

**ALLOCATION OF RIGHTS TO TAX ACTIVE BUSINESS INCOME AND  
THE PRINCIPLE OF INTER-NATION EQUITY - AN ANALYSIS FROM  
THE PERSPECTIVE OF BRAZIL, INDIA, AND CHINA**

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## **ABSTRACT**

This thesis analyses whether the existing international framework for allocation of rights to tax active business income can be considered fair or equitable from the perspective of Brazil, India, and China (the BICs) and suggests steps that could be taken in the short and medium terms to advance fairness. Chapter I highlights the challenges in the framework from the standpoint of the BICs and also other developing countries. It is argued that an understanding of these concerns is important to achieve the OECD's Base Erosion and Profit Shifting project's aim of a certain and stable arrangement. Chapter II contends that fairness in both the rule-making process and the rules is critical to this end. Chapters III-V examine the evolution and development of the prevailing rules for division of rights to tax active business income and the key aspects of these rules from the BICs' perspective based on the parameters for assessing procedural and substantive fairness established in chapter II. It is discussed that the BICs either had no or ineffective participation in the formulation of these rules. Resultantly, the BICs diverge from some of the basics of the rules towards positions that better account for these countries' contributions in the generation of global profits. Chapter VI proposes enhancing the authority and legitimacy of the UN's Committee of Experts on International Cooperation in Tax Matters as both a short and medium term option for fairer international taxation rule-making for the BICs, and, importantly, other developing countries as well. Chapter VII suggests a significant economic presence test for nexus along with a low rate withholding tax, and the greater use of the profit split method as steps towards a fairer allocation of taxing rights from the perspective of the BICs. Further analysis of theoretically superior but longer-term alternatives, such as global formulary apportionment, is also recommended.

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## LIST OF ABBREVIATIONS

ALP	Arm's Length Principle
AMP	Advertising, Marketing, and Promotion
APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting
BIC	Brazil, India, and China
BIFD	Bulletin for International Fiscal Documentation
BTR	British Tax Review
CBDT	Central Board of Direct Taxes
CFA	Committee of Fiscal Affairs
CPM	Cost Plus Method
CTF	Canadian Tax Foundation
CTJ	Canadian Tax Journal
CTR	Current Tax Reporter
CUP	Comparable Uncontrolled Price
DESA	Department of Economic and Social Affairs
ECOSOC	Economic and Social Council
FDI	Foreign Direct Investment
FIS	Fees for Included Services
FTS	Fees for Technical Services
GATS	General Agreement on Trade in Services
HMRC	Her Majesty's Revenue and Customs
HC	High Court
IBFD	International Bureau of Fiscal Documentation
IFA	International Fiscal Association
IFS	Institute for Fiscal Studies
IMF	International Monetary Fund
INE	Inter-Nation Equity
Int'l	International
IR	Indian Revenue Service
IT Act	Income Tax Act
ITA	Income Tax Appeal
ITAT	Income Tax Appellate Tribunal

ITR	Income Tax Reporter
JSTB	Jiangsu State Tax Bureau
L	Law
LONs	League of Nations
LSA	Location Specific Advantage
MNE	Multinational Enterprise
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Cooperation and Development
OECD TPG	OECD's Transfer Pricing Guidelines
OUCBT	Oxford University Centre for Business Taxation
PE	Permanent Establishment
PSM	Profit Split Method
RPM	Resale Price Method
RF	Receita Federal
SAT	State Administration of Taxation
SCALE	Supreme Court Almanac
SCC	Supreme Court Cases
TCM	Tax Court Memorandum Decisions
TNMM	Transactional Net Margin Method
TTJ	Tax Tribunal Judgments
UBC	University of British Columbia
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UN Tax Committee	United Nations Committee on International Cooperation in Tax Matters
UN TPM	UN's Transfer Pricing Manual
WTO	World Trade Organization

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## **Chapter I**

### **Introduction**

In this thesis, the author analyses the existing international framework for allocation of rights to tax active business income between countries from the perspective of Brazil, India, and China, or the BICs, through the lens of Inter-Nation Equity (INE). The aim is to determine whether this set-up can be considered fair or equitable from the BICs' standpoint, and if not, then what directions of reform could be pursued in the short and medium terms to achieve a fairer international arrangement for division of rights to tax active business from these countries' perspective.

Parts I and II of this chapter establish the broad contours of this research. This involves setting out the author's position on the preliminary question of appropriateness of profits as the base for a tax at the corporate level in part I. Following on from that, part II provides an insight into the three pillars of this research: the prevailing international framework for assignment of rights to tax active business income; the principle of INE; and the BICs. Part III lays out the structure of the thesis, further clarifies the scope and limits of this research, and discusses how each aspect shall be pursued.

## **I. Tax on corporate profits: justifications, criticisms, and the existing scenario**

Corporation tax is commonly understood as a tax on a company's taxable profits.<sup>1</sup> The following sections highlight some of the main arguments for and against corporation tax. The objective is to show that, despite being a controversial levy, this tax remains largely resilient across the world; and how this has, in turn, influenced the author's decision to not delve into the issue of a more suitable base for taxation of cross-border activities of multinational enterprises (MNEs).

### **a. Justifications underlying corporation tax**

Several normative and political justifications contribute to the tax's existence. The first of these is the corporation tax's 'withholding' or 'backstop' function.<sup>2</sup> In the absence of corporate tax, shareholders could prevent income earned through the corporation – a distinct legal entity – from being taxed until a dividend is paid or the shareholders sell their shares.<sup>3</sup> Theoretically, it may be possible to measure company profits for tax purposes, allocate them to shareholders based on the extent of their

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<sup>1</sup> 'Taxing Corporate Income' in Institute for Fiscal Studies (IFS) and James Mirrlees (eds), *Tax by Design: The Mirrlees Review* (OUP 2011) (Tax by Design: The Mirrlees Review) 406, 412.

<sup>2</sup> Jeffrey K MacKie-Mason and Roger H Gordon, 'Why is there Corporate Taxation in a Small Open Economy? The Role of Transfer Pricing and Income Shifting' (1994) NBER Working Paper No 4690, 3 <[www.nber.org/papers/w4690](http://www.nber.org/papers/w4690)> accessed 15 December 2015. See also Kim Brooks, 'Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax' (2003) 36 UBC L Rev 621, 639; Alfons J Weichenrieder, '(Why) Do We Need Corporate Taxation?' (2005) CESifo Working Paper No 1495, 14 <[www.econstor.eu/bitstream/10419/18959/1/cesifo1\\_wp1495.pdf](http://www.econstor.eu/bitstream/10419/18959/1/cesifo1_wp1495.pdf)> accessed 15 December 2015.

<sup>3</sup> This argument assumes that at least some burden of corporate tax falls on the shareholders. Also, taxation of company profits at the corporate level as well as at the personal level when the profits are distributed to the shareholders of the company as dividends raises double taxation concerns. This issue and the ways of addressing it have been discussed widely in taxation literature. See Alvin C Warren Jr, 'The Relation and Integration of Individual and Corporate Income Taxes' (1981) 94 Harvard L Rev 717; Hugh J Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices' (1992) 47 Tax L Rev 565; Richard J Vann, 'General Report' in International Fiscal Association (IFA) (ed), *Trends in Company/Shareholder Taxation: Single or Double Taxation?*, Cahiers de Droit Fiscal International Vol 88a (IFA 2003) 21.

ownership in the company, and then tax them under the personal tax framework. This, however, would be administratively burdensome, particularly in the case of big companies with thousands of domestic and foreign shareholders.<sup>4</sup>

The second reason often given to support corporation tax is that the tax serves as a payment for the benefits a country confers on a corporation.<sup>5</sup> These benefits can range from legal privileges available on incorporation, to more general goods and services offered by a country that help a company generate profits. The latter could include suitable infrastructure, a well-educated labour force, proximity to large markets, a stable regulatory framework, etc.<sup>6</sup> The difficulty, however, is in assessing the value of specific benefits available to any particular corporation and setting a commensurate tax on corporate profits.<sup>7</sup> Also, many of these benefits would be available to both corporate and unincorporated forms of business operating in the country.<sup>8</sup>

Another distinct argument in support of corporation tax is that the tax acts as a check on the power of the corporate management.<sup>9</sup> The idea underlying this view is that corporate income adds to the resources of a corporation, which in turn are

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<sup>4</sup> 'Taxing Corporate Income' in *Tax by Design: The Mirrlees Review* (n 1) 409.

<sup>5</sup> In this thesis, the terms country and State are used interchangeably.

<sup>6</sup> Edwin R A Seligman, *Essays in Taxation* (9th edn, MacMillan 1921) 223-227; Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (5th edn, McGraw-Hill 1989) 373-374. See also Rebecca S Rudnick, 'Who Should Pay the Corporate Tax in a Flat Tax World?' (1988) 39 *Case Western Reserve L Rev* 965, 1062.

<sup>7</sup> Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy' (2001) 54 *Tax L Rev* 261, 298.

<sup>8</sup> Herwig J Schlunk, 'I Come Not to Praise the Corporate Income Tax, But to Save It' (2003) 56 *Tax L Rev* 329, 341-342.

<sup>9</sup> Reuven S Avi-Yonah, 'Corporations, Society, and the State: A Defense of the Corporate Tax' (2003) 90 *Virginia L Rev* 1193, 1244-49. For criticism of Avi-Yonah's argument see Yariv Brauner, 'The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy' (2008) *Michigan State L Rev* 591, 602-618.

controlled by the corporate management. This gives the management substantial economic, political, and social power. Corporate tax reduces these resources, and thus helps the State, acting as a representative of the people, to limit excessive accumulation of power in the hands of the corporate management.<sup>10</sup> As per this justification of corporate tax, whatever the incidence of corporate tax,<sup>11</sup> the most immediate burden falls on corporate management.<sup>12</sup>

There is also much public appeal in the idea that at least some burden of corporation tax is borne by wealthy owners of capital.<sup>13</sup> This is especially so because the tax allows a State the opportunity to reach out to foreign owners of capital operating in the country.<sup>14</sup> Politically, this can make it difficult for governments across the world to take measures towards removing or even substantially altering the corporation tax. Apart from this, in the international context, a source-based tax or taxing corporate profits where they are generated, is administratively simpler when

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<sup>10</sup> *ibid* 1244. For a narrower argument on the corporate governance aspect of corporate income tax see Mihir A Desai, Alexander Dyck, and Luigi Zingales, 'Theft and Taxes' (2007) 84 *Journal of Financial Economics* 591.

<sup>11</sup> Incidence of tax refers to who effectively bears the burden of the tax. This aspect vis-à-vis corporate income tax is discussed in section b of part I of this chapter.

<sup>12</sup> Avi-Yonah, 'Corporations, Society, and the State: A Defense of the Corporate Tax' (n 9) 14.

<sup>13</sup> Particularly in the post-2008 financial crisis world, corporations not paying their 'fair' share of tax has emerged as a sensitive political issue in countries across the world. See Bloomberg, 'The Great Corporate Tax Dodge' (*Bloomberg*, 2014) <<http://topics.bloomberg.com/the-great-corporate-tax-dodge/>> accessed 21 December 2014; Sebastian Chrispin, 'Pressure Grows to Tighten Global Tax Rules' *BBC News* (London, 31 October 2014) <[www.bbc.co.uk/news/business-29850055](http://www.bbc.co.uk/news/business-29850055)> accessed 21 December 2014; Heath Aston and Georgia Wilkins, 'Big Business Shirks Fair Share of Tax Load' *The Sydney Morning Herald* (Sydney, 29 September 2014) <[www.smh.com.au/business/the-economy/big-business-shirks-fair-share-of-tax-load-20140928-3gtm2.html](http://www.smh.com.au/business/the-economy/big-business-shirks-fair-share-of-tax-load-20140928-3gtm2.html)> accessed 21 December 2014; Rowena Mason and Jennifer Rankin, 'EU Could Force Google to Pay More UK Tax' *The Guardian* (London, 28 January 2016) <[www.theguardian.com/politics/2016/jan/28/eu-could-force-google-to-pay-more-uk-tax](http://www.theguardian.com/politics/2016/jan/28/eu-could-force-google-to-pay-more-uk-tax)> accessed 20 February 2016. Arguably, inherent in this development is the general belief that at least some burden of a tax on corporate profits falls on wealthy owners of capital.

<sup>14</sup> 'Taxing Corporate Income' in *Tax by Design: The Mirrlees Review* (n 1) 411. The terms source and residence are used above in their legal sense. These are discussed to a greater extent in part II of this chapter.

compared to calculating a corporation's worldwide income for taxation in the corporation's State of residence.<sup>15</sup>

## **b. Criticisms of corporation tax**

Corporation tax influences key choices of companies. Whereas the effective average tax rate or the proportion of pre-tax income taken in tax affects the location of investments; the marginal tax rate, or the point at which the marginal product of capital equals the cost of capital, affects its scale thereafter.<sup>16</sup> Statutory tax rate in turn influences where companies declare taxable profits.<sup>17</sup> Research shows that globalisation has fuelled competition between countries for mobile capital and profits.<sup>18</sup> For instance, as can also be seen in graph 1 on the following page, over the years, the OECD countries have witnessed a consistent decline in their statutory corporate income tax rates.<sup>19</sup> The predicted 'race to the bottom' and the concomitant doom of corporation tax has, however, not really been seen in practice. Graph 2 reflects that across the same OECD economies, there has been no such similar downward trend in corporation tax revenues. This has been attributed to base-

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<sup>15</sup> *ibid* 433.

<sup>16</sup> Michael P Devereux, Rachel Griffith, and Alexander Klemm, 'Corporate Income Tax Reforms and International Tax Competition' (2002) 17 *Economic Policy* 451, 454-456; Michael P Devereux and Rachel Griffith, 'Evaluating Tax Policy for Location Decisions' (2003) 10 *Int'l Tax and Public Finance* 107, 108.

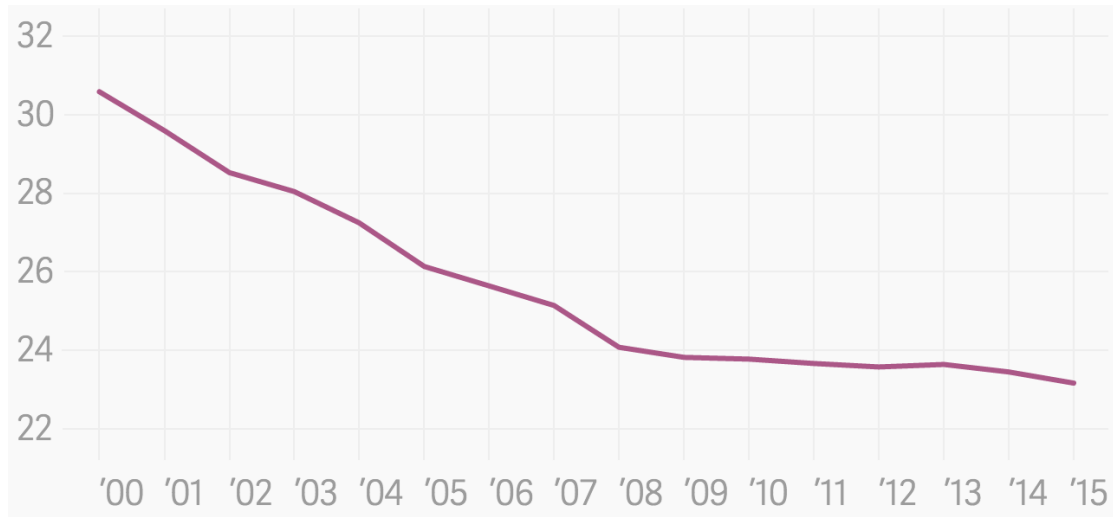
<sup>17</sup> Alan J Auerbach, Michael P Devereux, and Helen Simpson, 'Taxing Corporate Income' in IFS (ed), *Dimensions of Tax Design: The Mirrlees Review* (OUP 2010) (Dimensions of Tax Design: The Mirrlees Review) 837, 854.

<sup>18</sup> *ibid* 856-857. See also Michael P Devereux, Ben Lockwood, and Michela Redoano, 'Do Countries Compete over Corporate Tax Rates?' (2008) 92 *Journal of Public Economics* 1210, 1211.

<sup>19</sup> Bert Brys, Stephen Matthews, and Jeffrey Owens, 'Tax Reform Trends in OECD Countries' (2011) Organisation for Economic Cooperation and Development (OECD) Taxation Working Papers No 1, 5 <<http://dx.doi.org/10.1787/5kg3h0xxmz8t-en>> accessed 12 January 2014.

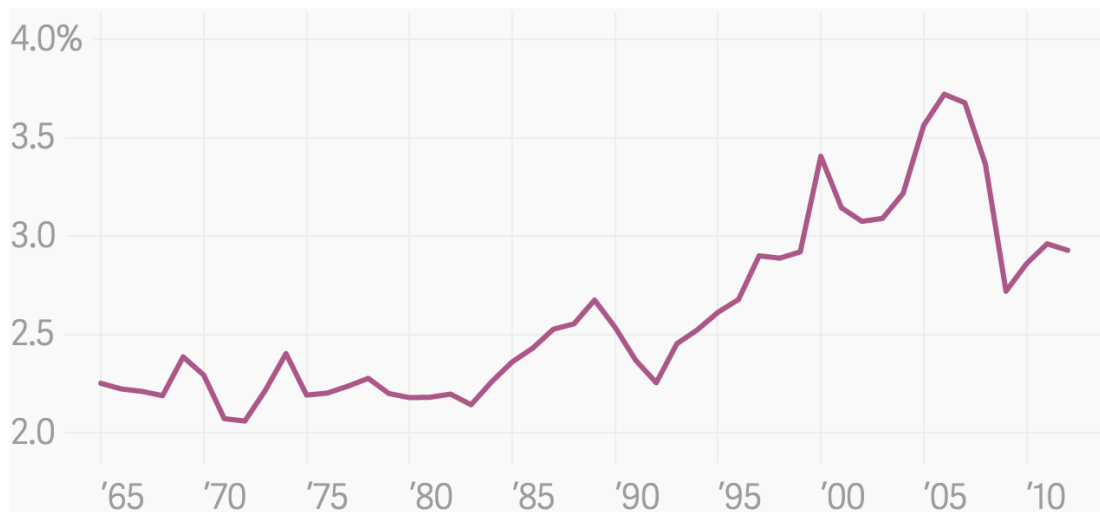
broadening measures, and the closure of loopholes used for tax planning, as well as overall growth in corporatisation and corporate income.<sup>20</sup>

**Graph 1 - Average corporate income tax rates for OECD countries**



Source: Based on data obtained from OECD. Stat.

**Graph 2 - Tax on corporate profits as a proportion of GDP for OECD countries**



Source: Based on data obtained from OECD. Stat.

<sup>20</sup> *ibid* 8-9; Joanna Piotrowska and Werner Vanborren, 'The Corporate Income Tax Rate-Revenue Paradox: Evidence in the EU' (2008) European Commission (EC) Taxation Papers, Working Paper No 12-2007, 23-24 <<http://bit.ly/1MwD8g9>> accessed 15 December 2015.

More fundamentally, taxing the income of a legal fiction such as a corporation raises the question of who actually bears the burden of this tax. Some economists have suggested that with capital being highly mobile, the burden of corporation tax is shifted to less mobile factors such as labour in the form of lesser wages, or consumers in the form of higher prices.<sup>21</sup> There are, however, others who support the idea that at least some incidence of the tax is on shareholders and owners of capital.<sup>22</sup> The variation in views appears to stem from the assumptions underlying the different studies.<sup>23</sup> Thus, the literature on this point could be considered inconclusive.

Tax on corporate income, however, has other distortionary effects. For instance, corporate income tax imposes an additional level of taxation on returns to investment in the corporate sector, with personal taxes being levied on both corporate and non-corporate investors. This favours non-incorporated forms of business.<sup>24</sup> The impact, however, has to be considered along with other non-tax benefits of incorporation in different industries.<sup>25</sup> Another example of the distortionary effect of corporate income

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<sup>21</sup> Rachel Griffith, James Hines, and Peter Birch Sørensen, 'International Capital Taxation' in *Dimensions of Tax Design: The Mirrlees Review* (n 17) 914, 924-925. See also Wiji Arulampalam, Michael P Devereux, and Giorgia Maffini, 'The Direct Incidence of Corporate Income Tax on Wages' (2012) 56 *European Economic Rev* 1038, 1039-1041; Li Liu and Rosanne Altshuler, 'Measuring the Burden of the Corporate Income Tax Under Imperfect Competition' (2013) 66 *National Tax Journal* 215, 233.

<sup>22</sup> Alan J Auerbach, 'Who Bears the Corporate Tax? A Review of What We Know' (2005) NBER Working Paper No 11686, 40-41 <[www.nber.org/papers/w11686](http://www.nber.org/papers/w11686)> accessed 20 January 2014; Kimberly A Clausing, 'Who Pays the Corporate Tax in a Global Economy' (2013) 66 *National Tax Journal* 151, 175.

<sup>23</sup> For instance, for critical questioning of the results reached by Liu and Altshuler, and Arulampalam, Devereux, and Maffini cited at (n 21) based on new data and different methods see Clausing, 'Who Pays the Corporate Tax in a Global Economy' (n 22) 155-156. See also Auerbach (n 22) 40-41; 'Taxing Corporate Income' in *Tax by Design: The Mirrlees Review* (n 1) 409.

<sup>24</sup> Austan Goolsbee, 'Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax' (1998) 69 *Journal of Public Economics* 143, 150-151.

<sup>25</sup> Roger H Gordon and Jeffrey K MacKie-Mason, 'Tax Distortions to the Choice of Organizational Form' (1994) 55 *Journal of Public Economics* 279, 304-305; Jeffrey K MacKie-Mason and Roger H

tax is the preference for debt finance. Interest payments are generally deductible in calculating the taxable profits of a company, but the normal return to equity finance is not. This makes it more attractive for companies to borrow. Piling on more debt as compared to the value of a company's assets means more fragile balance sheets, and thus potentially greater number of defaulters in the case of economic decline.<sup>26</sup> In the international setting, the same debt bias encourages corporations to shift profits by borrowing in high-tax countries from affiliates in low-tax countries.<sup>27</sup>

In the international context, a preliminary issue with taxation of corporate profits is the definition of profits for tax purposes. This can vary to different degrees between the countries in which an MNE operates, and thus can lead to the same income being taxed in more than one country.<sup>28</sup> It can, however, also work to MNEs' advantage in some cases, such as when the same expense is deductible in more than one country. Another issue is that tax on corporate profits raises the pre-tax required rate of return on investment.<sup>29</sup> This makes it an obvious factor in assessing a country's

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Gordon, 'How Much Do Taxes Discourage Incorporation?' (1997) 52 *The Journal of Finance* 477, 504. Also, the effect depends on the personal tax system of the country. For instance, this would not be the case in the UK or countries with full integration between corporate and personal tax systems.

