  —fixed place of business
  —dependent agents
  —exclusion of preparatory activities
- What changes to the fixed place of business threshold are appropriate?
  —separate treatment of each fixed place
  —time aspect
- Is a threshold based on the nature of activity appropriate?
  —exclusion of preparatory activities
  —authority to conclude contracts

15:30-17:00 Threshold requirements for taxing business income—II: alternatives to the permanent establishment concept

Discussion leader: Brian Arnold

- Should there be a physical presence threshold for services?
  —threshold for employees and UN model threshold for services
- Are monetary thresholds appropriate?
- Are different threshold requirements for business profits covered by other articles justifiable?
  —immovable property
  —entertainment
  —employment
  —dividends, interest, royalties, and other income
- What should the threshold requirement for remote businesses (electronic commerce) be?

Friday, October 25

Chair: Joanna Wheeler

9:00-10:30 Source rules for business income in tax treaties

Discussion leader: Hugh Ault

- Introduction
- Should source rules conform to economic principles?
- What is the relationship between domestic source rules and treaty source rules?
- Should treaties provide more detailed source rules?
  —article 7 provides limited source rules
  —should the force-of-attraction principle be reconsidered?
- Is a residence-of-the-payer source rule for interest and royalties appropriate?
- What should the source rule be for services income?
- Source rules and triangular cases
  —payments by resident effectively connected to PE in third state
  —receipts by PE in third state
  —should PEs qualify for treaty benefits?

11:00-12:30 The computation of income under the separate-entity approach (articles 7 and 9)—I

Discussion leader: Richard Vann

- Was there ever a single arm's-length principle?
- Should the paradigm be branches or subsidiaries?
- What is the policy justification for the arm's-length principle?
- Should transactions be respected or not? Why?
- Is the PE principle residence or source based?
- What is and should be the place of the PE principle in the division of revenues between countries?

Chair: Jacques Sasseville

13:30-15:00 The computation of income under the separate-entity approach (articles 7 and 9)—II

Discussion leader: Richard Vann

- What, as a matter of international law, do articles 7 and 9 require?
- Are the 1995 guidelines a charter for tax avoidance under article 9?
- What is meant by profits in article 7?
- Is there a divide between common law and civil law countries or exemption and credit countries over the meaning of article 7?
- Is article 7 inconsistent with allocation of revenue and expenses? If so, how does an allocation country apply its law to PEs?
- How can differing treatments of different kinds of enterprises be justified under article 7?

- Why is paragraph 4 in article 7? Should it be retained?
- Why is paragraph 5 in article 7? Should it be retained?

15:30-17:00 Techniques for effectively collecting taxes on business profits: withholding taxes and other alternatives for gross and net basis taxation

Discussion leader: Robert Couzin

- Introduction
- How to get the necessary information?
  —domestic, bilateral, and multilateral information rules
- What enforcement techniques are available?
  —domestic legislation: unilateral abolition of the revenue rule, reciprocity
  —bilateral measures
  —OECD proposed article 27
  —national practice
  —multilateral measures
  —OECD-Council of Europe Mutual Assistance Convention
  —European Union
- Is provisional withholding effective?
  —current use
  —implementation issues
- An integrated system?
- Is final withholding on business profits acceptable in any circumstances?
  —gross revenue tax is not income tax
  —OECD model

Saturday, October 26

Chair: Eric Zolt

9:00-10:30 Another approach to the taxation of business profits: formulary apportionment—I

Discussion leader: Malcolm Gammie

- Will the traditional arm's-length methodology remain a viable option for allocating profits to the member states of the European Union for the foreseeable future?
- What are the viable alternative methods in a single market for allocating profits?
  —is agreement on a common tax base necessary?
- If the European Union departs from traditional arm's-length methods, what are the implications for use of the OECD's transfer-pricing guidelines (a) as between Europe and the NAFTA countries and (b) for the rest of the world?

11:00-12:30 Another approach to the taxation of business profits: formulary apportionment—II

Discussion leader: Michael McIntyre

- Can a combined reporting/formulary apportionment regime operate effectively?
  —is the experience of US states transferable to the international arena?
  —is the most promising approach for some regional group, such as the European Union or NAFTA, to adopt combined reporting and work out the technical issues?
- What is the best way for countries to agree on how to share income tax revenue derived from income earned by multinational companies from cross-border activities?
  —which approach, a combined reporting system or an arm's-length/source-rule system, is more likely to result in a fair, transparent, and administrable tax regime?
  —is a 50-50 sharing between the production state and the market state a reasonable approach?
- Which aspects, if any, of the theory underlying combined reporting are unacceptable to the international community?
  —disregard of the formal organizational structure of the enterprise
  —apportionment formula based on payroll, property, and revenue provides only a rough approximation of the income generated in a particular country

12:30-12:45 Conclusion

APPENDIX 3 SEMINAR PAPERS AND AUTHORS

"Threshold Requirements for Taxing Business Profits Under Tax Treaties"—Brian J. Arnold, Goodmans LLP, Toronto

"Source Rules for Taxing Business Profits Under Tax Treaties"—Brian J. Arnold, Goodmans LLP, Toronto, and Jacques Sasseville, Centre for Tax Policy and Administration, OECD, Paris