<sup>26</sup> Daniel Shaviro, 'Income Tax Reform Implications of the Financial Crisis' in Julian S Alworth and Giampaolo Arachi (eds), *Taxation and the Financial Crisis* (OUP 2012) 174. See also Serena Fatica, Thomas Hemmelgarn, and Gaëtan Nicodème, 'The Debt-Equity Tax Bias: Consequences and Solutions' (2012) EC Taxation Papers, Working Paper No 33, 2 <<http://bit.ly/20Dj7MQ>> accessed 15 January 2015.

<sup>27</sup> Harry Huizinga, Luc Laeven, and Gaëtan Nicodème, 'Capital Structure and International Debt Shifting' (2008) 88 *Journal of Financial Economics* 80, 81. Undertaking such tax planning and checking it involves costs for both MNEs and governments across the world. For a discussion on such and other costs generated by the existing corporate income tax see Brauner, 'The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy' (n 9) 597 and the literature cited there.

<sup>28</sup> When the same income is taxed in one or more States in the hands of different taxpayers, this is known as economic double taxation. When the same taxpayer is taxed on the same income in two or more States, this is known as juridical double taxation. See Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 *Int'l Tax & Business L* 1, 6.

<sup>29</sup> Starting from Diamond and Mirrlees's production efficiency theorem, there is substantial literature suggesting that small open economies should give up source-based taxation of income from capital. See Peter A Diamond and James A Mirrlees, 'Optimal Taxation and Public Production I: Production

appeal as an investment destination.<sup>30</sup> An option that economists suggest is a tax that seeks to collect location-specific economic rent or any surplus over the minimum required rate of return on the investment owing to factors distinct to that economy.<sup>31</sup> Designing a tax that captures all or a part of economic rents without resulting in outflow of capital and mobile rents from the economy is, however, a challenging proposition.<sup>32</sup> However, this concern also has to be seen along with non-tax factors that influence the investment attractiveness of an economy.<sup>33</sup>

### **c. The existing scenario**

Over the years, several alternatives to the existing corporate tax base have been suggested. The prominent ones include the 1978 Meade report's R (real base), the R+F (real and financial base), and the S (share base).<sup>34</sup> All of these involve taxation of economic rent only.<sup>35</sup> This, as mentioned above, is potentially non-distortionary as to the scale of investment. Further, although some distinction between debt and equity financed investments will persist under the R+F and S bases, the R base will lead to the same treatment of both.<sup>36</sup>

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Efficiency' (1971) 61 *American Economic Rev* 8; Peter A Diamond and James A Mirrlees, 'Optimal Taxation and Public Production II: Tax Rules' (1971) 61 *American Economic Rev* 261.

<sup>30</sup> Harry Huizinga, 'The Optimal Taxation of Savings and Investment in an Open Economy' (1995) 47 *Economics Letters* 59; Michael Keen and Hannu Piekkola, 'Simple Rules for the Optimal Taxation of International Capital Income' (1997) 99 *Scandinavian Journal of Economics* 447, 448-450.

<sup>31</sup> Alan J Auerbach, Michael P Devereux, and Helen Simpson, 'Taxing Corporate Income' in *Dimensions of Tax Design: The Mirrlees Review* (n 17) 872.

<sup>32</sup> *ibid.*

<sup>33</sup> OECD, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* (OECD 2007) 77-79.

<sup>34</sup> J E Meade, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade* (George Allen & Unwin 1978).

<sup>35</sup> *ibid* 230-235.

<sup>36</sup> For more discussion on the Meade report's proposals see 'Taxing Corporate Income' in *Tax by Design: The Mirrlees Review* (n 1) 420-421; Alan J Auerbach, Michael P Devereux, and Helen

In 1991, the Institute for Fiscal Studies' Capital Taxes Group proposed another type of flow-of-funds tax – the Allowance for Corporate Equity (ACE).<sup>37</sup> The idea is to permit interest deductions, but then to have an allowance for the cost of equity finance or an ACE. This will be based on the 'equity invested in the company including retained profits and the past equity allowances, less tax and dividends paid and less net investment in other companies'.<sup>38</sup> The amount of the allowance for any period will be established by reference to a government fixed normal commercial rate of interest.<sup>39</sup> Such an allowance would align the tax treatment of debt and equity. Also, as the tax will be only on economic rent, there would be no adverse impact on the scale of investment. The 2011 Mirrlees Review in the UK supported this idea of ACE as an alternative to the existing tax base.<sup>40</sup>

Another suggestion for reforming the tax base, the Comprehensive Business Income Tax (CBIT), was proposed by the US Treasury in 1992.<sup>41</sup> This eliminates deductibility of interest from taxable income, which would result in a single tax on all corporate income, regardless of whether it is debt or equity financed. A modification

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Simpson, 'Taxing Corporate Income' in *Dimensions of Tax Design: The Mirrlees Review* (n 17) 842-843, 860-861.

<sup>37</sup> Allowance for Corporate Equity (ACE) was first discussed by Boadway and Bruce in 1984. See Robin Boadway and Neil Bruce, 'A General Proposition on the Design of a Neutral Business Tax' (1984) 24 *Journal of Public Economics* 231, 237-238.

<sup>38</sup> The IFS Capital Taxes Group, *Equity for Companies: A Corporation Tax for the 1990s* (The IFS 1991) 2.

<sup>39</sup> *ibid.*

<sup>40</sup> 'Corporate Taxation in an International Context' in *Tax by Design: The Mirrlees Review* (n 1) 449.

<sup>41</sup> US Department of Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (US Government Printing Office 1992) 39-58.

of the CBIT is the Dual Income Tax (DIT).<sup>42</sup> Under the DIT, all forms of capital income are subject to a uniform proportional tax, and progressive taxation is maintained for a taxpayer's income from all other sources.<sup>43</sup> Application of the DIT at only the corporate level would give the same structure as the CBIT.<sup>44</sup>

A more recent proposal is to impose a cash-flow tax on destination basis.<sup>45</sup> As explained by Devereux and de la Feria, it will be a tax on the R+F tax base to the extent that there will be immediate expensing of all investment expenditure and inclusion of net financial flows in the tax base.<sup>46</sup> The distinctive feature will, however, be a zero rate of tax on all exports, with all imports being taxed. Thus, in proximity with value added tax, income will be taxed in the country where the customer purchases the goods and services rather than where they are produced or performed, with the key difference being deductibility of labour costs.<sup>47</sup>

Despite these alternatives having existed for a reasonable amount of time, none of these options for replacing the existing corporate tax base have received

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<sup>42</sup> Peter Birch Sørensen, 'From the Global Income Tax to the Dual Income Tax - Recent Tax Reforms in the Nordic Countries' (1994) 1 *Int'l Tax and Public Finance* 57, 59-61; Søren Bo Nielsen and Peter Birch Sørensen, 'On the Optimality of the Nordic System of Dual Income Taxation' (1997) 63 *Journal of Public Economics* 311, 312.

<sup>43</sup> Peter Birch Sørensen (n 42) 58.

<sup>44</sup> For an insight into the differences between the Comprehensive Business Income Tax (CBIT) and the DIT see Alan J Auerbach, Michael P Devereux, and Helen Simpson, 'Taxing Corporate Income' in *Dimensions of Tax Design: The Mirrlees Review* (n 17) 878-879.

<sup>45</sup> See Stephen R Bond and Michael P Devereux, 'Cash Flow Taxes in an Open Economy' (2002) Centre for Economic Policy Research Discussion Series, Discussion Paper 3401.

<sup>46</sup> Michael P Devereux and Rita de la Feria, 'Designing and Implementing a Destination-Based Corporate Tax' (2014) Oxford University Centre for Business Taxation (OUCBT) Working Paper Series, Working Paper 14/07, 3.

<sup>47</sup> *ibid* 3, 9. As discussed by Devereux and de la Feria, tax base proposed for a destination-based tax is in effect equal to the tax base for value added tax except for the treatment of labour costs, which are deductible under the former. See *ibid* 10.

widespread application.<sup>48</sup> The Mirrlees Review highlights that countries across the world continue to operate a form of corporate income tax, and appear reluctant to forego their share of source-based tax on corporate profits.<sup>49</sup> This is particularly true for the countries that are the focus of this thesis – Brazil, India, and China (the BICs). In fact, in the broad and heterogeneous group of developing countries, Brazil is the only country that has, in the form of a variant of ACE, come close to experimenting with any of these proposals. Unlike any theoretical conception of ACE or any form of ACE that has been applied by other countries,<sup>50</sup> under the Brazilian approach, notional interest is deductible as ‘interest on equity’ or ‘remuneration to equity’ only in the case of distributed earnings.<sup>51</sup> No deduction is permitted for retained earnings. The remuneration is calculated based on the book value of equity and the notional rate of return is equal to the interest rate on long-term loans.<sup>52</sup>

Theoretical and empirical analysis of the Brazilian approach to ACE has shown that, as expected, the exact effects of the system depend on dividend payout ratios.<sup>53</sup> Companies with high ratios, which are fewer, are covered under the ACE. Greater numbers of companies have low dividend payout ratios, and hence have only dividend

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<sup>48</sup> Some like the destination-based cash-flow tax have not been tried practically at all. For an insight into the criticisms of the idea see Wei Cui, ‘A Critical Review of Proposals for Destination-Based Cash-Flow Corporate Taxation as an International Tax Reform Option’ (2015) OUCBT Working Paper Series, Working Paper 15/21.

<sup>49</sup> ‘Corporate Taxation in an International Context’ in *Tax by Design: The Mirrlees Review* (n 1) 432.

<sup>50</sup> These include Italy, Croatia, Belgium, and Austria. For an overview of these countries’ application of ACE see Ruud A de Mooij and Michael P Devereux, ‘Alternative Systems of Business Tax in Europe: An Applied Analysis of ACE and CBIT Reforms’ (2009) EC Taxation Papers, Working Paper No 17-2009, 14-16 <<http://bit.ly/1m7Cpgu>> accessed 20 November 2014.

<sup>51</sup> Republic of Brazil, Law No 9, 249 of 26 of December 1995, Article 9 <[www.receita.fazenda.gov.br/legislacao/leis/ant2001/lei924995.htm](http://www.receita.fazenda.gov.br/legislacao/leis/ant2001/lei924995.htm)> accessed 20 November 2014.

<sup>52</sup> See Devereux and de Mooij (n 50) 16.

<sup>53</sup> Alexander Klemm, ‘Allowances for Corporate Equity in Practice’ (2006) International Monetary Fund (IMF) Working Paper WP/06/259, 24 <[www.imf.org/external/pubs/ft/wp/2006/wp06259.pdf](http://www.imf.org/external/pubs/ft/wp/2006/wp06259.pdf)> accessed 20 November 2014.

deductibility.<sup>54</sup> This too should have encouraged a change in the capital structure towards more equity finance, but that has not happened.<sup>55</sup> Further, owing to a low notional interest rate, there has remained a debt bias for companies that paid dividends in excess of the notional return.<sup>56</sup> An increase in investment inflows was seen after Brazil's 1996 economic reforms, as a part of which the remuneration to equity was introduced. However, it could not be established whether this was because of the new ACE like approach or due to a simultaneous reduction in statutory corporate income tax rates.<sup>57</sup>

Arguably, it is because of such neutral results that over the last 15 years, Brazil has neither removed the remuneration to equity nor made any substantial changes to it. Brazil's move to full ACE appears unlikely in view of the fact that corporation tax makes up close to 11% of Brazil's total tax revenues,<sup>58</sup> and the country has for long maintained a high statutory tax rate, which at present is 34%.<sup>59</sup> This tax rate lies on the higher end of the global spectrum, and it makes a shift to full ACE, which would narrow the country's tax base, difficult.<sup>60</sup> The Mirrlees Review acknowledges contraction of tax base as an effect of ACE, and seems to propose greater reliance on

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<sup>54</sup> *ibid.*

<sup>55</sup> *ibid.*

<sup>56</sup> *ibid* 14.

<sup>57</sup> *ibid* 25.

<sup>58</sup> This percentage is based on the data obtained from OECD, Economic Commission for Latin America and the Caribbean (ECLAC), and the Inter-American Center of Tax Administrations (CIAT), *Revenue Statistics in Latin America* (OECD 2014) 88. This percentage is based on the data for 2011. See also Roberto Machado and José Zuloeta, 'The Impact of the Business Cycle on Elasticities of Tax Revenue in Latin America' (2012) Inter-American Development Bank (IADB) Working Paper No 340, 3 <[www10.iadb.org/intal/intalcdi/PE/2012/11296.pdf](http://www10.iadb.org/intal/intalcdi/PE/2012/11296.pdf)> accessed 10 December 2014.

<sup>59</sup> OECD, *OECD Economic Surveys: Brazil 2013* (OECD 2013) 21.

<sup>60</sup> According to the 2013 OECD Economic Survey for Brazil, at that time, the OECD average for corporate income tax rates was 25%.

consumption taxes as one option to make up for the loss of revenue.<sup>61</sup> The viability of this route, however, appears doubtful for a country like Brazil that already has a high consumption tax burden.<sup>62</sup>

In India and China, discussion around shifting to another base for tax at the corporate level has been almost completely absent. Tax on corporate profits forms more than 34% and 19% of the total tax revenues of the countries respectively.<sup>63</sup> While Brazil has a tax to GDP ratio of about 36.3%,<sup>64</sup> India's and China's is approximately 16.4% and 22% respectively.<sup>65</sup> This is on the lower side when compared to OECD countries that have an average tax to GDP ratio of 34.4%.<sup>66</sup> The pressure to raise greater tax revenues thus faced by these countries would make it difficult for their governments to take steps in a direction that could potentially interfere with or reduce an important revenue resource.<sup>67</sup>

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<sup>61</sup> 'Corporate Taxation in an International Context' in *Tax by Design: The Mirrlees Review* (n 1) 450.

<sup>62</sup> OECD, ECLAC, CIAT (n 58) 89.

<sup>63</sup> These percentages are based on the data obtained from Ministry of Finance, 'Union Budget: 2014-2015' (Government of India 2014) <<http://indiabudget.nic.in/budget2014-2015/budget.asp>> accessed 10 December 2014; National Bureau of Statistics, 'China Statistical Yearbook' (China Statistical Press 2013) <[www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm](http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm)> accessed 10 December 2014. The figure for India is based on the data for 2012-2013. The figure for China is based on the data for 2010.

<sup>64</sup> OECD, ECLAC, CIAT (n 58) 24.

<sup>65</sup> These percentages are based on the data obtained from Ministry of Finance, 'Indian Public Finance Statistics: 2012-2013' (Government of India 2013) 14 <<http://finmin.nic.in/reports/IPFStat201213.pdf>> accessed 10 December 2014; China Statistical Yearbook 2013 (n 63). These represent India's tax to GDP ratio for 2011-2012, and China's tax to GDP ratio for 2012.

<sup>66</sup> This was the tax to GDP ratio of OECD countries for 2014. The tax to GDP ratio of OECD countries for 2013 was 34.2%, and for 2012 was 33.8%. See OECD, 'Revenue Statistics - Provisional Data on Tax Ratios for 2014' (OECD 2015) <[www.oecd.org/ctp/tax-policy/revenue-statistics-ratio-change-latest-years.htm](http://www.oecd.org/ctp/tax-policy/revenue-statistics-ratio-change-latest-years.htm)> accessed 10 December 2014.

<sup>67</sup> Based on the data from the sources cited at (n 65), in India and China, taxes on the sale of goods and services are already quite high. This would make it hard to increase consumption tax so as to recover loss in tax revenue expected owing to a shift to ACE.

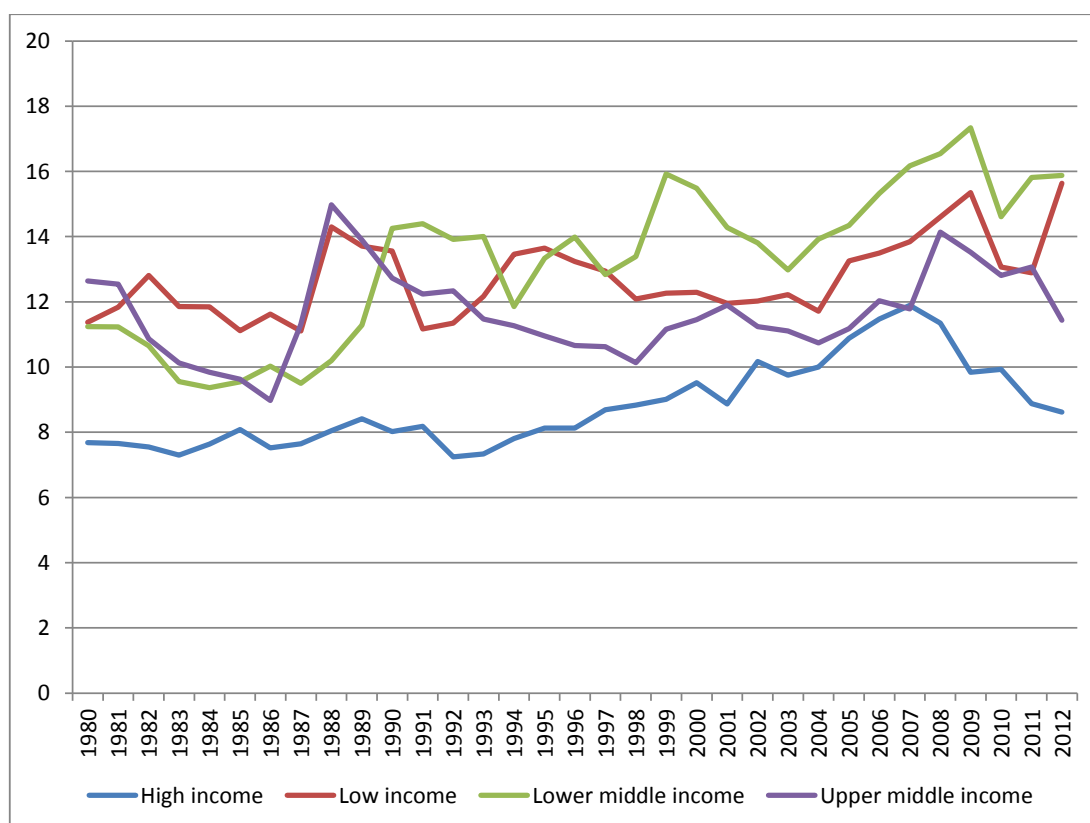
As can be seen in graph 3 on the next page, compared to developed countries, corporate income tax is of greater importance for developing countries.<sup>68</sup> On average, other developing countries' tax to GDP ratios are much lower than those of the BICs.<sup>69</sup> Some of the reasons behind the absence of any official consideration of a shift to an alternative corporate tax base in these countries include the constant need to raise greater tax revenues to fund their development and the limited technical and administrative capability to undertake a fundamental change in the operation of a key source of revenue.

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<sup>68</sup> Roger Gordon and Wei Li, 'Tax Structure in Developing Countries: Many Puzzles and a Possible Explanation' (2009) 93 *Journal of Public Economics* 855, 857. See also Vito Tanzi and Howell H Zee, 'Tax Policy for Emerging Markets: Developing Countries' (2000) 53 *National Tax Journal* 299, 307.

<sup>69</sup> Gordon and Li (n 68) 857; Tanzi and Zee (n 68) 303. An OECD report for the G20 Development Working Group (DWG) on the impact of Base Erosion and Profit Shifting (BEPS) in low-income countries points out that half of the sub-Saharan African countries still mobilise less than 15% of their GDP in tax revenues, which is below the minimum of 20% that was considered necessary by the United Nations (UN) to achieve the Millennium Development Goals by 2015. See OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (OECD 2014) 10 <[www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf](http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf)> accessed 10 December 2014.

**Graph 3 - Revenue from corporate income tax as a percentage of total revenue**



Source: International Monetary Fund (IMF), ‘Spillovers in International Corporate Taxation’ (2014) IMF Policy Papers.

Thus, in the foreseeable future, a complete change of corporate tax base does not appear to be a reality for either the BICs or other developing countries.<sup>70</sup> Recent developments at the international level potentially entrench this position. The Base Erosion and Profit Shifting (BEPS) project taken up by the OECD at the mandate of the Group of 20 (G20), which could be considered the most significant international taxation reform effort since the time of the League of Nations (LONs), took tax on

<sup>70</sup> Richard J Vann, ‘Current Trends in Balancing Residence and Source Taxation’ in Yariv Brauner and Pasquale Pistone (eds), *BRICS and the Emergence of International Tax Coordination* (IBFD 2015) 367, 391. In this piece Vann discusses how the BICs specifically are ‘great believers in the corporate income tax’ and are ‘determined to shake up the international tax system to assert very strongly the importance of the corporate income tax as a source tax and not to give up on it, as some of the “old” economies seemed to be doing before the BEPS initiative came along’.

corporate profits as its starting point.<sup>71</sup> In fact, at the heart of the project are some of the issues arising because of the deficiencies in and the abuse of the prevailing international set-up for taxation of corporate profits.<sup>72</sup>

In view of all these facts, this thesis limits itself to the existing notion of corporation tax discussed in this part, with the focus being on the prevailing international framework for allocation of rights to tax active business income between countries.

## **II. The broad contours of this research**

The question that this thesis explores is whether the existing framework for assignment of rights to tax active business income between countries can be considered fair from the BICs' perspective. Thus, there are three key elements of this research: the international set-up for assignment of rights to tax active business income, the principle of Inter-Nation Equity (INE) in the context of the same, and the BICs. Part II introduces each of these aspects.

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<sup>71</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 13; OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 13.

<sup>72</sup> For example see OECD, *Action Plan on Base Erosion and Profit Shifting* 2013 (n 71) Action 1 - Address the tax challenges of the digital economy, Action 4 – Limit base erosion via interest deductions and other financial payments, Action 6 – Prevent treaty abuse, Action 7 – Prevent the artificial avoidance of PE status, Actions 8, 9, 10 – Assure that transfer pricing outcomes are in line with value creation. See also Richard J Vann, 'Policy Forum: Policy Underpinnings of the BEPS Project – Preserving the International Corporate Income Tax?' (2014) 62 *Canadian Tax Journal* 433, 435-36. Vann argues how in this way the main objective of the BEPS project is, in fact, 'protection and restoration of the international corporate income tax base'. Vann contrasts this development with previous OECD sponsored works that suggested replacing the corporate income tax with more efficient taxes such as OECD, *Taxing Profits in a Global Economy* (OECD 1991); OECD, *Fundamental Reform of Corporate Income Tax* (OECD 2007).

**a. The existing international framework for allocation of rights to tax active business income**

Tax sovereignty is an integral attribute of every politically independent country. It encompasses a country's right to create and enforce laws governing the sphere of taxation.<sup>73</sup> Yet, it is difficult to deny that the international taxation 'regime' or framework, the majority of which might not bind States, influences the limits of legitimate exercise of States' fiscal powers.<sup>74</sup> Under the prevailing international taxation framework, a State's 'right' to tax depends on the existence of certain commonly accepted 'connecting factors' that can be divided into two broad categories: nationality and territoriality.<sup>75</sup> Nationality involves a taxpayer's personal connection to the State.<sup>76</sup> In the case of a corporate taxpayer, this personal connection can be in the form of the taxpayer's incorporation, residence, or domicile in the State. In comparison, territoriality concerns the link between a taxpayer's economic activities and a State's geographical borders.<sup>77</sup> 'Subjective' connections under nationality and 'objective' connections under territoriality are more generally referred to as giving a right to tax on 'residence' and 'source' basis.<sup>78</sup>

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<sup>73</sup> Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson 1992) 307-308.

<sup>74</sup> Reuven S Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 *Texas L Rev* 1301, 1303-1304. See also Brian J Arnold and Michael McIntyre, *International Tax Primer* (2nd ed, Kluwer Law International 2002) 2-3; Yariv Brauner, 'An International Tax Regime in Crystallization' (2003) 56 *Tax L Rev* 259; Allison Christians, 'Hard Law, Soft Law, and International Taxation' (2007) 25 *Wisconsin Int'l L Journal* 325.

<sup>75</sup> Angel Schindel and Adolfo Atchabahian, 'General Report' in IFA (ed), *Source and Residence: New Configuration of Their Principles*, Cahiers de Droit Fiscal International Vol 90a (IFA 2005) 21, 29.

<sup>76</sup> *ibid.*

<sup>77</sup> *ibid.*

<sup>78</sup> *ibid* 29-30.

It is commonly asserted that the need to maintain equity among residents of a State requires taxation according to their economic capacity or ‘ability to pay’ as reflected from their income defined comprehensively.<sup>79</sup> This has been used to justify the scope of the right to tax on residence basis as extending to the worldwide income of a State’s residents.<sup>80</sup> In comparison, the conventional basis of the source State’s right to tax is the previously mentioned benefit principle.<sup>81</sup> Most countries across the world simultaneously exercise the right to tax on residence and source basis vis-à-vis their residents and non-residents respectively.

The potential for double taxation of income inherent in States’ competing rights to tax on source and residence basis can be addressed in several ways: either States can unilaterally allow their residents to deduct foreign taxes paid, or give them credit for the tax paid in another country against their total tax liability, or entirely exempt foreign source income from taxation in the State of residence.<sup>82</sup> Alternatively, bilateral tax treaties can be used. Over 3000 bilateral treaties are in existence.<sup>83</sup> These are largely based on the OECD Model Tax Convention (OECD Model) and the UN Model Tax Convention (UN Model).<sup>84</sup>

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<sup>79</sup> Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (n 6) 223-231.

<sup>80</sup> Hugh J Ault, Brian J Arnold, and others, *Comparative Income Taxation: A Structural Analysis* (2nd edn, Kluwer Law International 2004) 345-50. See also J Clifton Fleming Jr, Robert J Peroni, and Stephen E Shay, ‘Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income’ (2001) 5 Florida Tax Rev 299.

<sup>81</sup> Dale Pinto, *E-Commerce and Source Based Income Taxation* (IBFD 2003) 17-23.

<sup>82</sup> Martin Norr, ‘Jurisdiction to Tax and International Tax Treaties’ (1962) 17 Tax L Rev 431, 439-441. See also Kevin Holmes, *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (IBFD 2007) 25-36.

<sup>83</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* (OECD 2014) 11.

<sup>84</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014); UN Department of Economic and Social Affairs (DESA), *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011).

The OECD Model and the UN Model draw their basic structure from the work carried out by the League of Nations (LONs) in the 1920s. The 1923 report of the LONs' Group of Economists discussed 'classification and assignment of sources'.<sup>85</sup> This involves giving the source country full or limited right to tax certain classes of income, with the remainder being subject solely to residence country taxation.<sup>86</sup> Although the Group of Economists rejected this method for being largely impracticable in its application to income tax, it was reflected in the LONs' early model treaties.<sup>87</sup> The idea has also persisted in the OECD Model and the UN Model. In both the Models, the primary right to tax active income or income arising from specific economic activities taking place in a State vests with that State or the source State or the host State.<sup>88</sup> In contrast, the State of residence or the home State has the first right to tax passive income.<sup>89</sup> For achieving a balance between the breadth and depth of research, this thesis is confined to the allocation of rights to tax active business income.

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<sup>85</sup> Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee of the League of Nations* (EFS73.F19, League of Nations (LONs) 1923). This report as well as other reports of the LONs' along with the reports of the Organisation for European Economic Cooperation (OEEC) cited in this work are also available at <<http://setis.library.usyd.edu.au/oztexts/parsons.html>>.

<sup>86</sup> *ibid* 42.

<sup>87</sup> LONs, General Meeting of Government Experts, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion* (C562.M178.1928II, LONs 1928) 7-21.

<sup>88</sup> Reuven S Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (CUP 2007) 11. See also Reuven S Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (n 74) 1306-1308. Unless specified, the terms source State and host State are used interchangeably. The same applies to residence State and home State.

<sup>89</sup> Reuven S Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (n 74) 1306-1308. This of course is a crude expression of the prevailing international division of taxing rights as, for instance, under both the OECD Model and the UN Model, host States are allowed to withhold tax at source on forms of passive income such as interests and dividends, *albeit* generally at lower rates.

Under Article 7 of the OECD Model and the UN Model, the source State can exercise its primary right to tax active business income arising from international commerce only when a non-resident enterprise has a permanent establishment (PE) in the State. The concept of PE, as contained in Article 5 of both the Models, envisages a certain degree of physical presence and a level of business activity of the enterprise in a State for the active business income generated by the enterprise to be taxable in the State. Generally, only income attributable to a PE can be taxed by the source State.<sup>90</sup>

A host State can also acquire the right to tax active business income by effectively becoming the home State when an MNE establishes an associated enterprise in the State. Determining active business income of the associated enterprise that the State can tax involves ascertaining prices of transactions between related enterprises or transfer prices between them. Article 9 of both the Models establishes the arm's length principle (ALP) as the basis of this exercise. The ALP requires transactions between associated enterprises to be treated as the same or similar transaction between independent entities acting under the same or similar circumstances.<sup>91</sup>

It is recognised that with financial innovations, the strict distinction between active and passive income is becoming difficult to maintain. The greater integration of economies across the world has made the source of income hard to identify and the

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<sup>90</sup> The limited 'force of attraction' principle contained under Article 7(1) of the UN Model could be considered an exception. The principle will be discussed in chapter III of this thesis.

<sup>91</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010) (OECD TPG) para 1.6; UN DESA, *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2013) (UN TPM) para 1.1.8.

residence requirement easier to abuse.<sup>92</sup> Developments in technology and business methods, particularly electronic commerce, have also rendered concepts such as physical presence less meaningful as compared to the ‘brick and mortar world’ in which they were conceived.<sup>93</sup> It is further acknowledged that the market analogy underlying the arm’s length principle (ALP) contradicts the rationale behind transacting with group entities as opposed to unrelated units, which makes the existing rules for determining the price of intra-entity transactions prone to exploitation by MNEs.<sup>94</sup>

These flaws highlight the need for reform in the prevailing international framework for assignment of rights to tax active business income. They, however, do not change what we have at present as the core aspects of this set-up. As the focus of this research is the arrangement as it exists, these aspects as elucidated in the preceding paragraphs, remain central. The thesis outline presented in part III of this chapter will clarify the exact issues concerning them that the author will explore in this work.

## **b. The principle of Inter-Nation Equity (INE)**

In their 1923 report, the LONs’ Group of Economists discussed the doctrine of ‘economic allegiance’. This doctrine was meant to lead to an objective division of

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<sup>92</sup> Michael P Devereux and John Vella, ‘Are We Heading Towards a Corporate Tax System Fit for the 21<sup>st</sup> Century’ (2014) 35 *Fiscal Studies* 449, 453-54.

<sup>93</sup> OECD, *Addressing Base Erosion and Profit Shifting* 2013 (n 71) 7-8. See also Arvid A Skaar, ‘Erosion of the Concept of Permanent Establishment: Electronic Commerce’ (2000) 28 *Intertax* 188; Aldo Forgiore, ‘Clicks And Mortar: Taxing Multinational Business Profits in the Digital Age’ (2003) 26 *Seattle University L Rev* 719.

<sup>94</sup> Timothy S Newlon, ‘Transfer Pricing and Income Shifting in Integrating Economies’ in Sijbren Cnossen (ed), *Taxing Capital Income in the European Union: Issues and Options for Reform* (OUP 2000) 215-218.

taxing rights among States based on their contribution to the production, possession, and disposition of wealth.<sup>95</sup> The Group was, however, also critical of ‘piecemeal’ taxation of taxpayers on source basis, and it favoured progressive taxation of global income by the taxpayer’s State of residence.<sup>96</sup> As stated before, taxation according to a taxpayers’ ability to pay is the core of pursuit of equity among residents of a State. Extending this to inter-nation settings, however, does not sit well with the doctrine of economic allegiance.<sup>97</sup>

The 1925 report of the LONs’ Technical Experts, which followed the 1923 report of the Group of Economists, was clear that the suggestions on the allocation of taxing rights between source and residence States contained therein were ‘for purely practical purposes and no inference in regard to economic theory or doctrine should be drawn’ from them.<sup>98</sup> Subsequent works of the LONs’ Fiscal Committee, as well as the discussions leading to the OECD Model and the UN Model, have followed a largely similar approach. Thus, except for the 1923 report of the LONs’ Group of Economists, there is little in terms of normative considerations or principles in the documents leading to the prevailing international taxation framework that can help rationalise the existing division of taxing rights between countries.

Academic literature has sought to cover this gap through a long existing engagement with norms such as efficiency, equity, and administrative feasibility in

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<sup>95</sup> LONs’ 1923 Report (n 85) 20-26.

<sup>96</sup> *ibid* 40, 45-46.

<sup>97</sup> Nancy H Kaufman, ‘Fairness and the Taxation of International Income’ (1998) 29 *L & Policy in Int’l Business* 145, 173, 182.

<sup>98</sup> LONs, Technical Experts to the Economic and Financial Committee, *Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee* (F.212, LONs 1925) 15.

the international taxation framework. In inter-nation settings, efficiency is generally understood to mean achieving minimum distortions to saving and investment decisions of MNEs.<sup>99</sup> Equity is commonly accepted as concerning fairness in the assignment of rights to tax income generated by cross-border activities of MNEs between countries.<sup>100</sup> Administrative feasibility involves ensuring that the international taxation rules are possible and easy to administer.<sup>101</sup> More recently, there has been growth in the literature discussing the importance of certainty and simplicity in domestic tax laws from the standpoint of investment attractiveness of a State.<sup>102</sup> The drawback, however, is that not all these norms have received equal academic interest.<sup>103</sup> Inter-nation equity (INE), which was first discussed in 1972 by two economists: Richard A Musgrave and Peggy B Musgrave (the Musgraves),<sup>104</sup> did not attract much interest from other economists. Pursued substantially only by Peggy B Musgrave (Musgrave) in the following years, post 1995, the norm has seen some resurgence of interest from legal academics.

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<sup>99</sup> Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (n 6) 569. See also Mihir A Desai and James R Hines, 'Evaluating International Tax Reform' (2003) 56 *National Tax Journal* 487, 488; Michael P Devereux, 'Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations' (2008) 24 *Oxford Rev of Economic Policy* 698, 701-704.

<sup>100</sup> Nancy H Kaufman, 'Equity Considerations in International Taxation' (2001) 26 *Brooklyn Journal of Int'l L* 1465, 1465-1466.

<sup>101</sup> Anne Schäfer and Christoph Spengel, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?' (2003) ZEW Discussion Paper No 03/53, 7-8 <[www.econstor.eu/bitstream/10419/23987/1/dp0353.pdf](http://www.econstor.eu/bitstream/10419/23987/1/dp0353.pdf)> accessed 21 December 2011.

<sup>102</sup> Kelly Edmiston, Shannon Mudd, and Neven Valev, 'Tax Structures and FDI: The Deterrent Effects of Complexity and Uncertainty' (2003) 24 *Fiscal Studies* 341, 343-345, 356-357.

<sup>103</sup> Kim Brooks, 'Inter-Nation Equity: The Development of an Important But Underappreciated International Tax Policy Objective' in John G Head and Richard Krever (eds), *Tax Reform in the 21<sup>st</sup> Century: A Volume in Memory of Richard Musgrave* (Kluwer Law International 2009) 471, 491-492.

<sup>104</sup> Richard A Musgrave and Peggy B Musgrave, 'Inter-Nation Equity' in Richard M Bird and John G Head (eds), *Modern Fiscal Issues: Essays in the Honour of Carl S. Shoup* (University of Toronto Press 1972) 63.

It is acknowledged that work on INE is challenging. There are complexities at each level, starting from defining what is fair to realising any notion of fairness in the international sphere, which is marked by power play. In this author's view, the former difficulty is equally present in an intra-State context. It has, however, not hindered the consideration of equity or fairness in domestic tax policy discussions.<sup>105</sup> The same approach should be taken in an inter-nation context. The potential impact of the relative economic powers of States on bilateral tax treaty negotiations between them, in fact, makes it even more important that the international taxation framework reflects some basic level of fairness from the perspective of all States. Arguably, only if the template for these negotiations embodies some minimal notion of INE can we expect to reach a result where the interests of the economically less powerful State have not been trumped entirely by the interests of the more influential State. This is important for driving all States' trust in, and consequently, compliance with the rules for division of taxing rights between countries. This, in turn, is critical for ensuring the stability and longevity of these rules.<sup>106</sup> This is particularly important when, as in the case of the existing international set-up for allocation of taxing rights, not all States that are expected to comply with the arrangement were parties to establishing it.<sup>107</sup>

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<sup>105</sup> Meade Report (n 34) 12-16; John Kay, 'The Base for Direct Taxation – Commentary by John Kay' in *Dimensions of Tax Design: The Mirrlees Review* (n 17) 656, 660-663.

<sup>106</sup> Donald J Puchala and Raymond F Hopkins, 'International Regimes: Lessons from Inductive Analysis' (1982) 36 *International Organization* 245, 250. This argument is pursued at greater length in chapter II.

<sup>107</sup> Alex J Easson, *International Tax Reform and the Inter-Nation Allocation of Tax Revenue* (Victoria University Press 1991) 20. Easson discusses that the existing international taxation regime is not based not any real agreement between nations, with its evolution being dominated by the interests of developed countries. Picciotto makes a similar argument. See Picciotto (n 73) 47-58. These arguments are explored in chapter III.

In recent years, the arguments made in the preceding paragraphs have become even more important because of several developments. One of these is the tax and development campaign.<sup>108</sup> This issue is now on the agenda of leading organisations for shaping international taxation policy such as the OECD and the UN.<sup>109</sup> An important point in this regard is developing countries' ability to raise tax revenues from cross-border activities of MNEs to fund their vital developmental needs. This aspect is, in turn, linked to the international taxation rules and whether the rules result in a fair assignment of taxing rights from the standpoint of economically diverse States.

Another important development is the rise in the global influence of developing countries like the BICs.<sup>110</sup> Whether through forums such as the OECD and the UN, or through actions at the domestic level, some of these countries have expressed strong positions on international taxation issues.<sup>111</sup> These positions pose as grounds to

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<sup>108</sup> For an insight into non-governmental organisations' contribution to this area see Christian Aid, 'Shifting Sands: Tax, Transparency and Multinational Companies' (Christian Aid, 2010) <[www.christianaid.org.uk/images/accounting-for-change-shifting-sands.pdf](http://www.christianaid.org.uk/images/accounting-for-change-shifting-sands.pdf)> accessed 30 December 2010; Tax Justice Network (TJN), 'Tax, Aid and Development' (2010) (TJN, 2010) <[www.taxjustice.net/cms/front\\_content.php?idcatart=122](http://www.taxjustice.net/cms/front_content.php?idcatart=122)> accessed 15 March 2011; Deborah Itriago, 'Owning Development: Taxation to Fight Poverty' (Oxfam, 2011) <<http://policy-practice.oxfam.org.uk/publications/owning-development-taxation-to-fight-poverty-142970>> accessed 12 June 2012.

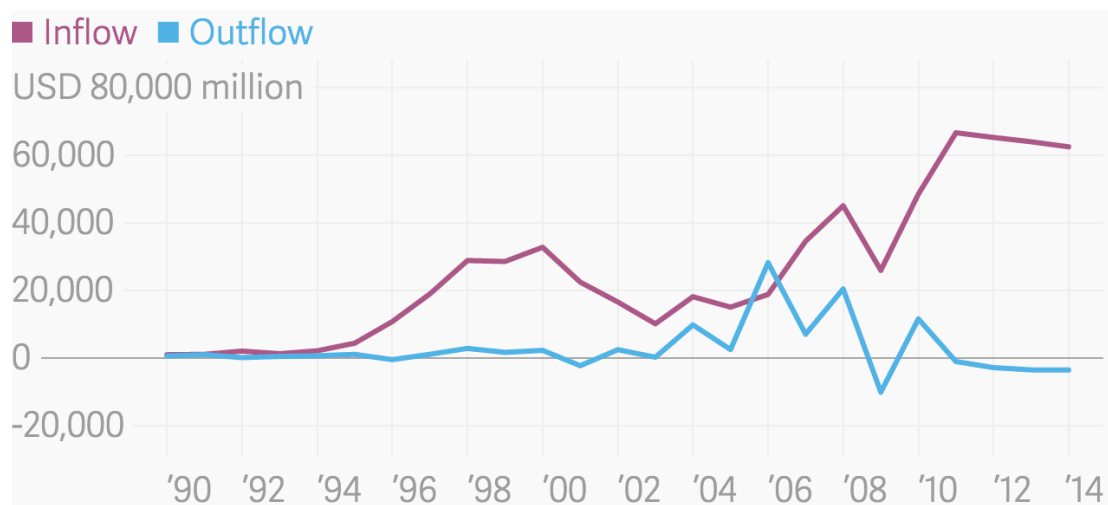
<sup>109</sup> OECD, 'Tax and Development Programme' (OECD) <[www.oecd.org/ctp/tax-global/taxanddevelopment.htm](http://www.oecd.org/ctp/tax-global/taxanddevelopment.htm)> accessed 21 December 2014; UN, *Monterrey Consensus on Financing for Development* (UN 2002) 9-10; UN, *Doha Declaration on Financing for Development* (UN 2009) 8-9.

<sup>110</sup> This statement is elucidated at greater length in the next section.

<sup>111</sup> These include the positions India and China expressed at the 2013 meeting of the UN Committee of Experts in International Cooperation in Tax Matters (UN Tax Committee) with respect to the requirement of physical presence of a non-resident enterprise in a country for deeming the existence of the enterprise's service PE in the country under Article 5(3)(b) of the UN Model, and India and China's positions on accounting for location-specific advantages in transfer pricing analysis. These and other such positions are explored in chapters IV and V. Although portfolio income is not discussed in this thesis, of interest nevertheless are the BICs' positions of taxation of capital gains arising from offshore transfer of shares between non-residents where there is an underlying economic impact in these countries. For more insight into this issue see *Vodafone International Holdings BV v Union of India* (2012) 6 SCC 613. See also Dongmei Qiu, 'China's Capital Gains Taxation of Nonresidents and the

explore cracks, if any, in the existing framework for division of taxing rights between States from the perspectives of these as well as other developing countries with whom, as shown in graphs 4, 5, and 6 (on this and the next page), the BICs share interests as net recipients of foreign investment.<sup>112</sup> This is important to reduce the possibility of States resorting to unilateral actions to address their discontent with this set-up, which in turn has the potential to cause uncertainty in the framework and affect its durability.<sup>113</sup>

**Graph 4 - FDI inflows and outflows for Brazil – 1990-2014**



Source: Based on data obtained from UNCTAD, *World Investment Report 2015*.

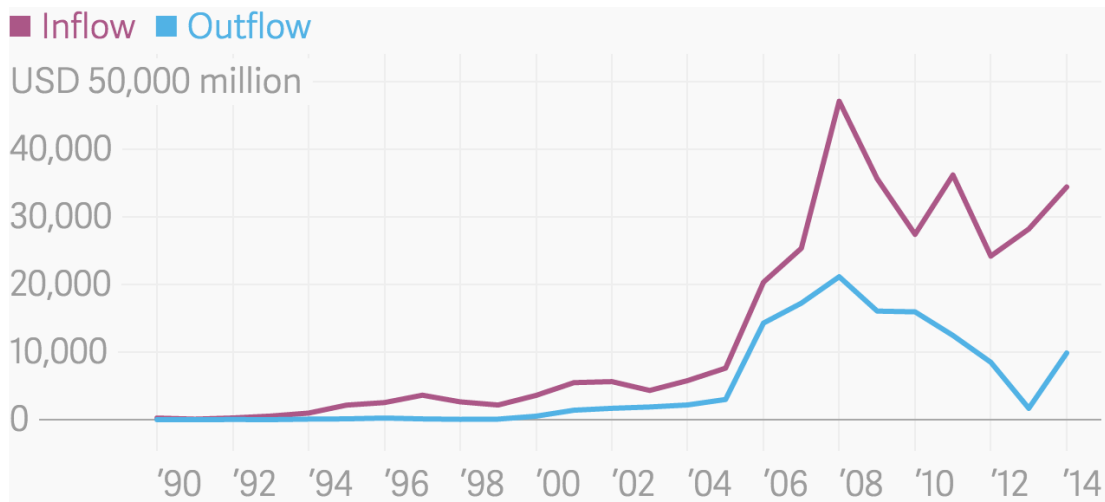
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Legitimate Use of Tax Treaties’ (22 November 2010) 60 *Tax Notes Int’l* 593; Kevin Holmes, ‘The Politics of the Improper Use of Double Tax Treaties: China Waves Red Flags’ [2011] *BTR* 307.

<sup>112</sup> The BICs’ FDI inflows still remain greater than outflows. See UN Conference on Trade and Development (UNCTAD), *World Investment Report 2015: Reforming International Investment Governance* (UN 2015), Annex Tables 1 and 2.