"What Are Business Profits?"—John Avery Jones, Special Commissioner of Taxation, United Kingdom

"Imposing and Collecting Tax"—Robert Couzin, Ernst & Young LLP, Toronto

"Arm's Length or Formulary Apportionment? A European Union Perspective"—Malcolm Gammie, Chambers of Lord Grabiner QC, London, United Kingdom

"The Use of Combined Reporting by Nation States"—Michael J. McIntyre, Wayne State University Law School, Detroit

"Taxation of Business Profits and the Arm's Length Principle: Thoughts in Progress"—Richard J. Vann, University of Sydney Law School, Sydney

—"Appendix: The Taxation of High-Value Services: Current Directions in Treaties"

"Tax Treaties and the Taxation of Business Profits: Objectives and Issues"—Eric M. Zolt and Jennifer Kowal, International Tax Program, Harvard Law School. Cambridge, Massachusetts

NOTES

1 See Brian J. Arnold, Jacques Sasseville, and Eric Zolt, "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century" (2002) vol. 50, no. 1 *Canadian Tax Journal* 65-144 and (2002) vol. 56, no. 6 *Bulletin for International Fiscal Documentation* 233-74.

2 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model convention").

3 Organisation for Economic Co-operation and Development, *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (Paris: OECD, December 2000). These changes are expected to be part of the 2002 update of the model convention.

4 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (Paris: OECD, February 2001).

5 "Tax Policy in the EU: Priorities for the Years Ahead," Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee, Brussels, May 23, 2001, COM (2001) 260 final.

6 This point was challenged at a later session of the seminar.

7 In this sense, source rules can be viewed as establishing both a nexus and a threshold for source-country taxation.

8 United Nations, *Model Double Taxation Convention Between Developed and Developing Countries*, 2001 (herein referred to as "the UN model convention").

9 The duration of the existence of a PE is generally unspecified, although the practice of countries indicates that 6 months is the minimum. See Organisation for Economic Co-operation and Development, *Draft Contents of the 2002 Update to the Model Tax Convention* (Paris: OECD, October 2001), paragraph 6 of the proposed changes to the commentary on article 5. In contrast, a 12-month period is used in paragraph 3 of article 5 of the OECD model convention with respect to construction sites.

10 Paragraph 7 of article 5 of the OECD model convention provides that parent and subsidiary corporations are not PEs in respect of each other merely by reason of their relationship. Paragraph 40 of the commentary on article 5 goes further by providing that even if the subsidiary's business is managed by the parent, the subsidiary will not be the PE of the parent.

11 In the European Union, there is a threshold based on gross sales of 100,000 euros for selling goods to consumers from abroad (for example, by mail order). It has been proposed that the same threshold should also apply to electronic commerce.

12 Paragraph 4(e) of article 7 is the general exclusion for preparatory and auxiliary activities. Paragraph 4(f) is the exclusion for activities that are a combination of the activities referred to in paragraphs 4(a) to (e). Paragraphs 4(a) through (d) of article 7 exclude specific activities such as purchasing, storage, delivery, and collection of information.

13 As Cockburn CJ said in *Sully v. Attorney General* (1860), 2 TC 149, at 150 (Ex. Chm.), "[i]t would be most impolitic thus to tax those who come here as customers."

14 Paragraph 3(b) of article 5 of the UN model convention provides that the furnishing of services constitutes a PE if the activities continue for more than 6 months in any 12-month period.

15 Paragraphs 28 to 31 of the commentary on article 11 of the OECD model convention. The commentary suggests that paragraph 5 of article 11 could be revised to make the source of the interest the country in which the PE is situated, even where the PE is situated in a third country. If, however, the PE is in a country with which the source country does not have a treaty, the source country will give up its right to tax the income without any assurance that the PE country will tax it.

16 For more discussion, see John F. Avery Jones et al., "Tax Treaty Problems Relating to Source" [1998] no. 3 *British Tax Review* 222-50.

17 Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979) and *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1994).

18 This is precisely what the OECD's *Discussion Draft on the Attribution of Profits to Permanent Establishments* (supra note 4) does. According to the draft's working hypothesis, the application of the arm's-length principle requires the postulation of dealings between a PE and other parts of an enterprise.

19 Supra note 4.

20 *The North West Life Assurance Co. of Canada*, 107 TC 363 (1997) and *Natl. Westminster Bank v. US*, 99-2 USTC 50, 654 (Ct. Cl.).

21 *Cudd Pressure Control Inc. v. The Queen*, [1999] 1 CTC 1 (FCA).

22 See *Holman v. Johnson* (1775), 98 ER 1120 (KB); *Government of India v. Taylor*, [1955] AC 491 (HL); *United States of America v. Harden* (1963), 41 DLR (2d) 721 (SCC); and *Her Majesty, Queen in Right, etc. v. Gilbertson*, 597 F. 2d 1161 (9th Cir. 1979).

23 A recent paper by Charles E. McLure Jr., "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment" (2002) vol. 56, no. 12 *Bulletin for International Fiscal Documentation* 586-99, was also distributed to the participants.

24 Historically, both US states and Canadian provinces gave the factors equal weight. Recently, US states have assigned greater weight to the sales factor.

25 *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (December 2002), case C-324/00 (Judgment of the Court (Fifth Chamber)).