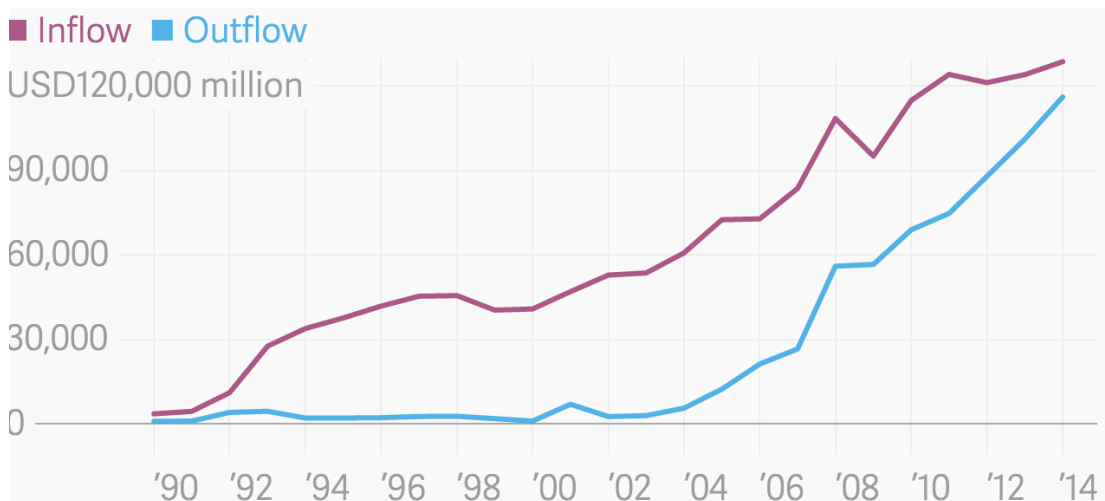
<sup>113</sup> For a mention of the negative effects of such unilateral actions see OECD, *Action Plan on Base Erosion and Profit Shifting* (n 71) 10-11.

**Graph 5 - FDI inflows and outflows for India – 1990-2014**



Source: Based on data obtained from UNCTAD, *World Investment Report 2015*.

**Graph 6 - FDI inflows and outflows for China – 1990-2014**



Source: Based on data obtained from UNCTAD, *World Investment Report 2015*.

Notably, after the 2008 recession, fairness in the international framework for assignment of taxing rights has not remained just a developing country issue. As stated before, in the past few years, there has been growing public pressure in countries across the world to ensure that the international taxation rules lead to States

collecting their fair share of revenue from cross-border activities of MNEs.<sup>114</sup> National level actions have been suggested to address this issue,<sup>115</sup> and demand has been expressed for solutions at the international level, resulting in the OECD being mandated by the G20 to undertake the BEPS project. Encouragingly, the BEPS project has been described as aiming to build a ‘fairer’ global economy.<sup>116</sup> This objective, and more so the nature of work undertaken in the project and its potential impact on economically very diverse States, makes it an opportune time to explore the notion of fairness that guides or should guide such an endeavour.

The aspects discussed in the preceding paragraphs along with the limited engagement with INE in academic literature have made the author believe in the value of contributing to this area. Accordingly this thesis suggests certain basic minimum parameters for assessing and furthering fairness in the prevailing framework for division of rights to tax active business income between countries.

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<sup>114</sup> For an academic analysis of the growing interest in this issue across the world and the sufficiency of the global response to it in the form of the BEPS project see Adam H Rosenzweig, ‘Defining a Country’s “Fair Share” of Taxes’ (2015) 42 Florida State University L Rev 373.

<sup>115</sup> For example see Pierre Collin and Nicolas Colin, ‘Task Force on the Taxation of the Digital Economy’ (Report to the Minister for Economy and Finance, the Minister for Industrial Recovery, the Minister for Budget, and the Minister for Small and Medium-Sized Enterprises, Innovation and the Digital Economy, 2013) <[www.hldataprotection.com/files/2013/06/Taxation\\_Digital\\_Economy.pdf](http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf)> accessed 21 December 2014; HMRC, ‘Diverted Profits Tax - Guidance’ (HMRC 2015) <[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/480318/Diverted\\_Profits\\_Tax.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf)> accessed 21 December 2015.

<sup>116</sup> Angel Gurría, ‘2nd Global Forum on Transfer Pricing: Addressing Base Erosion and Profit Shifting’ (OECD, 6 March 2013) <[www.oecd.org/about/secretary-general/2nd-global-forum-on-transfer-pricing-addressing-base-erosion-and-profit-shifting.htm](http://www.oecd.org/about/secretary-general/2nd-global-forum-on-transfer-pricing-addressing-base-erosion-and-profit-shifting.htm)> accessed 21 December 2014.

**c. Why analyse INE in the prevailing framework for allocation of rights to tax active business income from the standpoint of the BICs?**

In 2001, Jim O’Neill of Goldman Sachs (GS) first used the acronym BRICs to discuss the emergence of Brazil, Russia, India, and China as the global economic forces of the future.<sup>117</sup> In a 2011 review of its 2001 and 2003 forecasts relating to the rise of the BRICs, GS points out that in the coming years the BRICs’ input to global growth will not be as ‘dramatic’ as it has been in the last decade when the BRICs contributed close to half of the world’s growth.<sup>118</sup> Among other reasons for declining growth rates unique to the four BRIC countries, a more common one is a decrease in cheap labour.<sup>119</sup> The report is, however, clear that the story of the ascent of the BRICs itself will continue, ‘and significantly so’, *albeit* dominated by other factors such as productivity growth.<sup>120</sup> The report estimates that by 2050, the BRICs’ contribution to global GDP will increase to approximately 40%, with all the four countries set for being among the world’s top five largest economies.<sup>121</sup>

A 2012 research by the Hong Kong and Shanghai Banking Corporation (HSBC) also supports the view that there is still much steam in the BRICs’ growth story.

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<sup>117</sup> Jim O’Neill, ‘Building Better Global Economic BRICs’ (Global Economics Paper No 66, Goldman Sachs (GS) 2001) 1 <[www.goldmansachs.com/our-thinking/archive/archive-pdfs/build-better-brics.pdf](http://www.goldmansachs.com/our-thinking/archive/archive-pdfs/build-better-brics.pdf)> accessed 20 December 2010. See also Dominic Wilson and Roopa Purushothaman, ‘Dreaming with BRICs: The Path to 2050’ (Global Economics Paper No 99, GS 2003) <[www.goldmansachs.com/our-thinking/archive/archive-pdfs/brics-dream.pdf](http://www.goldmansachs.com/our-thinking/archive/archive-pdfs/brics-dream.pdf)> accessed 20 December 2010.

<sup>118</sup> Dominic Wilson and others, ‘The BRICs 10 Years On: Halfway Through the Great Transformation’ (Global Economics Paper No 208, GS 2011) 5 <<http://blogs.univ-poitiers.fr/o-bouba-olga/files/2012/11/Goldman-Sachs-Global-Economics-Paper-208.pdf>> accessed 1 December 2014. This was more than double the BRICs’ contribution to global growth in the 1990s, which was 23%, and in the 1980s, when it was 18%.

<sup>119</sup> *ibid* 13.

<sup>120</sup> *ibid* 4, 13.

<sup>121</sup> *ibid* 6.

According to the HSBC report, which projects the economic positions of countries up till 2050 based on the fundamentals of income per capita, rule of law, democracy, education levels, and demographic change, India and China stay in the list of ‘fast-growth economies’ or countries with an expected average annual growth of more than 5%.<sup>122</sup> Brazil and Russia are placed in the list of ‘growth economies’ or countries that are expected to grow between 3%-5% annually.<sup>123</sup> Most developed countries stay in the ‘stable’ category or economies that are expected to expand less than 3% per year.<sup>124</sup>

Similarly, a 2013 research by PricewaterhouseCoopers (PwC), which takes into account demographics, capital investment, education levels, and technological progress, projects that by 2017 China will overtake the United States (US) as the largest economy in purchasing power parity (PPP) terms.<sup>125</sup> The same research suggests that by 2050, India will be the third ‘economic giant’ followed by Brazil, with Russia being at the sixth spot after Japan.<sup>126</sup> Articulating an already apparent development, the PwC report states that in the coming years, the BRICs will not just be low cost production locations but also increasingly large consumer markets.<sup>127</sup> The report advises that at a time when trend annual growth in advanced economies is projected to be no more than 2%, ‘companies seeking growth will need to look

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<sup>122</sup> Karen Ward, ‘The World in 2050: From the Top 30 to the Top 100’ (Hong and Shanghai Banking Corporation (HSBC) Global Research, 2012) 2.

<sup>123</sup> *ibid.*

<sup>124</sup> *ibid* 13.

<sup>125</sup> PricewaterhouseCoopers (PwC), ‘World in 2050 – The BRICs and Beyond: Prospects, Challenges and Opportunities’ (PwC Economics 2013) 1 <[www.pwc.com/it/it/publications/assets/docs/world-2050.pdf](http://www.pwc.com/it/it/publications/assets/docs/world-2050.pdf)> accessed 1 December 2014.

<sup>126</sup> *ibid.*

<sup>127</sup> *ibid* 3.

increasingly to these emerging markets'.<sup>128</sup> In line with the message of the previously discussed 2011 study by GS, the PwC report cautions that such markets can, however, be 'challenging places to do business'.<sup>129</sup> Thus, it will be important for investors to understand and adapt to local rules, regulations, and customs, choose the right entry strategy and local partners, and maintain good relations with local government and regulatory bodies.<sup>130</sup>

These reports highlight how, more than a decade later, O'Neill's focus on the BRICs has not only been justified but also remains relevant for the future. Deeper problems exist in the BRICs: from corruption and inadequate infrastructure to the need for economic and political reforms of varying degrees.<sup>131</sup> While domestic efforts to address these concerns and to stay on the path of realising the above-mentioned projections continue, international investment into these economies remains strong (this is also seen in the following figures 1 and 2).<sup>132</sup> Thus, now and in the near future, with over 40% of the world's population, 25% of its' landmass, and over 25% of the global GDP, there is little doubt that the BRICs will continue to be key players in the global economy. Therefore, arguably, it will be hard to ignore the positions expressed

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<sup>128</sup> *ibid.*

<sup>129</sup> *ibid.* See also Dominic Wilson and others (n 118) 4.

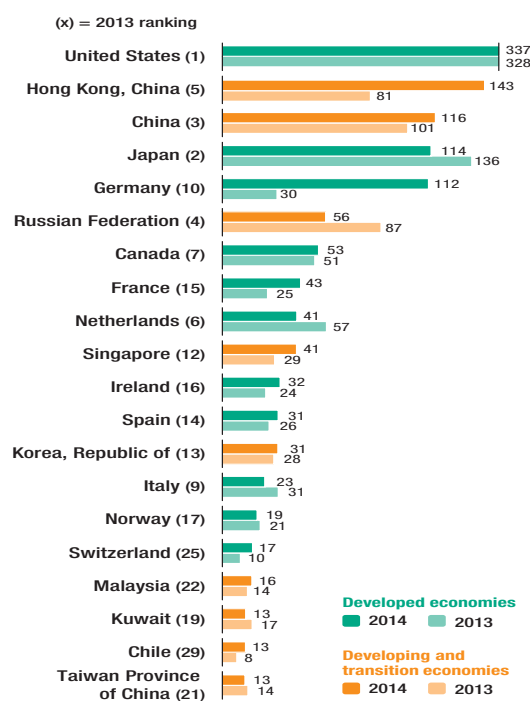
<sup>130</sup> *ibid.*

<sup>131</sup> BRICS, *The BRICS Report: A Study of Brazil, Russia, India, China, and South Africa with Special Focus on Synergies and Complementarities* (OUP 2012) 160-68.

<sup>132</sup> UNCTAD, *World Investment Report 2015* (n 112) 3, 60 and 48. In 2014, with China's FDI inflows rising 4% from 2013 to 129 billion USD, it surpassed the United States (US) to become the largest recipient of investment inflows in the world. Although FDI inflows in Brazil at around 62 billion USD remained close to those in 2013, India saw a 22% increase to approximately 34 billion USD. As can be seen from figure 1, with this Brazil and India were placed 6<sup>th</sup> and 9<sup>th</sup> respectively in the list of the top 20 host economies in 2014. Figure 2 establishes that along with the US, all the three countries are expected to remain in the top 4 host economies for MNEs from 2015-2017.

by these countries individually, and increasingly even as a group, as regards international regulatory structures.<sup>133</sup>

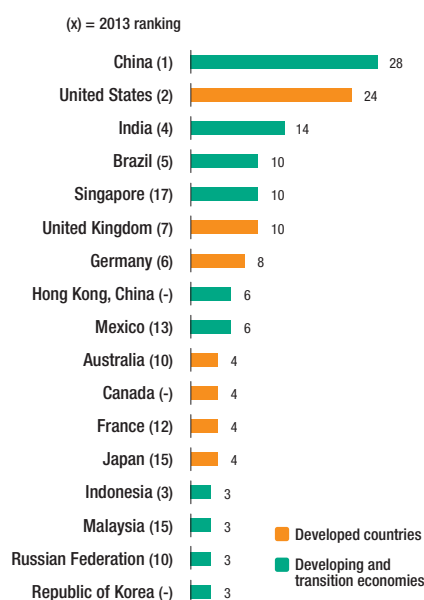
**Figure 1 - FDI inflows: Top 20 host economies, 2013 and 2014 (Billions of dollars)**



Source: UNCTAD, *World Investment Report 2015*.  
 Note: The data excludes Caribbean offshore financial centres.

<sup>133</sup> In 2013, the BRICS also agreed to joint contributions in the development of the global standards in international taxation and transfer pricing ‘taking into account aspirations of developing countries in general and the BRICS countries in particular’. For a statement to this effect see Press Information Bureau, Ministry of Finance, ‘Heads of the Revenue of BRICS Countries Identify Seven Areas of Tax Policy and Tax Administration for Extending their Mutual Cooperation’ (Joint Communiqué issued after a Two Day Meeting of the Heads of Revenue of the BRICS, Government of India 2013) <<http://pib.nic.in/newsite/PrintRelease.aspx?relid=91684>> accessed 1 December 2014.

**Figure 2 - MNEs' top prospective host economies, 2013 and 2014 (Per cent)**



Source: UNCTAD, *World Investment Report 2015*.

Note: Absence of a number in the parentheses means that the economy was not in the top 20 in 2013.

As mentioned previously in this chapter, in the past years, some of the BRIC countries have taken strong positions with regards to the existing framework for allocation of taxing rights between countries. These positions, especially when considered in light of the BRICs' rise in the world economy in the last decade and the projections for the persistence of their global economic influence, drew the author towards exploring the issue of fairness in the international set-up for assignment of rights to tax active business income from the BRICs' perspective. After preliminary research it was established that such positions are, however, not shared by Russia. Unlike Brazil, India, and China (the BICs), Russia's bilateral tax treaties remain largely compliant with the OECD Model, and developments in the country's domestic taxation law have also not showed signs of any particular concerns or dissatisfaction

with the prevailing rules for division of taxing rights between countries.<sup>134</sup> While the BICs have been the leading voice in shaping international taxation rules at the level of the UN Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee), Russia has been largely absent on this front. Also, whereas India and China have only participant status in the work of the OECD's Committee on Fiscal Affairs (CFA),<sup>135</sup> which is the OECD's main body dealing with tax matters, and Brazil lacks even that, Russia was in talks for accession to the OECD that were postponed in early 2014.<sup>136</sup> Owing to these differences, the scope of this thesis was narrowed down to the BICs.<sup>137</sup>

This thesis also intends to be a starting point for understanding whether the prevailing framework for assignment of rights to tax active business income could be considered fair from the standpoint of developing countries more generally. The difficulty in researching this aspect per se is that developing countries as a whole are a broad and heterogeneous group.<sup>138</sup> Comparatively, the BICs are a more homogenous

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<sup>134</sup> Bilateral tax treaties of India and China exhibit proximity to the UN Model, but those of Brazil appear closer to the OECD Model. A *prima facie* look at the international aspects of Brazil's domestic legal framework for taxation, however, reveals that this should not be taken as Brazil's agreement with the OECD's position on allocation of taxing rights between countries. This aspect will become clearer in chapters IV and V.

<sup>135</sup> Chapter IV discusses what participant status actually entails. For the purpose of this chapter, it is sufficient to say that it does not bring the same ability to influence the OECD's tax work as a member country has.

<sup>136</sup> OECD, 'Statement by the OECD Regarding the Status of the Accession Process with Russia & Cooperation with Ukraine' (OECD, 13 March 2014) <[www.oecd.org/russia/statement-by-the-oecd-regarding-the-status-of-the-accession-process-with-russia-and-co-operation-with-ukraine.htm](http://www.oecd.org/russia/statement-by-the-oecd-regarding-the-status-of-the-accession-process-with-russia-and-co-operation-with-ukraine.htm)> accessed 1 December 2014.

<sup>137</sup> Luís Eduardo Schoueri, 'Brazil'; Danil V Vinnitskiy, 'Russia'; D P Sengupta, 'India'; and Tianlong Hu and Na Li, 'China Tax Treaty and Policy: Development and Updates' in Brauner and Pistone (n 70) 41, 81, 115, and 181. Interesting support for this choice is also provided by the content of these four chapters of the book. Whereas the discussion on the key concerns of the BICs with respect to the existing international taxation framework touches on some core allocation of taxing rights issues, the chapter on Russia lacks any substantial engagement with them.

<sup>138</sup> José Antonio Alonso, Ana Luiza Cortez, and Stephan Klasen, 'LDC and Other Country Groupings: How Useful are Current Approaches to Classify Countries in a More Heterogeneous Developing

collection of States as regards their economic interests and influence.<sup>139</sup> The BICs share the former with other developing countries to the extent of having long been strong capital importing nations or host or source States.<sup>140</sup> Thus, the positions taken by the BICs vis-à-vis the existing international framework for allocation of rights to tax active business income can provide initial points for exploring fairness in this set-up from the perspective of developing countries more generally.

However, through the last decade, capital outflows from the BICs have also been constantly increasing (as seen in graphs 4, 5, and 6).<sup>141</sup> Other developing countries, particularly in the African continent, are common destinations for investors from the BICs.<sup>142</sup> In such a scenario, degree of overlap in the economic interests of the BICs and other developing countries, and the BICs' preparedness to offer these countries the same tax positions that the BICs seek when they are host States, could provide a useful insight into the extent to which working towards a fairer international taxation framework from the BICs' standpoint would mean a more equitable division

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World' (2014) UN Committee for Development Policy Background Paper No. 21, ST/ESA/2014/CDP/21<[www.un.org/en/development/desa/policy/cdp/cdp\\_background\\_papers/bp2014\\_21.pdf](http://www.un.org/en/development/desa/policy/cdp/cdp_background_papers/bp2014_21.pdf)> accessed 1 December 2014.

<sup>139</sup> Although talks to include South Africa in the BRICs were in progress when this research was commenced, there was and there still is much discussion on the appropriateness of South Africa's inclusion in this group. Therefore, the researcher decided to focus on the BRICs rather than the BRICS.

<sup>140</sup> See graphs 4, 5, and 6.

<sup>141</sup> UNCTAD, *World Investment Report 2015* (n 112) 5, 6, 8, 48, 60-61. Since 2000, FDI outflows from the BICs have increased markedly. In 2014, FDI outflows from mainland China reached a record high of 116 billion USD. This made China third in the list of the top 20 home economies in the world. Breaking a downward trajectory from 2009 and beyond, investment outflows from India increased fivefold from 2013 to 10 billion USD. Due to Brazilian MNEs' continuing receipt of repayments of loans or borrowings from their foreign affiliates, FDI outflows from the country, however, remained negative for the fourth consecutive year. Thus, as also seen from graphs 4, 5, and 6, with only China showing a steady rise, especially in the last 5 years, this growth in FDI outflows from the BICs does not display the same parity as the rise in investment inflows in these countries. More importantly, again except for China, the gap in FDI inflows and outflows still remains quite strongly on the side of the former.

<sup>142</sup> UNCTAD, 'Global Investment Trends Monitor - The Rise of BRICS FDI and Africa' (UNCTAD 2013) 1, 4 <[http://unctad.org/en/PublicationsLibrary/webdiaeia2013d6\\_en.pdf](http://unctad.org/en/PublicationsLibrary/webdiaeia2013d6_en.pdf)> accessed 1 December 2014.

of rights to tax active business income from the perspective of other developing countries.<sup>143</sup> This will also depend on whether economically more powerful BICs' success in furthering their interests in this area can be achieved for less resourced countries.

### **III. Outline of this research**

Part II laid out the broad contours of this thesis. This part outlines the nuances of this research and the methods through which the author will pursue them.

**Chapter II** of this thesis builds on part II's discussion of the challenges in as well as the importance of dealing with INE in the international framework for assignment of rights to tax active business income, particularly in light of the BEPS project. The chapter then critically analyses the existing literature on INE and highlights that an important drawback of the prevailing notions of INE is their failure to engage with fairness in process. The author argues that fairness in the rule-making process and fairness in the outcome of the process or the rules themselves influence each other. Even independent of this relation, fairness in process is important because it affects the stakeholders' perception of a regulatory set-up, and hence their willingness to comply with it. In view of this, based on international law and international relations literature, chapter II suggests parameters that could be considered starting points for assessing and furthering fairness in the international taxation rule-making process.

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<sup>143</sup> This is only if this research establishes that the prevailing international framework for assignment of rights to tax active business income cannot be considered fair from the BICs' perspective.

Further, chapter II discusses the Musgraves' construct of INE as a useful concept for evaluating fairness in the international rules for allocation of rights to tax active business income.<sup>144</sup> Owing to the construct's inability to comprehensively guide the assessment of proposals for furthering fairness in these rules, other works on INE, including Nancy Kaufman's suggestion to consider the theory of economic allegiance for developing a notion of INE, are studied for establishing parameters for advancing fairness in these rules. These parameters could be viewed as representing the basic minimum expectation of fairness on the part of the key parties to this framework: countries at different levels of economic development and MNEs.

**Chapter III** focuses on whether the process of evolution of the existing international rules for assignment of rights to tax active business income could be considered fair from the perspective of the BICs primarily and other developing countries more generally. As elucidated in part II of this chapter, the key aspects of these rules are the concept of PE, the rules for attribution of profits to PEs, and the rules for apportionment of profits between associated enterprises. Chapter III examines the origin and development of these through the work of the LONs to the introduction of the OECD Model and the UN Model based on the parameters for assessing fairness in the rule-making process set out in chapter II.

**Chapters IV and V** study the BICs' involvement in international taxation rule-making post the advent of the UN Model, and hence the role played by the BICs in relation to some of the post-1980 key developments in the OECD Model's as well as the UN Model's position on allocation of rights to tax active business income. These

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<sup>144</sup> Richard A Musgrave and Peggy B Musgrave (n 104) 68.

chapters will also give an insight into the extent to which the BEPS project can be expected to further the BICs' positions. Together with chapter III, findings from these chapters will help establish whether the international taxation rule-making process could be considered as becoming fairer from the BICs' perspective.

In this way **Chapters IV and V** have a dual objective. Primarily, these chapters analyse whether some of the basics of the prevailing international rules for allocation of rights to tax active business income, such as the concept of PE, and the theory and the practice of the arm's length principle (ALP) for attribution of profits to PEs and for apportionment of profits between associated enterprises, could be considered fair from the BICs' standpoint. In this evaluation, these chapters also discuss several important developments in these areas since the advent of the OECD Model and the UN Model, and the BICs' involvement in shaping them, which helps assess fairness in the process of development of these rules from the BICs' perspective.<sup>145</sup>

The fundamental principle concerning the concept of PE that **chapter IV** focuses on is the requirement of a certain degree of physical presence of a non-resident enterprise in a country for the active business income generated by the enterprise to be taxable in the country. This aspect, as set out in Article 5 of the OECD Model and the UN Model, is studied in the context of non-resident enterprises rendering services. This choice was influenced foremost by the strong positions expressed by Brazil and India, and more recently even China, vis-à-vis the application of the existing concept of PE to taxation of income arising from cross-border services.

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<sup>145</sup> Among others, these include the introduction of a deemed service PE alternative in the Commentary to Article 5 of the OECD Model and the on going discussions to include a provision for taxation of fees for technical services in the UN Model.

Additionally, the area has seen one of the most significant developments in the OECD's position on the rules for determining a country's right to tax active business income in the last decade.<sup>146</sup> It is also witnessing an important change in the UN's position in this regard.<sup>147</sup> Interestingly, it is also a matter with respect to which other developing countries have been significantly vocal at the UN level.

To understand what, if anything, concerning one of the basic aspects of the concept of PE can be considered unfair from the BICs' perspective, this chapter examines the BICs' positions on taxation of active business income of non-resident service providers as reflected from the BICs' bilateral tax treaties based on the parameter for assessing fairness in the division of taxing rights established in chapter II. This evaluation is supplemented with a study of the stands taken by experts and representatives from the BICs at the OECD and the UN levels, and relevant developments in the BICs' domestic tax laws in the last decade (that marked the rise of the BICs as global economic powers) based on the same parameter.

The core of **chapter V** is the arm's length principle (ALP). The aim is to identify what, if any, aspects of the theory and application of the ALP for attributing profits to PEs and for apportionment of profits between associated enterprises (based on the assessment factor set out in chapter II) could be considered unfair from the BICs' perspective. Accordingly, the focus is on Articles 7 and 9 of both the Models, the OECD's Transfer Pricing Guidelines (OECD TPG), and the UN's Transfer Pricing

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<sup>146</sup> This is the introduction of the deemed service PE formulation in the OECD Model 2014 (n 84) Commentary to Article 5, para 42.11-42.48.

<sup>147</sup> For a brief overview of the points that have been put forward at the UN level in this area see UN Tax Committee, 'Report on the Seventh Session' (2012) E/2011/45-E/C.18/2011/6, para 97.

Manual (UN TPM).<sup>148</sup> Like in chapter IV, the BICs' positions on these are studied from the BICs' bilateral tax treaties, the views expressed by government representatives and experts from these countries at the OECD and the UN levels, and the developments in the BICs' domestic tax laws in the last decade.

**Chapters VI and VII** analyse potential international developments, such as those covered in the BEPS project as well as academic proposals at the level of the international taxation rule-making process and the rules for assignment of rights to tax active business income between countries, respectively.<sup>149</sup> This evaluation is conducted based on the parameters for furthering fairness in the international framework for allocation of rights to tax active business income set out in chapter II. The objective of this study is to highlight directions of reform towards a fairer international framework for division of rights to tax active business income from the BICs' standpoint that could be pursued in the short- and medium-terms. These chapters also briefly reflect on what the preferable options from the BICs' perspective would mean for developing countries more generally.

A culmination of the discussion in chapters II-VII, **Chapter VIII** concludes this thesis by pointing out some of the areas for further research on the issues covered in this work.

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<sup>148</sup> OECD TPG (n 91); UN TPM (n 91).

<sup>149</sup> Only literature available up to August 2015 has been analysed in this thesis. An attempt was, however, made in the final draft of this work to highlight, where necessary, the content of the second set of deliverables of the BEPS project released on 5 October 2015.

## **Conclusion**

This chapter laid out the arguments for and against the taxation of corporate profits, and the author's reasons for restricting the scope of this thesis to the existing framework for allocation of rights to tax active business income. The chapter introduced the key aspects of this set-up and the rationale for examining them from the BICs' perspective through the lens of INE.

Through the issues in focus in the subsequent chapters, the author aims to build a better understanding of what could be considered a more equitable or fairer set-up for division of rights to tax active business income from the BICs' standpoint particularly and other developing countries more generally. The utility of this exercise is increased when considering the BEPS project and the related expectation of attaining a stable and durable international taxation framework.

## Chapter II

### **Establishing a Framework for Assessing and Advancing INE in the International Set-up for Allocation of Taxing Rights between Countries**

Chapter I highlighted how fairness is a less explored, yet important, normative consideration in the international framework for assignment of taxing rights between countries. Part I of this chapter builds on those arguments to show how the prevailing times are, in fact, an opportune moment to engage with a comprehensive and pragmatic notion of fairness in this set-up. Part II studies the existing ideas of fairness in the international taxation literature. These are further evaluated and supplemented in part III with discussions of fairness in the inter-nation context outside of this literature. The objective is to identify parameters that could be considered a more holistic, and practically more realisable, basic minimum standard of fairness in the international taxation framework.

#### **I. Difficulties in and the importance of discussing fairness in inter-nation settings**

Understanding fairness or equity in taxation is often considered challenging. Despite this, an affirmation of the importance of this normative consideration is common. In Kay and King's leading work on the British tax system, equity concerns form an important part of the discussion on the design of a tax schedule. However, Kay and King also point out the difficulty in balancing the aims of incentivising income producing efforts with achieving vertical equity, which is concerned with how people in different circumstances are treated.<sup>1</sup> They further highlight the problem of defining

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<sup>1</sup> J A Kay and M A King, *The British Tax System* (5th edn, OUP 1990) 36-39.

the tax unit for the purpose of horizontal equity, which involves like treatment of comparably situated people.<sup>2</sup>

This sentiment is shared by the 1978 Meade Committee Report, which acknowledges that a ‘good tax system’ must be horizontally and vertically equitable.<sup>3</sup> The Report, however, also recognises that these are not ‘straightforward simple objectives’.<sup>4</sup> The Meade Committee Report states that ‘taxable capacity’ for the purpose of ascertaining who should bear the same tax burden, and those who should endure greater tax burden, is ‘very difficult to define’, and is a ‘matter on which opinions will differ rather widely’.<sup>5</sup> It raises important questions such as: whether it is the similarity of ‘opportunity’ or of ‘outcome’ that is relevant for this determination?; what is the nature of the tax units that should be employed for comparing taxable capacity?; and what type of redistribution of welfare among tax units ought to be promoted?<sup>6</sup> The Meade Committee Report notes that all of these questions involve ‘value judgments’, which although constitute a ‘basic task for political decisions’, were ‘quite impossible’ even for the Committee to disregard.<sup>7</sup> Accordingly, the Committee decided to be ‘open, frank and unbiased’ in explaining the distributional issues of the tax structures they studied and to confine themselves to value judgments, which, in their view, would ‘command a wide measure of political agreement’.<sup>8</sup>

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<sup>2</sup> *ibid* 41-42.

<sup>3</sup> J E Meade, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade* (George Allen & Unwin 1978) 12.

<sup>4</sup> *ibid* 13.

<sup>5</sup> *ibid* 14.

<sup>6</sup> *ibid* 14-15.

<sup>7</sup> *ibid* 16.

<sup>8</sup> *ibid*.

Writing for the 2010 Mirrlees Review, Banks and Diamond rejected the Meade Committee's position that taxes should relate to some measure of taxable capacity.<sup>9</sup> According to them, taxable capacity is not 'well enough measurable and not sufficiently uniformly evaluated to be usable' for this purpose.<sup>10</sup> Therefore, Banks and Diamond do not view the 'definition of an ideal tax base, one that reflects both horizontal and vertical equity, as a good starting point for the consideration of taxation'.<sup>11</sup> Nevertheless, even Banks and Diamond admit that horizontal equity arguments could be viewed as providing 'limitations' on allowable tax policies.<sup>12</sup>

In response to Banks and Diamond's criticism, John Kay asserts that just because taxable capacity is hard to define, it does not mean that no significance should be attached to it.<sup>13</sup> In a classic analogy, Kay asserts that, 'we talk of a beautiful face, a kind person, a great work of art or piece of music, without having or being capable of having any quantitative measure of beauty, kindness, or greatness. Yet we are able to identify indicators of beauty, kindness, and greatness and to achieve substantial, though not necessarily complete, consensus on rankings of beauty, kindness, or greatness.'<sup>14</sup>

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<sup>9</sup> James Banks and Peter Diamond, 'The Base for Direct Taxation' in IFS (ed), *Dimensions of Tax Design: The Mirrlees Review* (OUP 2010) (Dimensions of Tax Design: The Mirrlees Review) 548, 610.

<sup>10</sup> *ibid.*

<sup>11</sup> *ibid* 555.

<sup>12</sup> *ibid.*

<sup>13</sup> John Kay, 'The Base for Direct Taxation – Commentary by John Kay' in *Dimensions of Tax Design: The Mirrlees Review* (n 9) 656, 660.

<sup>14</sup> *ibid.*

If we extend this discussion of challenges in discussing equity versus the importance of doing so to inter-nation settings, many of the arguments remain the same. Even in the international context, fairness remains a norm that is difficult to define or measure, and attempts to formulate standards of fairness are often criticised for leading to ‘metaphysical speculations’.<sup>15</sup> If anything, the problems in conceiving and furthering a subjective ideal are compounded by the involvement of independent sovereigns with diverse interests and power play among them.<sup>16</sup> Specifically in the case of the international taxation framework, the absence of a binding multilateral document laying out the rights and obligations of the main actors of this framework,<sup>17</sup> or an international regulatory body, or even a dispute resolution forum, could also be seen as factors intensifying the challenge. Despite these issues, as in the case of the domestic tax system, it is hard to deny the importance of fairness in an inter-nation set-up.

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<sup>15</sup> A R Albrecht, ‘The Taxation of Aliens under International Law’ (1952) 29 *British Ybk Int’l L* 145, 148.

<sup>16</sup> For research exploring the influence of parties’ self-interest on their idea of fairness in the domestic context see David M Messick and Keith P Sentis, ‘Fairness and Preference’ (1979) 15 *Journal of Experimental Social Psychology* 418, 434; Linda Babcock and others, ‘Biased Judgments of Fairness in Bargaining’ (1995) 85 *American Economic Rev* 1337, 1342; Linda Babcock and George Loewenstein, ‘Explaining Bargaining Impasse – The Role of Self-Serving Biases’ (1997) 11 *Journal of Economic Perspectives* 109, 119-124; James Konow, ‘Fair Shares: Accountability and Cognitive Dissonance in Allocation Decisions’ (2000) 90 *American Economic Rev* 1072, 1087-1090. For discussions on the role of power play in international relations see Kenneth N Waltz, *Theory of International Politics* (Addison-Wesley 1979) 129-132, 190-195; William Mark Habeeb, *Power and Tactics in International Negotiations: How Weak Nations Bargain with Strong Nations* (The John Hopkins University Press 1988) 10-26, 145-146; Robert O Keohane and Joseph S Nye, *Power and Interdependence* (2 edn, Scott, Foresman and Company 1989) 11-19, 224-226; Hans J Morgenthau, *Politics Among Nations: The Struggle For Power and Peace* (rev edn, McGraw-Hill 1993) 29-49; John J Mearsheimer, *The Tragedy of Great Power Politics* (Norton 2003) 2-6, 13-22; Joseph S Nye Jr, *Power in the Global Information Age: From Realism to Globalization* (Routledge 2004) 53-65.

<sup>17</sup> The chief actors of this framework are sovereign countries at different levels of development, which have diverse economic interests. Another key group affected by this set-up are businesses across the world.

Inequality in the economic positions and the living conditions of people in different countries is extreme. Around 60.9% of workers in developing countries still live on less than 4 USD a day, with 1.2 billion people across the world living in extreme poverty or on under 1.25 USD a day.<sup>18</sup> An estimated 863 million people in the developing world reside in slums.<sup>19</sup> At least one in eight persons around the globe suffers from chronic hunger, and the vast majority of these (about 827 million) live in developing countries.<sup>20</sup> In 2011, 57 million children of primary school age were out of school, and globally around 123 million youth (aged 15-24) lacked basic reading and writing skills, with 61% of them being young women in developing countries.<sup>21</sup>

One could argue that it is not moral to allow such differences in income levels and quality of lives of people to persist simply because they were born in a certain part of the world. On the one hand there are commentators who, on the grounds of basic humanity, plead that fairness in inter-nation settings should involve a transfer of wealth from richer to poorer countries.<sup>22</sup> This can be achieved through foreign aid, or through legal and regulatory frameworks that play a role in determining a country's ability to generate wealth, such as that concerning international trade, or even that for

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<sup>18</sup> UN Department of Public Information, 'We can End Poverty: Millennium Development Goals and Beyond 2015 – Fact Sheet' (UN 2013) <[www.un.org/millenniumgoals/pdf/Goal\\_1\\_fs.pdf](http://www.un.org/millenniumgoals/pdf/Goal_1_fs.pdf)> accessed 2 April 2014. See also UN Development Programme (UNDP), *Human Development Report 2013 – The Rise of the South: Human Progress in a Diverse World* (UNDP 2013) 13-14.

<sup>19</sup> UN, *The Millennium Development Goals Report 2013* (UN 2013) 42.

<sup>20</sup> Food and Agricultural Organisation (FAO), International Fund for Agricultural Development (IFAD), and World Food Programme (WFP), *The State of Food Insecurity in the World: The Multiple Dimensions of Food Security* (FAO 2013) 8.

<sup>21</sup> UN, *The Millennium Development Goals Report 2013* (n 19) 14.

<sup>22</sup> This is the cosmopolitan philosophy, which supports the existence of distributive justice obligations in inter-nation settings. See Thomas Pogge, 'World Poverty and Human Rights' (2005) 19 *Ethics & Int'l Affairs* 1, 5-7; Charles R Beitz, 'Cosmopolitanism and Global Justice' (2005) 9 *The Journal of Ethics* 11, 19-24. See also Charles Jones, *Global Justice: Defending Cosmopolitanism* (OUP 1999) 23-108; Kok-Chor Tan, *Justice Without Borders: Cosmopolitanism, Nationalism and Patriotism* (CUP 2004) 1, 4, 10-12, 29-39.

allocation of taxing rights between countries.<sup>23</sup> On the other hand, there are commentators who have opposed the pursuit of a moral agenda at the international level. According to them, people in different countries care most about their fellow citizens, to whom they are related through long-lasting reciprocal and cooperative relationships, and thus, are less likely to support their governments in such initiatives except in cases of dire humanitarian crises.<sup>24</sup> Over the years, these arguments have, however, been undermined by practical examples such as the success of the fair trade movement and the promotion of ethical buying choices in the light of concern for the rights and living conditions of workers across the world.

As shall be argued in part II as well, the idea of active redistribution through the international taxation framework might appear politically less palatable. Nonetheless, in the recent years, even in the area of international taxation, there has been a growing focus on ensuring that the set-up assists in mobilising resources for countries to meet their developmental needs. This position is at the centre of the tax and development campaign of several NGOs.<sup>25</sup> The OECD's interest in the issue too has increased significantly in the last decade.<sup>26</sup> The cause has also been recognised through the

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<sup>23</sup> Joseph E Stiglitz and Andrew H Charlton, *Fair Trade for All: How Can Trade Promote Development* (OUP 2005) 24-40; Priscilla Schwartz, 'Development in World Trade Law' (2009) 4 *Journal of Int'l Commercial L and Technology* 50, 55-58; Ilan Benshalom, 'The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law' (2010) 85 *New York University L Rev* 1, 67-81.

<sup>24</sup> This is the statist philosophy, which limits the pursuit of distributive justice to the members of a single nation State. See David Miller, 'Cosmopolitanism: A Critique' (2002) 5 *Critical Rev of Int'l Social & Political Philosophy* 80, 82-85; Thomas Nagel, 'The Problem of Global Justice' (2005) 33 *Philosophy and Public Affairs* 113, 120-122. See also John Rawls, *A Theory of Justice* (Clarendon Press 1972) 378-382; John Rawls, *The Law of Peoples* (Harvard University Press 1999) 113-120.

<sup>25</sup> For example see Tax Justice Network (TJN) 'Tax, Aid and Development' (TJN 2010) <[www.taxjustice.net/cms/front\\_content.php?idcatart=122](http://www.taxjustice.net/cms/front_content.php?idcatart=122)> accessed 15 March 2011; Action Aid, 'Bringing Taxation into the Post-2015 Development Framework' (Action Aid 2013) 10-11 <[www.actionaid.org.uk/sites/default/files/doc\\_lib/post\\_2015\\_-\\_tax.pdf](http://www.actionaid.org.uk/sites/default/files/doc_lib/post_2015_-_tax.pdf)> accessed 30 March 2014.

<sup>26</sup> For an overview of the OECD's tax and development work see OECD, 'Tax and Development' (OECD) <[www.oecd.org/tax/global/taxanddevelopment.htm](http://www.oecd.org/tax/global/taxanddevelopment.htm)> accessed 21 December 2014.

UN's Financing for Development programme, under which the UN Tax Committee is placed.<sup>27</sup> As shall be seen in the subsequent chapters, the Committee, which is the UN's main body for dealing with international taxation issues, has been particularly active in recent years in engaging with concerns of developing countries vis-à-vis the existing international division of taxing rights.

Apart from the moral considerations that could have driven these developments, there is arguably an important functional reason that promoting fairness in international settings serves. It has long been argued that legal or regulatory frameworks that are perceived as 'fair' by their key stakeholders are more likely to generate the stakeholders' compliance with them, and hence are more likely to enjoy certainty and stability.<sup>28</sup> In comparison, unfairness could drive those stakeholders capable of doing so to resort to unilateral measures to reach what could be perceived as fairer positions from their perspective.<sup>29</sup> This creates uncertainty and instability in the framework.

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<sup>27</sup> UN, *Monterrey Consensus on Financing for Development* (UN 2002) 9-10; UN, *Doha Declaration on Financing for Development* (UN 2009) 8-9; UN General Assembly (UNGA) Resolution 68/204 (20 December 2013) A/Res/68/204.

<sup>28</sup> Donald Puchala and Raymond Hopkins, 'International Regimes: Lessons from Inductive Analysis' (1982) 36 *International Organization* 245, 250. See also E H Carr, *The Twenty Years' Crisis, 1919-1939: An Introduction to the Study of International Relations* (Michael Cox ed, Palgrave 2001) 173-174; Elinor Ostrom, *Understanding Institutional Diversity* (Princeton University Press 2005) 20-21, 167; Andrew G Brown and Robert M Stern, 'Concepts of Fairness in the Global Trading System' (2007) 12 *Pacific Economic Rev* 293, 294.

<sup>29</sup> Ethan B Kapstein, *Economic Justice in an Unfair World: Toward a Level Playing Field* (Princeton University Press 2006) 33-34; Niv Tadmor, 'Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age' (2007) 61 *Bulletin for Int'l Taxation* 2, 11; Arthur J Cockfield, 'Purism and Contextualism within Tax Law Analysis: How Traditional Analysis Fails Developing Countries' (2007) 5 *eJournal of Tax Research* 199, 224 <<http://bit.ly/1NHfFNh>> accessed 15 November 2014. See also David L Forst, 'Old and New Issues in the Taxation of Electronic Commerce' (1999) 14 *Berkeley Technology L Journal* 711, 715; Richard M Bird and Jack M Mintz, 'Sharing the International Tax Base in a Changing World' in Sijbren Cnossen and Hans-Werner Sinn (eds), *Public Finance and Public Policy in the New Century* (The MIT Press 2003) 405, 432-435.

As mentioned in chapter I, in the recent years, the BICs have taken some distinct positions on international taxation issues.<sup>30</sup> Besides the negative consequences highlighted above, such divergent positions expose businesses to double taxation, and hence adversely impact the flow of international commerce.<sup>31</sup> In view of the preceding paragraph, checking such results and working towards a robust, and more durable international taxation framework demands understanding these positions from the standpoint of a fairer structure from the BICs' perspective. As the BICs have historically shared interests as predominant capital importers with other developing countries, this could also be a starting point for studying fairness in the international taxation framework from the perspective of developing countries more generally.

Interestingly, post the economic crisis of 2008, fairness in this set-up is not just a developing country or emerging economy issue. Governments across the world have been pressured into taking actions that further the realisation of their country's fair share of tax on the income generated by cross-border activities of MNEs.<sup>32</sup> Internationally, this led to the BEPS project, which as stated in chapter I, could be rightly considered the biggest international taxation reform effort since this framework was first established by the LONs.

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<sup>30</sup> Some of these are explored in chapters IV and V of this thesis. Among other notable ones, as mentioned in chapter I, is the BICs' position on taxation of capital gains arising from transfer of assets located outside the country between two non-resident enterprises when the underlying economic impact is in these countries.

<sup>31</sup> Tadmor (n 29) 11.

<sup>32</sup> For example see Pierre Collin and Nicolas Colin, 'Task Force on the Taxation of the Digital Economy' (Report to the Minister for Economy and Finance, the Minister for Industrial Recovery, the Minister for Budget, and the Minister for Small and Medium-Sized Enterprises, Innovation and the Digital Economy, 2013) <[www.hldataprotection.com/files/2013/06/Taxation\\_Digital\\_Economy.pdf](http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf)> accessed 21 December 2014; HMRC, 'Diverted Profits Tax - Guidance' (HMRC 2015) <[www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/480318/Diverted\\_Profits\\_Tax.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf)> accessed 21 December 2015.

The Action Plan of the BEPS project released in 2013 clearly aimed to limit the ‘chaos’ caused by unilateral actions of countries.<sup>33</sup> The project itself has often been discussed as seeking to ‘build a fairer a global economy’.<sup>34</sup> As articulated by John Kay in the domestic context, achieving this objective requires any such endeavour to be guided by at least some basic ‘indicators’ of this complex norm against which countries can evaluate and reconcile conflicting interests. This is important to ensure, to the extent possible, that such initiatives do not end up being another inherently fragile set of rules imposed by economically more influential countries over weaker ones.

For all the above-discussed reasons, particularly the contribution this study can make in light of the focus on and the momentum towards changes to the prevailing international taxation framework brought by the BEPS project, the following two parts undertake the exercise of finding such parameters.

## **II. Approaches to fairness in the international taxation literature**

The obvious first stop in the search for indicators of fairness in the international taxation framework is the international taxation literature. The leading approach to fairness therein is the Musgraves’ idea of INE.<sup>35</sup> At the heart of this notion, which

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<sup>33</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 11-12.

<sup>34</sup> Angel Gurría, ‘2nd Global Forum on Transfer Pricing: Addressing Base Erosion and Profit Shifting’ (OECD, 6 March 2013) <[www.oecd.org/about/secretary-general/2nd-global-forum-on-transfer-pricing-addressing-base-erosion-and-profit-shifting.htm](http://www.oecd.org/about/secretary-general/2nd-global-forum-on-transfer-pricing-addressing-base-erosion-and-profit-shifting.htm)> accessed 21 December 2014.

<sup>35</sup> Richard A Musgrave and Peggy B Musgrave, ‘Inter-Nation Equity’ in Richard M Bird and John G Head (eds), *Modern Fiscal Issues: Essays in the Honour of Carl S. Shoup* (University of Toronto Press 1972) 63. Both Richard and Peggy Musgrave had discussed INE before this essay, but separately and briefly. See Peggy B Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (John Hopkins Press 1963) 24, 27; Richard A Musgrave, ‘The Carter Commission Report’ (1968) 1 The

was proposed in 1972, is the concept of ‘national loss and gain’. According to the Musgraves, as the national wealth of a country includes the total wealth of its residents, income earned by investors resident in country A from their investments in source country B, constitutes a national gain to country A.<sup>36</sup> This gain in the national wealth of country A is reduced, or there is a ‘national loss’ to country A, if country B taxes the income generated by A’s residents from their investments in B.<sup>37</sup> For the Musgraves, this allocation of national loss and gain between countries due to taxation of income of non-resident investors by the source country is ‘the issue of INE’.<sup>38</sup>

As can be seen, the focus in this formulation, which persists in Peggy Musgrave’s later discussions of INE in terms of ‘entitlement’ to tax, is on the source country’s taxing rights. Or in the Musgraves’ own words, on ‘whether B should be permitted to tax, and if so, by how much’.<sup>39</sup> This position can be understood from the Musgraves’ starting point of all wealth arising from international investments of investors of the residence country belonging to the country. In comparison, the Musgraves’ most convincing explanation for source taxation was the ‘principle of territorial sovereignty’.<sup>40</sup> According to this, a country is entitled to tax the income arising from economic activities undertaken within its borders.<sup>41</sup>

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Canadian Journal of Economics 159, 180-181; Peggy B Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (The Law School of Harvard University 1969) 130-133. Both Richard and Peggy Musgrave’s first most detailed engagement with the concept of INE was, however, their 1972 essay. After that only Peggy Musgrave continued writing on INE.

<sup>36</sup> Richard A Musgrave and Peggy B Musgrave (n 35) 68.

<sup>37</sup> *ibid.*

<sup>38</sup> *ibid.*

<sup>39</sup> *ibid.* 71. See also Peggy B Musgrave, ‘International Tax Base Division and the Multinational Corporation’ (1972) 27 *Public Finance* 394, 394-395; Peggy B Musgrave, ‘Fiscal Coordination and Competition in an International Setting’ in Lorraine Eden (ed), *Retrospectives on Public Finance* (Duke University Press 1991) 276, 281-282.

<sup>40</sup> Richard A Musgrave and Peggy B Musgrave (n 35) 70-74. See also Peggy B Musgrave, ‘Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union’

Interestingly, some of Peggy Musgrave's later writings do not reflect the narrow interpretation of territoriality on which the existing rules for determining a source country's right to tax business profits, as contained in the OECD Model and the UN Model, are based.<sup>42</sup> This interpretation rests on the supply approach, according to which, income has its source where the factors giving rise to it, such as land, labour, and capital, interact.<sup>43</sup> This necessitates physical presence of a non-resident enterprise in the source country. Instead, her works show equal support for the supply-demand approach, which encompasses the idea that profits are generated through the interaction of demand and supply.<sup>44</sup> Thus, tax base should be divided between the jurisdictions where the income producing activity takes place and where the product is used or consumed, irrespective of the degree of physical presence of the non-resident enterprise in the country.<sup>45</sup>

On the second important issue of determining how much of a non-resident enterprise's income a source country can tax, the Musgraves first focused on the method of dividing the tax base between countries. More than 50 years ago, the

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in Sijbren Cnossen (ed), *Taxing Capital Income in the European Union: Issues and Options for Reform* (OUP 2000) 46, 52-54.

<sup>41</sup> Richard A Musgrave and Peggy B Musgrave (n 35) 71-72. See also Peggy B Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union' (n 40) 53.

<sup>42</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Articles 5 and 7; UN Department of Economic and Social Affairs (DESA), *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011) Articles 5 and 7.

<sup>43</sup> OECD, 'Are the Current Treaty Rules for Taxing Business Profits Appropriate for E - commerce? – Final Report' (OECD 2004) para 40 <[www.oecd.org/ctp/treaties/35869032.pdf](http://www.oecd.org/ctp/treaties/35869032.pdf)> accessed 2 November 2012.

<sup>44</sup> For instance see Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' in Charles E McLure Jr (ed), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover Institution Press 1984) 228, 234; Peggy B Musgrave, 'Interjurisdictional Coordination of Taxes on Capital Income' in Sijbren Cnossen (ed), *Tax Coordination in the European Community* (Kluwer Law and Taxation 1987) 197, 203.

<sup>45</sup> Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' (n 44) 234.

Musgraves criticised arm's length principle (ALP)-based separate accounting as full of difficulties and potentially arbitrary.<sup>46</sup> They were, however, also of the view that an apportionment based on a formula will not be workable in the absence of an international tax administration.<sup>47</sup> According to the Musgraves, the only satisfactory solution to the problem of division of tax base between source countries was the taxation of income of MNEs on an international basis with subsequent allocation of proceeds among the participating countries.<sup>48</sup> In Peggy Musgrave's later writings there is, nevertheless, a greater engagement with formulary apportionment, with the supply side factors of the formula being labour and capital and the demand side one being sales.<sup>49</sup>

Tax rates were the second aspect of the Musgraves' discussion of the scope of a source country's right to tax the income of a non-resident enterprise. In a world where there is a 'highly unequal distribution of resource endowments and per capita income' among countries, the Musgraves suggested using tax rates to further distributional considerations.<sup>50</sup> They proposed an internationally agreed uniform tax rate schedule substituting corporate and withholding tax rates, where the tax rates would relate

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<sup>46</sup> Richard A Musgrave and Peggy B Musgrave (n 35) 82, 85. This approach, which essentially treats related entities as independent enterprises transacting in comparable circumstances for determining the price of the transactions between them, is studied in chapter V.

<sup>47</sup> *ibid* 85.

<sup>48</sup> *ibid*. In this proposition, the Musgraves sought to accommodate distributional considerations through the use of tax rates. This aspect is discussed in the subsequent paragraph.

<sup>49</sup> Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' (n 44) 234-244. Peggy Musgrave believed that this might also be a better way of giving effect to the supply-demand approach. See Peggy B Musgrave, 'Sovereignty, Entitlement, and Cooperation in International Taxation' (2001) 26 *Brooklyn Journal of Int'l L* 1335, 1344-1345; Peggy B Musgrave, 'Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World' in Inge Kaul and Pedro Conceição (eds), *The New Public Finance: Responding to Global Challenges* (OUP 2006) 176.

<sup>50</sup> Richard A Musgrave and Peggy B Musgrave (n 35) 74.

inversely to per capita income in the source country and directly to per capita income in the residence country.<sup>51</sup>

For the author, what stands out in the above outline of the Musgraves' and Peggy Musgrave's later writings on fairness in the international taxation framework is the core of their notion of INE: the idea of national gain and loss, and its possible relation with a country's compliance with or deviation from the international rules for assignment of taxing rights between countries. Arguably, if a division of taxing rights leads to an acceptable gain or loss in a country's national wealth, or in other words, is fair from a country's perspective, the country is likely to comply with the rules giving rise to it. Likewise, a possible reason behind a country's divergence from those rules could be its dissatisfaction with the gain or loss in its national wealth that the rules result in.<sup>52</sup> Or phrased differently, the rules could be considered unfair from the country's standpoint.

This gives a crude, yet useful standard for assessing whether the existing international rules for assignment of taxing rights between countries could be considered fair from a country's perspective. However, the Musgraves' construct of INE and even Peggy Musgrave's discussions of the norm do not explain what makes a gain or loss in a country's national wealth fair or unfair, or what makes the ends discussed by them, and more extensively by Peggy Musgrave, fair. Due to this, their

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<sup>51</sup> *ibid.*

<sup>52</sup> It is acknowledged that there could be other reasons for this divergence, such as historical or cultural. Arguably, an improvement in its economic position is, however, difficult for a country to resist for long. Therefore, if the rules lead to a more acceptable gain or loss in a country's national wealth, the country would move in their direction rather than away from them.

contribution in the area is unable to deliver a general parameter for furthering fairness in these rules.

The Musgraves' and Peggy Musgrave's work on INE nevertheless remains important because most subsequent commentators have either used their idea of INE as the general notion of fairness in the international taxation framework,<sup>53</sup> or they have applied it as an evaluative criterion in discussing different proposals for reform in the same.<sup>54</sup> The majority of the writings which have engaged more substantially with INE also build on the Musgraves' redistributive approach. These works are examined by the author in the following section (a) under the heading of redistributive notions of INE. Section (b) studies the alternative which goes beyond the Musgraves' and Peggy Musgrave's approach and suggests considering the doctrine of economic allegiance as a theory of fairness in the allocation of taxing rights between countries.

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<sup>53</sup> For example see Mitsuo Sato and Richard M Bird, 'International Aspects of the Taxation of Corporations and Shareholders' (1975) 22 International Monetary Fund (IMF) Staff Papers 384, 421-429; Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press 1998) 73-74; Prafula Fernandez and Jeff Pope, 'International Taxation of Multinational Enterprises' (2002) 12 Revenue L Journal 106, 123-124; Walter Hettich and Stanley L Winer, 'Rules, Politics, and Normative Analysis of Taxation' in Jürgen G Backhaus and Richard E Wagner (eds), *Handbook of Public Finance* (Kluwer Academic Publishers 2004) 109, 116-117; Cécile Brokeblind, 'The Evolution of International Income Tax Law Applied to Global Trade' in Roger Blanpain and Boel Flodgren (eds), *Corporate and Employment Perspectives in a Global Business Environment* (Kluwer Law International 2006) 123, 127.

<sup>54</sup> For example see Joel P Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (1993) 34 Harvard Int'l L Journal 47, 72-73; Richard L Doernberg and others, *Electronic Commerce and Multijurisdictional Taxation* (Kluwer Law International 2001) 68-69; Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation' (2002) 50 Canadian Tax Journal 823, 826-827, 838-839, 851; Jinyan Li, 'Improving Inter-Nation Equity Through Territorial Taxation and Tax Sparing' in Arthur J Cockfield (ed), *Globalization and its Tax Discontents: Tax Policy and International Investments* (University of Toronto Press 2010) 117. For an excellent review of the Musgraves' and Peggy Musgrave's later work on INE and how it has been applied by subsequent scholars see Kim Brooks, 'Inter-Nation Equity: The Development of an Important But Underappreciated International Tax Policy Objective' in John G Head and Richard Krever (eds), *Tax Reform in the 21<sup>st</sup> Century: A Volume in Memory of Richard Musgrave* (Kluwer Law International 2009) 471.

### **a. Redistributive notions of INE**

The first of such proposals is made by Avi-Yonah. Like the Musgraves, Avi-Yonah suggests the use of tax rates to promote INE.<sup>55</sup> Additionally, Avi-Yonah recommends that when a choice is presented between two otherwise comparable rules, one of which has progressive and another that has regressive implications for the division of the international tax base between poorer and richer countries, the progressive rule should be preferred over the regressive one.<sup>56</sup> According to Avi-Yonah, such a concept of INE has a ‘better chance of achieving more meaningful distributive goals’.<sup>57</sup>

Another redistributive notion of INE is proposed by Benshalom. He argues that commercial relationships between people in developed and developing countries ‘often take a form in which the former benefit from the poverty of the latter by way of the frequent unfairness in market transactions between them’.<sup>58</sup> Benshalom suggests that the international framework for allocation of taxing rights between countries can address the ‘immorality of this pattern’ by helping developed countries fulfil their ‘relationship-distributive duties’ or duties arising from trade relationships with people in economically less developed countries.<sup>59</sup> According to him, one way of achieving

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<sup>55</sup> Reuven S Avi-Yonah, ‘Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State’ (2000) 113 *Harvard L Rev* 1573, 1649. In Avi-Yonah’s view, there is no sound theoretical reason to restrict distributional considerations to the domestic context.

<sup>56</sup> *ibid* 1650.

<sup>57</sup> *ibid*.

<sup>58</sup> Ilan Benshalom, ‘The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law’ (n 23) 6-7.

<sup>59</sup> *ibid* 1, 43, 37, 69-81.

this can be ‘increasing the scope of source jurisdiction at the expense of residence’.<sup>60</sup> More recently, Benshalom has suggested variations of unitary taxation with global formulary apportionment as ways of pursuing the redistributive agenda.<sup>61</sup>

Compared to these works, the other redistributive approaches to fairness in the division of taxing rights between countries have more specific goals. For instance, Brooks considers bilateral tax treaties from a feminist perspective. She suggests that these treaties could be used to allocate greater revenue to countries that ‘actively promote women’s equality’, and to ‘punish corporate taxpayers who act in ways that erode or hamper’ the same.<sup>62</sup> In another example, Ring suggests expanding on some ‘accepted thinking on human rights to encompass more clearly defined economic rights’ as the basis of ensuring adequate tax revenue to those developing countries that are the ‘locus of significant human rights concerns (in terms of standard of living and related measures)’.<sup>63</sup>

Infanti has developed a more sophisticated version of Ring’s idea.<sup>64</sup> He proposes measures that both source and residence countries can undertake to promote human development. For source countries, Infanti suggests adopting a ‘sliding scale of withholding taxes’, which could be implemented through the country’s domestic law or through its tax treaties. This scale would be tied to the measures of human

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<sup>60</sup> *ibid* 76.

<sup>61</sup> Ilan Benshalom, ‘How to Redistribute? A Critical Examination of Methods to Promote Global Wealth Redistribution’ (2014) 64 *University of Toronto L J* 317, 354-357.

<sup>62</sup> Kim Brooks, ‘Global Distributive Justice: The Potential for a Feminist Analysis of International Tax Revenue Allocation’ (2009) 21 *Canadian J Women & L* 267, 290-291.

<sup>63</sup> Diane Ring, ‘Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation’ (2009) 9 *Florida Tax Rev* 555, 590.

<sup>64</sup> Anthony C Infanti, ‘International Equity and Human Development’ in Yariv Brauner and Miranda Stewart (eds), *Tax, Law and Development* (Edward Elgar 2013) 209.

development in the annual Human Development Reports, such as the Human Development Index (HDI), the Inequality Adjusted HDI (IHDI), and the Gender Inequality Index (GII).<sup>65</sup> The source country could then offer lower withholding tax rates to residents of countries that appear in the HDI's 'very high human development' category or are among the highest scorers in the 'HDI improvement rank'.<sup>66</sup> Other factors relevant for securing low withholding tax rates could be a country's performance on the equality criteria as measured by IHDI or the gender equality aspect as measured by GII.<sup>67</sup> Similarly, a residence country could encourage investment in countries doing well in terms of human development and gender equality by exempting income generated from those countries from tax.<sup>68</sup> The residence country could discourage investment in source countries doing poorly in those areas by allowing only a deduction for taxes paid in those countries or, in worse cases, by denying relief from double taxation.<sup>69</sup> According to Infanti, in these ways, INE in the international taxation framework would have a more robust meaning.

These redistributive approaches to fairness can be seen as an important contribution to understanding how the international taxation framework can further global development. A problem, however, is that not all of them give a more general parameter to advance fairness concerns in this structure. For instance, in Avi-Yonah's idea of choosing progressive options for poorer countries over the regressive ones, there is no clear basis for classifying alternatives in these two categories. Even in Benshalom's proposals, the ends are clear, but on what basis they can be claimed as

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<sup>65</sup> *ibid* 230-232.

<sup>66</sup> *ibid*.

<sup>67</sup> *ibid*.

<sup>68</sup> *ibid* 233-236.

<sup>69</sup> *ibid* 234.

being fair or fairer is not. The suggestions of Brooks, Ring, and Infanti do well on this count. The challenge nevertheless is in maintaining a broad enough approach to INE that can be applicable across a range of countries. For example, based on GDP levels, in relation to the majority of countries, some developing countries such as the BICs are not likely to qualify for the benefit of redistribution.<sup>70</sup> If, however, factors such as income poverty or the level of human development in the BICs are taken into account, the result could be different.<sup>71</sup>

Even in the case of a sufficiently wide basis for promoting fairness in the international taxation framework, an outright sacrifice of revenue on the part of the more developed countries mandated in all the redistributive proposals makes them practically more difficult to realise. A good reflection of this is the OECD's position on tax sparing provisions in bilateral tax treaties. These ensure that even if a source country decides not to tax a non-resident investor, the benefit of that choice will stay with the investor and will not pass over to the residence country.<sup>72</sup> The latter could happen if the residence country relieves double taxation by the credit method, or

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<sup>70</sup> According to the World Bank, in 2012, Brazil's GDP was 2.253 trillion USD, India's GDP was 1.859 trillion USD, and China's GDP was 8.227 trillion USD. This puts the BICs in the top ten countries in the world in terms of GDP levels with China coming second to the US, Brazil being seventh after Japan, Germany, France and the UK, and India tenth after Russia and Italy. This data can be obtained from World Bank, 'Country Profiles' (World Bank) <[www.worldbank.org/en/country](http://www.worldbank.org/en/country)> accessed 15 April 2014; World Bank, 'Gross Domestic Product – 2014' (World Bank 2014) <<http://databank.worldbank.org/data/download/GDP.pdf>> accessed 15 April 2014.

<sup>71</sup> In 2009, 6.1% and 11.8% of the total population of Brazil and China respectively lived in extreme poverty (less than 1.25 USD a day). In 2010, 32.7% population of India lived in extreme poverty. According to the rankings for 2012, all the three BICs ranked low on the Human Development Index (HDI). Brazil stood at 85, China at 101, and India at a disappointing 136 out of 186 countries. See UNDP, *Human Development Report 2013 – The Rise of the South: Human Progress in a Diverse World* (n 18) 143-159.

<sup>72</sup> Luís Eduardo Schoueri, 'Tax Sparing: A Reconsideration of the Reconsideration' in Yariv Brauner and Miranda Stewart (n 64) 106, 109. There are arguments against the effectiveness of tax incentives and also with regards to the potential abuse of tax sparing provisions. For the limited discussion of these aspects in this chapter it is, however, assumed that both these issues can be dealt with by how the source country designs, implements, and monitors such provisions

grants exemption only for certain sources of income or does so only when income is taxed at some minimum level in the source country.<sup>73</sup>

The OECD's Committee of Fiscal Affairs (CFA) has, however, recommended that the OECD members consider tax sparing 'only' in regard to countries having economic levels 'considerably below' that of the OECD countries'.<sup>74</sup> Some of the major OECD countries, such as the US, were never in favour of tax sparing anyway.<sup>75</sup> Over the years, in line with the CFA's position, other OECD members have also become less inclined to allow tax sparing provisions in their bilateral tax treaties. For example, one of the common reasons given for the termination of the Brazil-Germany tax treaty is Brazil's insistence on continuing with the tax sparing provisions in the treaty, which was not agreeable to Germany.

The example of Brazil also highlights that the case for a straight revenue transfer by more developed countries as required by the redistributive approaches to fairness will be particularly difficult when developing countries like the BICs are the intended beneficiaries. This is even though levels of poverty or human development in these countries continue to be dismal. The debate around stopping the UK's development aid to India is another example of this.<sup>76</sup> For the past few years, the

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<sup>73</sup> OECD, 'Tax Sparing: A Reconsideration' in OECD, *Model Tax Convention on Income and on Capital* (OECD 2010) R (14), 11-12.

<sup>74</sup> *ibid* 28.

<sup>75</sup> Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International 2003) 22.

<sup>76</sup> Will Straw and Alex Glennie, 'In Aid of India: Defining a Positive Role for the UK' (Institute for Public Policy Research 2013) 8-10 <[www.ippr.org/files/images/media/files/publication/2013/02/in-aid-of-india\\_Feb2013\\_10231.pdf?noredirect=1](http://www.ippr.org/files/images/media/files/publication/2013/02/in-aid-of-india_Feb2013_10231.pdf?noredirect=1)> accessed 15 March 2014.

same has evoked strong reactions among politicians and members of the public in the UK, leading to the decision to discontinue the aid from 2015.<sup>77</sup>

Economic pressures on countries across the globe mean that it will not be easy for governments to justify to their public the sacrifice of tax revenue that could be used to support development at home.<sup>78</sup> Again, the problem will be more intense when it is in favour of economies such as the BICs that, for the past few years, have seen stronger GDP growth than many developed economies.<sup>79</sup> Thus, at least in the short term, it will remain difficult to realise in practice even a theoretically broad-based redistributive idea as the general approach to furthering fairness in the international taxation framework.

## **b. Pursuing economic allegiance as a theory of INE**

According to Kaufman, the use of the doctrine of economic allegiance for basing a theory of fairness in the international taxation framework demands greater attention

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<sup>77</sup> BBC News, 'Who, What, Why: Why Does the UK give Aid to India' (BBC 1 March 2011) <[www.bbc.co.uk/news/magazine-12607537](http://www.bbc.co.uk/news/magazine-12607537)> accessed 15 March 2014; Tim Ross, 'Britain's £280 million Aid to India will be Scrapped' *The Telegraph* (London, 9 November 2012) <[www.telegraph.co.uk/news/9666249/Britains-280-million-aid-to-India-will-be-scrapped.html](http://www.telegraph.co.uk/news/9666249/Britains-280-million-aid-to-India-will-be-scrapped.html)> accessed 15 March 2014. A similar controversy exists in the case of China. See Maria Tadeo, 'Millions in Aid to China Criticised as Ambitious Space Programme is Announced' *The Independent* (London, 16 December 2013) <[www.independent.co.uk/news/uk/home-news/millions-in-aid-to-china-criticised-as-ambitious-space-programme-is-announced-9007000.html](http://www.independent.co.uk/news/uk/home-news/millions-in-aid-to-china-criticised-as-ambitious-space-programme-is-announced-9007000.html)> accessed 15 March 2014.

<sup>78</sup> As stated in chapter I, after the economic crisis of 2008, people across the world have become more sensitive about their countries not getting their fair share of tax over profits of MNEs. See *The Telegraph*, 'MPs Demand Action Over Starbucks, Amazon and Google Tax Avoidance' *The Telegraph* (London, 3 December 2012) <[www.telegraph.co.uk/news/newsvideo/uk-politics-video/9718420/MPs-demand-action-over-Starbucks-Amazon-and-Google-tax-avoidance.html](http://www.telegraph.co.uk/news/newsvideo/uk-politics-video/9718420/MPs-demand-action-over-Starbucks-Amazon-and-Google-tax-avoidance.html)> accessed 12 February 2013; Rowena Mason and Jennifer Rankin, 'EU Could Force Google to Pay More UK Tax' *The Guardian* (London, 28 January 2016) <[www.theguardian.com/politics/2016/jan/28/eu-could-force-google-to-pay-more-uk-tax](http://www.theguardian.com/politics/2016/jan/28/eu-could-force-google-to-pay-more-uk-tax)> accessed 20 February 2016.

<sup>79</sup> According to the World Bank, between 2009 and 2012, the BICs (particularly India and China) have generally enjoyed strong GDP growth rates, which are as follows: Brazil - 0.3%, 7.5%, 2.7%, and 0.9%; India - 8.5%, 10.3%, 6.6%, and 4.7%; China - 9.2%, 10.4%, 9.3%, and 7.8%.

than it has received. The German scholar George Von Schanz first proposed the doctrine in 1892.<sup>80</sup> It was, however, given international prominence by the LONs' Group of Economists who discussed it in their 1923 Report as an approach for establishing a country's taxing right over the income generated by cross-border activities of MNEs.

In view of the LONs' Economists, 'a part of [the] total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority'.<sup>81</sup> The LONs' Economists gave three fundamental considerations for determining where a taxpayer's 'true economic interests' lie. These are: 1) production of wealth, 2) possession of wealth, and 3) disposition of wealth.<sup>82</sup> The LONs' Economists' idea of 'production' of wealth covers all stages from carrying out the income producing activity to the sale of the output of that activity.<sup>83</sup> Thus, arguably, this factor for determining a taxpayer's economic interests in a country or the taxpayer's economic allegiance to the country could be used for allocating the income generated by international activities of an MNE to the country where the activity giving rise to that income takes place and also to the one that provides a market for the output of that activity.

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<sup>80</sup> George Von Schanz, 'Zur Frage der Steuerpflicht' (1892) 9 II Finanzarchiv 1, 4 as cited in Klaus Vogel, 'Worldwide vs. Source Taxation - A Review and Re-evaluation of Arguments (Part I)' (1988) 16 Intertax 216, 219.

<sup>81</sup> Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee of the League of Nations* (EFS73.F19, League of Nations (LONs) 1923) 20.

<sup>82</sup> *ibid* 22-23.

<sup>83</sup> *ibid* 23.

The LONs' Economists explained 'disposition' of wealth as the wealth reaching its final owner who can use it the way he chooses,<sup>84</sup> and 'possession' of wealth as covering stages between production and disposition.<sup>85</sup> The LONs' Economists gave importance to the place of production and the place of disposition of wealth. For them, stages covered under possession of wealth were, in most cases, significant only for reinforcing the claims of either of these countries.<sup>86</sup>

This approach for dividing taxing rights between countries, which takes into account different countries' contribution in the production and enjoyment of the underlying income, appears to be a fitting starting point for pursuing a notion of fairness in the international assignment of taxing rights. This, however, is not how the LONs' Economists applied the doctrine. In fact, when the LONs' Economists proposed their allocation of taxing rights between countries, their focus was entirely on addressing the issue of double taxation.<sup>87</sup>

According to the LONs' Economists, the 'most desirable practical method' of alleviating double taxation was to exempt all non-residents from taxation imposed by the country of origin on income drawn from within the country's borders.<sup>88</sup> They nevertheless acknowledged that this approach might be more suitable between countries having reciprocal flows of investment.<sup>89</sup> Hence, they proposed that 'certain classes of investments and embodiments of wealth, such as rents of land and of

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<sup>84</sup> *ibid.*

<sup>85</sup> *ibid.*

<sup>86</sup> *ibid* 25.

<sup>87</sup> *ibid* 40.

<sup>88</sup> *ibid* 51.

<sup>89</sup> *ibid* 49.

houses and mortgages on real property' may be subject to tax wholly at the place of origin, and the residence country may charge 'other sources in full'.<sup>90</sup> These positions of the LONs' Economists were influenced by the ability-to-pay principle. Applied to achieve equity among taxpayers of a country or inter-individual equity (IIE), the ability-to-pay principle requires that each taxpayer must be taxed on his entire income, irrespective of the geographical source of the taxpayer's income.<sup>91</sup>

Kaufman argues that a residence country's right to tax the worldwide income of its residents means that the country has a greater interest in the income produced by cross-border activities of MNEs than it would have under a system founded on economic allegiance.<sup>92</sup> Accordingly, the existing rules for allocation of taxing rights between countries do not reflect a standard of IIE that involves the sharing of interests in international income that is implicit in the theory of economic allegiance.<sup>93</sup> In Kaufman's view, it may be the goal of an ability-to-pay income tax to tax each resident's entire payment capacity, wherever derived.<sup>94</sup> This, however, 'does not mean that the measure of taxpayer equality for any one country's income tax should be, or even is worldwide income'.<sup>95</sup> According to Kaufman, a taxpayer's entire ability-to-pay would be subject to tax even if each country with which such a taxpayer has ties imposes its tax on the portion of the taxpayer's capacity that arises within the

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<sup>90</sup> *ibid* 42, 51.

<sup>91</sup> *ibid* 18-20.

<sup>92</sup> Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 *L & Policy in Int'l Business* 145, 199.

<sup>93</sup> *ibid* 198-199.

<sup>94</sup> *ibid* 173.

<sup>95</sup> *ibid*.

country.<sup>96</sup> The largely global move towards territoriality appears to be a step in this direction.

Kaufman does not suggest an ability-to-pay tax at source. She does, however, point out the fallacy in the view that a comprehensive income tax base cannot be divided among distinct geographical sources.<sup>97</sup> Kaufman further questions whether under the comprehensive income tax base as a tax base without a source and a sovereign, it is equitable for one country to tax the worldwide income of its residents.<sup>98</sup> According to Kaufman, a just international tax system cannot exist until each country limits its tax base in a manner that gives effect to INE.<sup>99</sup>

Kaufman does not suggest a notion of fairness in the international taxation framework. Instead, she points out the aspects to be considered in working towards one based on the doctrine of economic allegiance. As highlighted in the preceding paragraphs, the most important is that the application of the doctrine should not be based on principles furthering the objectives of any particular type of country. Instead, it should be used in a way that promotes the doctrine's core idea of dividing taxing rights over income generated by cross-border activities of MNEs among countries in a manner that recognises countries' role in the creation of that income on an equal footing.

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<sup>96</sup> *ibid* 174.

<sup>97</sup> *ibid* 175.

<sup>98</sup> *ibid* 182.

<sup>99</sup> *ibid* 188.

Arguably, such an approach to fairness would neither be able to hold the prevailing international assignment of taxing rights, nor the Musgraves' position on INE as fair or equitable. As stated by Kaufman, at the centre of both of these is the assumption that the country of residence owns the income producing capital and hence, has at least a residual interest in the taxpayer's income.<sup>100</sup> In comparison, under the doctrine of economic allegiance, ownership of capital, rather than being a superior factor for basing a claim for greater taxing rights, is relevant only to the extent that it helps determine a taxpayer's economic interest in its home country.<sup>101</sup>

### **III. Further gaps and deficiencies in the international taxation literature from the perspective of providing parameters for assessing and advancing fairness considerations and how they can be filled**

Some of the gaps and deficiencies in the approaches to fairness in the international taxation literature were highlighted in part II. There is, however, a more fundamental shortfall in all of them that demands separate attention. This is the lack of engagement with fairness in process or procedural fairness to any serious degree.<sup>102</sup> Although a similar story is evident in the policy documents of the LONs, the OECD and the UN, more recently there have been some proactive attempts to involve developing countries in the process of development of the rules for allocation of taxing rights between countries. As will be studied in chapter VI, the UN Tax Committee has

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<sup>100</sup> *ibid* 198.

<sup>101</sup> *ibid*.

<sup>102</sup> The author found that even the works that trace the evolution and development of the prevailing international rules for allocation of taxing rights between countries, some of which are cited in chapter III, do not really employ any concrete theoretical framework to analyse that process. The writings discussing institutional reform in the international taxation set-up, which will be studied in chapter VI, highlight some of the indicators of procedural fairness that will be discussed in this section. However, they also do not formulate them in terms of an approach to fairness in the rule-making process.

discussed including developed and developing countries equally in international taxation rule-making through the establishment of a single inter-governmental body for this purpose.<sup>103</sup> In comparison to the OECD's previous tax work, the BEPS project has also been much more open to input from developing countries.<sup>104</sup> These developments make it particularly opportune to reflect on the importance of fairness in process in the international taxation framework and to establish parameters for assessing and advancing the same.

Section (a) relies on broader international law and international relations literature to find such parameters. Section (b) focuses on substantive fairness. The academic works on INE outlined in part II have dealt considerably with fairness in the allocation of taxing rights between countries. Therefore, the author relies on those, particularly the suggestion to pursue the doctrine of economic allegiance for developing a notion of fairness in the assignment of taxing rights, for identifying indicators for furthering fairness in the international division of rights to tax active business income.

#### **a. The existing approaches to fairness in the international taxation literature and fairness in process: the missing keystone**

A study of fairness in the international context outside of the international taxation literature reveals an emphasis on two key elements of the idea of fairness: procedural

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<sup>103</sup> UN Economic and Social Council (ECOSOC), 'Strengthening of Institutional Arrangements to Promote International Cooperation in Tax Matters, including the Committee of Experts on International Cooperation in Tax Matters' (18 March 2011) E/2011/76, para 63-74.

<sup>104</sup> OECD, 'OECD Engages with Developing Countries on BEPS' (*OECD*, 27 September 2013) <[www.oecd.org/tax/oecdengageswithdevelopingcountriesonbeps.htm](http://www.oecd.org/tax/oecdengageswithdevelopingcountriesonbeps.htm)> accessed 20 March 2014. See also OECD, *Action Plan on Base Erosion and Profit Shifting* 2013 (n 33) 25-26.

fairness and substantive fairness. In his pioneering work on fairness in international law, Franck gives two grounds on which the ‘fairness of international law, as of any other legal system’ will be judged. The first concerns procedural fairness or fairness in the rule-making process, and the second relates to substantive fairness or fairness in the outcome or the rules themselves.<sup>105</sup> According to Franck, the former is a key element of the concept of fairness for it ‘accommodates a deeply felt popular belief that for a system of rules to be fair, it must be firmly rooted in a framework of formal requirements about how rules are made, interpreted and applied’.<sup>106</sup>

In Franck’s view, it cannot be said definitively that a fair process will lead to a fair outcome for all the stakeholders of a system.<sup>107</sup> As the involvement of all stakeholders is integral to such a process, it nevertheless increases their chances of shaping a fairer outcome. After all, for Franck fairness is a ‘process of discourse, reasoning, and negotiation leading, if successful, to an agreed formula located at the conceptual intersection between various plausible formulas for allocation’.<sup>108</sup> In any case, regardless of the impact that a fair process has on the outcome, Franck considers it important for reinforcing the perception of effectiveness of a system of rules among its stakeholders, which in turn can help secure their compliance with the system.<sup>109</sup>

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<sup>105</sup> Thomas M Franck, *Fairness in International Law and Institutions* (OUP 1995) 7.

<sup>106</sup> *ibid* 7-8.

<sup>107</sup> *ibid* 23.

<sup>108</sup> *ibid* 14.

<sup>109</sup> *ibid* 7-8, 23.

Other literature engaging with fairness in the international context supports Franck's argument.<sup>110</sup> This body of work suggests that procedures that give all the stakeholders an opportunity to be 'at the table' and have their differences deliberated upon, along with mechanisms to help reduce the impact of their relative power and technical capabilities, are more likely to be perceived by them as fair.<sup>111</sup> Such procedures enhance stakeholders' ability to influence the outcome, and hence could deliver results that are more equitable from the stakeholders' perspective.<sup>112</sup> Also, legal or regulatory frameworks that stakeholders view as procedurally fair are more satisfying for them and thus are more likely to be acceptable to them.<sup>113</sup>

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<sup>110</sup> For example see Steven Suranovic, 'A Positive Analysis of Fairness with Applications to International Trade' (2000) 23 *The World Economy* 283, 286-294; Cecilia Albin, *Justice and Fairness in International Negotiation* (CUP 2001) 8-12; Stiglitz and Charlton, *Fair Trade for All: How Can Trade Promote Development* (n 23) 67-86; Amrita Narlikar, 'Fairness in International Trade Negotiations: Developing Countries in the GATT and WTO' (2006) 29 *The World Economy* 1005, 1007-1010; Americo Beviglia Zampetti, *Fairness in the World Economy: US Perspectives on International Trade Relations* (Edward Elgar 2006) 28-31; Brown and Stern (n 28) 295; Manfred Elsig, 'The World Trade Organization's Legitimacy Crisis: What Does the Beast Look Like?' (2007) 41 *Journal of World Trade* 75, 81-86; Cosmas Milton and Obote Ochieng, 'The EU-ACP Economic Partnership Agreements and the 'Development Question': Constraints and Opportunities Posed by Article XXIV and Special and Differential Treatment Provisions of the WTO' (2007) 10 *Journal of Int'l Economic L* 363, 389-390; Friedrich Soltau, *Fairness in Climate Change Law and Policy* (CUP 2009) 146-149; Geoff Moore, 'Fairness in International Trade: The Case of Economic Partnership Agreements' in Geoff Moore (ed), *Fairness in International Trade* (Springer 2010) 195, 205-208; Steven Suranovic, *A Moderate Compromise: Economic Policy Choice in an Era of Globalization* (Palgrave Macmillan 2010) 68-77; Marco Grasso and Simona Sacchi, 'Procedural Justice in International Negotiations on Climate Change' (Research Paper No 6/2011, CISEPS 2011) 2-3 <<http://bit.ly/1NSBYxm>> accessed 12 April 2014; Mario Prost and Alejandra Torres Camprubi, 'Against Fairness? International Environmental Law, Disciplinary Bias, and Pareto Justice' (2012) 25 *Leiden Journal of Int'l L* 379, 396.

<sup>111</sup> At the international level, the most likely stakeholders for participating in the rule-making procedures of a legal or regulatory framework are sovereign countries. Through various consultation mechanisms, the process can also benefit from the involvement of other entities relevant to the set-up, such as technical bodies and non-government organisations (NGOs).

<sup>112</sup> Paul Burrows and Graham Loomes, 'The Impact of Fairness on Bargaining Behavior' in John G Hey (ed), *Experimental Economics* (Springer 1994) 21, 22

<sup>113</sup> Richard M Bird and J Scott Wilkie, 'Source- vs. Residence-Based Taxation in the European Union: the Wrong Question?' in Cnossen, *Taxing Capital Income in the European Union: Issues and Options for Reform* (n 40) 105; Albin, *Justice and Fairness in International Negotiation* (n 110) 13; Soltau (n 110) 152. The position reflected from the literature discussing the relevance of procedural fairness in inter-nation settings aligns with the findings of empirical and socio-psychological studies that have explored its importance in multiple contexts, such as dispute resolution, organisations, and also general social situations. For an insight into such works see Laurens Walker and others, 'Reactions of Participants and Observers to the Modes of Adjudication' (1974) 4 *Journal of Applied Social Psychology* 295, 308-309; S LaTour, 'Determinants of Participant and Observer Satisfaction with

An example from international trade negotiations helps substantiate these arguments. This concerns the talks for coverage of services under the General Agreement on Tariffs and Trade (GATT).<sup>114</sup> At that time, the developed countries controlled the trade in services, while this sector was emerging and relatively unregulated even in larger developing countries like Brazil and India. Therefore, countries such as Brazil and India feared that the requirement to open up their service sector was against their economic interests.<sup>115</sup> These countries, and developing countries more generally, instead sought access to developed country markets in sectors important to them like textiles and agriculture. In two important ways, the procedures adopted for dealing with these issues helped attain an outcome that was agreeable for all countries. First, as they allowed all interested parties to be involved in agenda-setting, a broad agenda covering diverse interests and concerns was established, which increased the room for striking better bargains.<sup>116</sup> Second,

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Adversary and Inquisitorial Modes of Adjudication' (1978) 36 *Journal of Personality and Social Psychology* 1531, 1532; John Thibaut and Laurens Walker, 'A Theory of Procedure' (1978) 66 *California L Rev* 541, 542; Gerald S Leventhal, 'What Should be Done with Equity Theory? New Approaches to the Study of Fairness in Social Relationships' in Kenneth J Gergen, M S Greenberg, and R H Willis (eds), *Social Exchange: Advances in Theory and Practice* (Plenum Press 1980) 27, 36-37; Tom R Tyler, 'The Role of Perceived Injustice in Defendant's Evaluation of their Courtroom Experience' (1984) 18 *L and Society Rev* 51, 68-71; Sheldon Alexander and Marian Ruderman, 'The Role of Procedural Justice and Distributive Justice in Organizational Behavior' (1987) 1 *Social Justice Research* 177, 192-194; E Allan Lind and Tom R Tyler, *Social Psychology of Procedural Justice* (Plenum Press 1988) 206-208; David Wasserman, 'The Procedural Turn: Social Heuristics and Neutral Values' in Klaus F Röhl and Stefan Machura (eds), *Procedural Fairness* (Aldershot 1997) 37; Paul Anand, 'Procedural Fairness in Economic and Social Choice: Evidence From a Survey of Voters' (2001) 22 *Journal of Economic Psychology* 247, 267; Gary E Bolton, Jordi Brandts, and Axel Ockenfels, 'Fair Procedures: Evidence from Games Involving Lotteries' (2005) 115 *The Economic Journal* 1054, 1071-1074.

<sup>114</sup> Albin, *Justice and Fairness in International Negotiation* (n 110) 128-129.

<sup>115</sup> Friedl Weiss, 'The General Agreement on Trade in Services' (1995) 32 *Common Market L Rev* 1177, 1200-1202.

<sup>116</sup> Albin, *Justice and Fairness in International Negotiation* (n 110) 129.

consensus based decision-making ensured that progress in talks on services was conditional on advance on other issues important to developing countries.<sup>117</sup>

The preceding paragraphs not only highlight the practical importance of procedural fairness, they also give what could be considered the most basic parameters of fairness in process: participation in the process and effectiveness of that participation. The first of these allows stakeholders to raise and jointly consider distinct positions.<sup>118</sup> This increases their ability to influence the outcome, and also impacts their perception of legitimacy of the system.<sup>119</sup> This, in turn, can help check divergences from the system.<sup>120</sup> However, these benefits of participation in the rule-making process can only be realised fully if the participation is effective.

Effectiveness of stakeholders' participation can be achieved in several ways. For instance, all stakeholders' involvement in drafting the agenda for the stakeholders' meetings means that they are not just 'at the table', but also have the opportunity to ensure that issues important to them are taken up for discussions.<sup>121</sup> A broad and inclusive agenda, in turn, creates greater scope for achieving mutually

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<sup>117</sup> *ibid.*

<sup>118</sup> Cecilia Albin, 'Getting to Fairness: Negotiations over Global Public Goods' in Inge Kaul and others (eds), *Providing Global Public Goods: Managing Globalization* (OUP 2003) 271.

<sup>119</sup> Lawrence Susskind and Jeffrey Cruikshank, *Breaking the Impasse – Consensual Approaches to Resolving Public Disputes* (Basic Books 1987) 24-25; Albin, *Justice and Fairness in International Negotiation* (n 110) 26.

<sup>120</sup> Franck (n 105) 8, 13; Albin, 'Getting to Fairness: Negotiations over Global Public Goods' (n 118) 271; Soltau (n 110) 152. See also Lind and Tyler (n 113) 63.

<sup>121</sup> Narlikar (n 110) 1024. See also Joseph E Stiglitz and Andrew H Charlton, 'Common Values for the Development Round' (2004) 3 *World Trade Rev* 495, 503.

acceptable compromises.<sup>122</sup> The previously discussed example of the GATT talks on services substantiates this position.

Another key step in achieving effective participation of all stakeholders in the rule-making process is making sure that they continue to have an adequate chance to freely put forth their positions on the issues covered in the agenda and have their competing interests deliberated upon regardless of how forcefully they can raise them.<sup>123</sup> This gives particular relevance to the rules relating to how discussions between various stakeholders are to proceed. These would cover issues such as the frequency of stakeholders' meetings, timing available for different stakeholders to present their views and have discussions on them, and the role of the chair of the meeting.<sup>124</sup>

Also of obvious importance in attaining stakeholders' effective participation are the rules concerning decision-making.<sup>125</sup> These relate directly to the extent to which the stakeholders can attain a fairer outcome from their perspective.<sup>126</sup> Each decision-making procedure has its own merits and demerits. For instance, a consensus-based method can ensure that parties can hold up an outcome until it reflects a satisfactory

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<sup>122</sup> William Zartman, 'Prenegotiation: Phases and Functions' and Janice G Stein, 'Getting to the Table: The Triggers, Stages, Functions and Consequences of Prenegotiation' in Janice G Stein (ed), *Getting to the Table: The Process of International Prenegotiation* (The John Hopkins University Press 1989) 10-12 and 254-255. See also Frederick Bird, Thomas Vance, and Peter Woolstencroft, 'Fairness in International Trade and Investment: North American Perspectives' in Geoff Moore (n 110) 168.

<sup>123</sup> Albin, *Justice and Fairness in International Negotiation* (n 110) 33.

<sup>124</sup> Albin, 'Getting to Fairness: Negotiations over Global Public Goods' (n 118) 272-273.

<sup>125</sup> *ibid* 271-272. See also Laurens Walker, E Allan Lind, and John Thibaut, 'The Relation between Procedural and Distributive Justice' (1979) 65 *Virginia L Rev* 1401, 1415-1416.

<sup>126</sup> Walker, Lind, and Thibaut (n 125) 1417; Julian Rode and Marc Le Menestrel, 'The Influence of Decision Power on Distributive Justice' (2011) 79 *Journal of Economic Behavior & Organization* 246, 253-254.

result for them. This, however, also means delays in reaching a decision.<sup>127</sup> Majority-based voting can potentially check such tactics, but this method runs the risk of being dominated by a group of stakeholders.

These indicators of effectiveness in participation are some of the many aspects that procedural fairness encompasses.<sup>128</sup> In the international taxation framework, where procedural fairness has received little attention, working on realising these can be the first step in the direction of a rule-making process that facilitates a balanced settlement of stakeholders' competing claims and enhances the legitimacy of the set-up. Additions and improvements to these basic indicators can also be expected to become easier after all countries start participating in the development of the international rules for allocation of taxing rights in a reasonably effective manner. In view of this understanding, participation of countries across the world in this process and the effectiveness of the same as ascertained from the elements discussed in the preceding paragraphs will be used in the following chapters as parameters for examining and promoting procedural fairness in the international taxation framework.

It is acknowledged that difference in bargaining powers and technical capabilities of diverse stakeholders has the potential to interfere with all of the above-discussed components of effective participation. Formal and informal mechanisms can, however, be adopted to minimise the impact of these factors. In fact, as suggested

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<sup>127</sup> Albin, *Justice and Fairness in International Negotiation* (n 110) 31.

<sup>128</sup> The others include: an appropriate neutral venue for holding the meetings, and the organisation for hosting/sponsoring the negotiations. For more discussion on these and other such factors see Albin, 'Getting to Fairness: Negotiations over Global Public Goods' (n 118) 272-276. See also Jeffrey Z Rubin and Bert R Brown, *The Social Psychology of Bargaining and Negotiation* (Academic Press 1975) 82-124; Paul Dolan and others, 'It Ain't What You Do, It's the Way You do It: Characteristics of Procedural Justice and their Importance in Social Decision-Making' (2007) 64 *Journal of Economic Behavior and Organization* 157, 160-161.

previously in this chapter, carefully selected parameters embodying a basic minimum standard of procedural and also substantive fairness serve as some safeguard against such consequences.<sup>129</sup>

For instance, owing to the disparity in power, economically weaker countries might feel the fear of repercussions when expressing positions that diverge from those of the economically stronger countries. In an open voting system, the fear of consequences might also influence the weaker countries' choice of outcome.<sup>130</sup> This scenario, however, only reinforces the importance of encouraging participation of all countries in all stages of the rule-making process. This can help economically less influential countries to derive strength from numbers and buttress their formal equality at all points in the negotiations.<sup>131</sup> Such countries can also benefit from prior regional coordination of positions on issues covered in international negotiations.

Larger developing countries with greater economic and political power can also play a strategic role in furthering positions that are of interest to developing countries as a group. Countries like Brazil and India have performed such a function in international trade negotiations.<sup>132</sup> However, the inherent weakness of this mechanism, and the reason it cannot be a lasting replacement for independent effective participation of all countries in the rule-making process, is that it can be

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<sup>129</sup> Stiglitz and Charlton, *Fair Trade for All: How Can Trade Promote Development* (n 23) 82. See also James Konow, 'Which is the Fairest One of All? A Positive Analysis of Justice Theories' (2003) 41 *Journal of Economic Literature* 1188, 1191; Julian Rode and Marc Le Menestrel (n 126) 253, 254; Carl Davidson, Steve Matusz, and Dough Nelson, 'Fairness and Political Economy of World Trade' (2006) 29 *The World Economy* 989, 1001.

<sup>130</sup> Albin, *Justice and Fairness in International Negotiation* (n 110) 31; Narlikar (n 110) 1014.

<sup>131</sup> Soltau (n 110) 151.

<sup>132</sup> Narlikar (n 110) 1006.

expected to work only to the extent economic interests of these more influential developing countries align with those of other developing countries.

With regards to the differences in the resources and technical capabilities of countries, developed countries can employ more experts to assess issues covered in international negotiations, and have better delegations for this purpose in terms of size and quality.<sup>133</sup> Developing countries often face limitations on all these counts. This reduces their ability to participate effectively in international forums where several issues in an area are being pursued simultaneously, especially if at a rapid speed. This is because many of these countries simply do not have the capacity to analyse the complex information exchanged and evaluate the implications of the various proposals, particularly in a short span of time.<sup>134</sup>

This impact of differences in resources and technical capacities can, however, be mitigated through capacity building programmes for developing countries.<sup>135</sup> Developed countries and larger developing countries can play a leading role in this, and so can the UN and the OECD, and various NGOs active in the field. Here again, if there is an opportunity for all stakeholders to be a part of the rule-making process right from the start, then developing countries can draw on numbers and the potentially greater bargaining power of larger developing countries to influence project timelines and consultation mechanisms.

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<sup>133</sup> Soltau (n 110) 151-152. See also Jouni Paavola and W Neil Adger, 'Fair Adaptation to Climate Change' (2006) 56 *Ecological Economics* 594, 600.

<sup>134</sup> Albin, 'Getting to Fairness: Negotiations over Global Public Goods' (n 118) 273.

<sup>135</sup> Soltau (n 110) 152. See also Pamela Chasek and Lavanya Rajamani, 'Steps Toward Enhanced Parity: Negotiating Capacity and Strategies of Developing Countries' in Kaul and others (n 118) 245-246, 258.

It is emphasised that a robust and durable legal or regulatory set-up is in the interest of all stakeholders. Considering the role procedural fairness can play in achieving such a framework, it is to the benefit of the stakeholders with greater bargaining powers to refrain from employing coercive tactics, and instead, to give importance to mechanisms that help reduce disadvantages resulting from differences in stakeholders' technical capabilities and resources.<sup>136</sup>

**b. The approaches to fairness in the international taxation literature and substantive fairness: filling the gaps and deficiencies**

Part II highlighted how the idea of national loss and gain that is at the centre of the Musgraves' construct of INE could be used for evaluating fairness in the allocation of taxing rights between countries. This essentially involves focusing on a country's divergence from the existing international rules for this purpose.<sup>137</sup> Due to the simplicity offered by this approach, it will be used in chapters IV, V, and VII as a benchmark for assessing the BICs' positions on the prevailing division of rights to tax active business income. The difficulty, however, lies in finding more general parameters to advance substantive fairness in the international taxation framework. As seen in part II, these are neither provided by the Musgraves' and Peggy Musgrave's later works, nor by the redistributive approaches to INE.

In comparison, the doctrine of economic allegiance discussed in part II involves taking into account the role played by a country or the contribution of a country in the

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<sup>136</sup> Albin, 'Getting to Fairness: Negotiations over Global Public Goods' (n 118) 270-271; Kapstein (n 29) 34.

<sup>137</sup> Text to n 52.

income generated by cross-border activities of an enterprise.<sup>138</sup> As pointed out in part II, this, however, is not necessarily reflected in the existing assignment of rights to tax on source and residence basis. Even when some of the nuances of the prevailing rules for determining a country's right to tax active business income are considered, the result remains the same. For instance, based on the supply approach, a source country can tax the income of a non-resident enterprise generated within its borders only if the enterprise meets the degree of physical presence envisaged under the concept of PE in Article 5 of the OECD Model and the UN Model in the country. The doctrine of economic allegiance would question the rejection of a country's contribution to the income of a non-resident enterprise when it is denied the right to tax the income just because the enterprise does not have this level of physical presence in the country.<sup>139</sup>

In this sense, advancing economic allegiance as a theory of INE only means re-visiting the situations where the contribution or role of a country in the creation of income by cross-border activities of MNEs is not reflected adequately in the division of taxing rights between countries or is undermined or trumped by that of other countries.<sup>140</sup> As the basic idea is applicable across a range of countries and commercial activities, it fills the gap in the Musgraves' and Peggy Musgrave's later works, which focus on the ends that would be fair, but do not engage with what makes them so. Even though this could be seen as a less ambitious approach as compared to the redistributive notions of INE studied in part II, it is more broad-based than them, and can be applied across the two key aspects of division of taxing rights between countries: determination of the right to tax and the method of dividing the tax base.

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<sup>138</sup> LONs' 1923 Report (n 81) 22-25.

<sup>139</sup> Tadmore (n 29) 4.

<sup>140</sup> Kaufman (n 92) 198.

For instance, in addition to the above-discussed example, one could focus on the ALP-based apportionment of profits between countries and assess whether the profits allocated to a country reflect the distinct advantages offered by the country in generation of income by a non-resident enterprise. Further, pursuing alternatives to the existing assignment of rights to tax active business income between countries on this basis, even if they lead to curtailment of the taxing rights enjoyed by some countries under the prevailing rules, may be politically more palatable than the outright sacrifice of revenue by the more developed countries demanded under the redistributive approaches.

It must be clarified that the idea of the contribution or the role of a country in the creation of income by an enterprise operating in the country is broader than the previously mentioned benefit principle.<sup>141</sup> It goes beyond the value of public goods and services provided by the country to an enterprise, and covers the totality of factors that make the country an attractive location for the enterprise.<sup>142</sup> It is acknowledged that like the benefit principle, this approach may come under criticism for its inability to precisely quantify a country's fair share of tax in the income generated by cross-border activities of MNEs. In fact, the inability to assign, in a quantitative sense, the proportions of allegiance of the different interested countries was a reason given by the LONs' Economists to ignore the doctrine of economic allegiance in their discussions on the international division of taxing rights.<sup>143</sup> It is, however, emphasised

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<sup>141</sup> Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 Cornell L Rev 18, 29-30; Charles E McLure Jr, 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm' (1992) 45 National Tax Journal 145, 148. See also Peter A Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries* (IBFD 1996) 446-489.

<sup>142</sup> Kaufman (n 92) 198.

<sup>143</sup> LONs' 1923 Report (n 81) 27.

that finding quantitative exactitude is not even the purpose of proposing this as the basis of pursuit of equitable allocation of rights to tax active business income between countries.<sup>144</sup> The idea is to have a general guiding principle to assess why a certain outcome in this regard might be more or less balanced from the perspective of a country.<sup>145</sup>

Viewing this in light of the classic cake-cutting problem, one of the ways of approaching a fair assignment is proportional division where each person gets a share that at least reflects his or her input.<sup>146</sup> Consider the income created by MNEs as an international resource. If each country receives a share of the resource in accordance with its contribution to the production of that resource, such a division would be proportionally fair. Irrespective of the size of the share a country receives, as long as the country's contribution in generation of the resource is recognised, even though roughly, or is not undermined by any other country, it can help reach an outcome which is more balanced from the perspective of different countries.<sup>147</sup>

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<sup>144</sup> Kaufman sees pursuing economic allegiance as a theory of INE as seeking a kind of 'rough justice, where each interested country obtains the approximate revenue it would receive if its interest could be quantified using an economic allegiance analysis'. See Kaufman (n 92) 199.

<sup>145</sup> This is in line with the limitation of the concept of equity recognised by Vogel. According to Vogel, 'equity is not a concept from which conclusions can be derived by legal or mathematical implication. Nor is it possible to prove or disprove something is equitable in the same way that mathematical facts can be proved. The attempt to formulate a definition of equity which is operational in the way in which definitions in exact sciences are, would be futile.' As also recognised by Vogel, it is nevertheless important to have some functional interpretation of equity relevant to the context. See Klaus Vogel, 'Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part III)' (1988) 11 *Intertax* 393.

<sup>146</sup> Steven J Brams and Alan D Taylor, *Fair Division: From Cake-Cutting to Dispute Resolution* (CUP 1996) 8-10, 31-38, 65-94.

<sup>147</sup> George C Homans, 'Social Behavior as Exchange' (1958) 63 *American Journal of Sociology* 597, 606; John Thibaut and Laurens Walker, 'A Theory of Procedure' (n 113) 542. For more experimental works exploring proportional division see James Konow, 'A Positive Theory of Economic Fairness' (1996) 31 *Journal of Economic Behavior and Organization* 13, 14-16; Jeremy Clark, 'Fairness in Public Good Provision: An Investigation of Preferences for Equality and Proportionality' (1998) 31 *Canadian Journal of Economics* 708, 726-727.

Admittedly, a challenge this idea itself may face is deciding what constitutes a contribution or role for the purpose of dividing taxing rights between countries on this basis.<sup>148</sup> While this question could still be answered to some extent by studying the tax practices of countries and academic contributions, the harder question is whether administrative feasibility warrants that every contribution or role should be recognised for this purpose.<sup>149</sup> It is difficult to disagree that this question will perhaps be best addressed collectively at the international level. This, in turn, reinforces the importance of a fair deliberative process discussed in the preceding section. However, even for that to be of use, the potential of this idea to further substantive fairness in the international rules for allocation of rights to tax active business income must first be acknowledged.

Further, it is important to recognise that the practical success of any such notion of fairness in the international taxation framework demands considering the issue from the standpoint of other key players of the set-up: the MNEs. As the most obvious objective of MNEs is to maximise profits, an outcome furthering this aim could be viewed as fair from their perspective. Both tax and non-tax factors play a role in this. Inbound FDI is recognised as being attracted by ‘macroeconomic stability, a supportive legal and regulatory framework, skilled labour and labour market flexibility, well-developed infrastructure, and business opportunities tied to market

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<sup>148</sup> Konow, ‘Which is the Fairest One of All? A Positive Analysis of Justice Theories’ (n 129) 1213. See also Wayne M Alves and Peter H Rossi, ‘Who Should Get What? Fairness Judgments of the Distribution of Earnings’ (1978) 84 *American Journal of Sociology* 541, 542-543.

<sup>149</sup> According to the ‘realistic doctrine’ of taxation, a State’s ‘tax jurisdiction is effectively defined by reference to its enforcement competence’. For more discussion on this see Tadmore (n 29) 4-5. See also A H Qureshi, ‘The Freedom of a State to Legislate in Fiscal Matters under General International Law’ (1987) 41 *Bulletin for Int’l Fiscal Documentation* 14, 18-19.

size'.<sup>150</sup> At the same time, complexity and uncertainty, in the sense of multiple tax rates, indeterminate language and inconsistent changes in tax laws, have a significant negative effect on inward FDI.<sup>151</sup> Although research showing a positive correlation between the presence of bilateral tax treaties and FDI inflows is limited,<sup>152</sup> it would be wrong to say that the possibility of double taxation and the assurance of relief from it - one of the main rationales given in favour of bilateral tax treaties - is not important to MNEs.<sup>153</sup>

Arguably, viewing such factors as a part of a fair outcome could help balance, to some extent, the competing interests of the different actors of the international taxation framework and make any approach to fair allocation of taxing rights from countries' perspectives more realisable and robust. For the sake of simplicity, this work starts by considering only alleviation of double taxation, certainty, and stability in the tax policy of a country.<sup>154</sup> These, together with recognition of the role played by a country in the income generated by cross-border activities of an enterprise, will be

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<sup>150</sup> OECD, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* (OECD 2007) 13.

<sup>151</sup> Kelly Edmiston, Shannon Mudd, and Neven Valev, 'Tax Structures and FDI: The Deterrent Effects of Complexity and Uncertainty' (2003) 24 *Fiscal Studies* 341, 343-345, 356-357. See also Martin Zagler and Cristiana Zanzottera, 'Corporate Income Taxation Uncertainty and Foreign Direct Investment' (2012) WU International Taxation Research Paper Series No 2012-07, 3-11, 17 <[http://epub.wu.ac.at/3767/1/2012\\_07\\_Zagler\\_Zanzottera.pdf](http://epub.wu.ac.at/3767/1/2012_07_Zagler_Zanzottera.pdf)> accessed 10 March 2014.

<sup>152</sup> For an insight into this issue see Karl P Sauvant and Lisa E Sachs, *The Effect of Tax Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (OUP 2009) 461-684. See also Fabian Barthel, Matthias Busse, and Eric Neumayer, 'The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data' (2010) 28 *Contemporary Economic Policy* 366, 376.

<sup>153</sup> It is recognised that tax-related factors would include other aspects like tax rates as well. It is, however, argued that they are not the chief issue when an enterprise plans to invest in a country, and their impact needs to be studied along with the other above-mentioned tax and non-tax features offered by the country.

<sup>154</sup> Like the country-specific factors highlighted in the preceding paragraph, foreign investment in a country also has positive and negative impacts. Due to the difficulty in assessing and balancing these, and again to maintain the simplicity of the above-discussed approach to substantive fairness in the framework for allocation of taxing rights between countries, such aspects are not included in the same.

used in chapter VII to evaluate alternatives for fairer division of rights to tax active business income from the BICs' perspective particularly and other developing countries more generally.

## **Conclusion**

Part I of this chapter highlighted why it is important to concentrate on fairness in the international taxation framework and how, in light of the BEPS project, it is an opportune time to do so. Part II studied the approaches to fairness in the international taxation literature. Part III pointed out that the chief deficiency in them is the absence of any significant engagement with fairness in process. Participation and effectiveness of participation as established by stakeholders' involvement in all stages of the rule-making process, from agenda-setting to decision-making, were selected as the parameters to fill this gap. These will be applied in chapter III for assessing procedural fairness in the evolution and development of the existing international rules for assignment of taxing rights between countries. The same will be used in chapter VI for evaluating alternatives towards a fairer international taxation rule-making process from the standpoint of the BICs and other developing countries.

Part III also reiterated the finding from part II concerning the potential of the Musgraves' construct of INE to provide a simple yet befitting benchmark for assessing whether a division of taxing rights could be considered fair from a country's standpoint. This will be applied in chapters IV and V for examining the prevailing international division of the right to tax active business income from the BICs' standpoint. As seen in part II, neither the Musgraves' and Peggy Musgrave's work on

INE, nor the redistributive approaches to INE, however, offer any general parameter for advancing fairness in the assignment of taxing rights between countries. Pursuing the doctrine of economic allegiance, recognition of a country's role or contribution in the income generated by cross-border activities of MNEs in the allocation of rights to tax that income between countries was selected for this purpose. To make this approach more robust, it was supplemented by a limited number of indicators of a fair outcome from the standpoint of businesses. This parameter-based approach to substantive fairness will be used in chapter VII for assessing options for a fairer division of rights to tax active business income from the perspective of the BICs particularly and other developing countries more generally.

## Chapter III

### **Fairness in the Process of Evolution of the Existing Rules for Allocation of Rights to Tax Active Business Income: An Examination from the BICs' Perspective**

Chapter II proposed participation and effectiveness of participation as indicators of fairness in the international taxation rule-making process. The parameters to evaluate effectiveness of participation included: all countries' involvement in agenda setting; the opportunity to present their positions and have them deliberated upon by other countries; and the chance to influence the outcome or the final decision on the rules. Part I of this chapter will apply all these factors to the process of establishment of the foundations of the existing international rules for assignment of rights to tax active business income under the LONs. Based on the same parameters, part II will examine fairness in the process of drafting of the OECD Model and the UN Model from the standpoint of the BICs primarily and other developing countries more generally.

#### **I. Assessing fairness in the process of evolution of the international rules for allocation of rights to tax active business income under the LONs from the perspective of the BICs and other developing countries**

The LONs' Economists' report of 1923 stated that 'a country wanting money cannot successfully "tax the foreigner"; it can only shut him out'.<sup>1</sup> Accordingly, the LONs' Economists advised that to facilitate investment inflows that could aid in development, host countries should exempt non-residents from taxation on source

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<sup>1</sup> Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee of the League of Nations* (EFS73.F19, League of Nations (LONs) 1923) 42.

basis.<sup>2</sup> The Economists were, however, quick to realise that this approach might not be desirable where the flows of investment between countries were not reciprocal. Thus, as highlighted in chapter II, they suggested that certain classes of investments such as rents from land and houses, and mortgages from real property could be taxed wholly in the host country or the source country.<sup>3</sup> The home country or the country of residence was to allow the whole of foreign tax as a deduction from the country's tax on its residents in respect of such sources of income. The country of residence was, however, to charge all other sources in full.<sup>4</sup>

From the perspective of the BICs and other developing countries that have historically been net importers of capital, the LONs' Economists' preference for greater rights to tax on residence basis was an inherently disadvantageous start for the international framework for allocation of taxing rights between countries.<sup>5</sup> Notably, this result was reached without any involvement of a member or a representative from the BICs or other developing countries. Two of the LONs' Economists came from the UK and the Netherlands – countries that were counted among the largest capital exporters of those times.<sup>6</sup> The third Economist, Prof Seligman, was from the US, which at that time was another capital exporter. His inclination towards residence-

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<sup>2</sup> *ibid.*

<sup>3</sup> *ibid* 42, 51.

<sup>4</sup> *ibid.*

<sup>5</sup> Commentators appear to be split on the extent to which the LONs' 1923 report influenced the development of the prevailing international rules for allocation of taxing rights between countries. For instance, Graetz and O'Hear give more importance in this regard to the pre-existing US legislation, the work of the International Chamber of Commerce (ICC), and the work of the LONs' Technical Committee that followed the LONs' Economists. See Michael J Graetz and Michael M O'Hear, 'The "Original Intent" of U.S. International Taxation' (1997) 46 *Duke L Journal* 1021, 1079. In comparison, Avi-Yonah and Ault give more importance to the LONs' 1923 report. See Hugh J Ault, 'Corporate Integration, Tax Treaties, and the Division of the International Tax Base: Principles and Practices' (1997) 47 *Tax L Rev* 565, 567; Reuven S Avi-Yonah, 'All of a Piece Throughout: The Four Ages of US International Taxation' (2005) 25 *Virginia Tax Rev* 313, 322-323.

<sup>6</sup> Sir Josiah Stamp (UK) and Prof Bruins (Netherlands).

based taxation and his influence in drafting the LONs' Economists' report of 1923 have both been widely recognised.<sup>7</sup> Only one economist among the four was from a country that, at that time, was a net recipient of foreign investment.<sup>8</sup>

This absence of the BICs and even other developing countries' participation in the LONs' work on the rules for assignment of taxing rights between countries continued through the LONs' 1925 Committee of Technical Experts.<sup>9</sup> The LONs' Committee of Technical Experts agreed in theory with the LONs' Economists' position on residence-based taxation. They did, however, recognise 'new' countries' desire to have a share in the taxes levied on income arising within their territory, and these countries' unwillingness to leave these taxes to home countries that were often 'already very rich'.<sup>10</sup> Accordingly, the LONs' Committee of Technical Experts reached a compromise with respect to the scope of source and residence-based taxation. The Committee suggested that personal taxes be allocated to the residence country and impersonal taxes be assigned to the source country.<sup>11</sup> Thus, the source country could tax income from immovable property, agricultural undertakings, and industrial and commercial establishments.

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<sup>7</sup> Graetz and O'Hear (n 5) 1074-1077.

<sup>8</sup> *ibid.* This was Prof Einaudi from Italy. Graetz and O'Hear point out that Prof Einaudi, the only economist from a debtor nation, had the least contribution in drafting the LONs' 1923 Report. Furthermore, eventually, Prof Seligman himself agreed that the Report was unbalanced in its presentation. See also Sunita Jogarajan, 'Stamp, Seligman, and the Drafting of the 1923 Experts' Report on Double Taxation' (2013) 5 *World Tax Journal* 368, 369-370.

<sup>9</sup> Members from Belgium, France, the UK, Italy, Netherlands, Switzerland, and Czechoslovakia constituted the Committee.

<sup>10</sup> LONs, Technical Experts to the Economic and Financial Committee, *Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee* (F.212, LONs 1925) 15.

<sup>11</sup> *ibid.* This position aligned with a 1924 resolution of the ICC. To gain an insight into the influence of the ICC on the work of the LONs see Graetz and O'Hear (n 5) 1066-1074.

The LONs' Committee of Technical Experts had emphasised that it wanted to carry out its task in 'international spirit' and serve the general interests of both member as well as non-member countries.<sup>12</sup> The Committee had further pointed out that its members knew that their agreement or non-agreement to any proposal would not in any way bind the governments that had nominated them. Hence, they were free to agree to, and had even accepted proposals, that differed from their domestic legislations or from the views expressed by their governments.<sup>13</sup> The Committee's suggested division of taxing rights between countries highlighted in the preceding paragraph was also an improvement over that proposed by the LONs' Economists. However, in the absence of the BICs or even other developing countries' positions on the LONs' 1925 Committee of Technical Experts' conclusion, it is difficult to ascertain whether the allocation of taxing rights proposed by the Committee was one that would have been sought by these countries if they had participated in the process of reaching this position. Furthermore, the LONs' Committee of Technical Experts' themselves stated that the Committee's proposal was made 'purely for technical purposes' and that 'no inference in regard to economic theory or doctrine' was to be drawn from it.<sup>14</sup> This reinforces the idea that the Committee's conclusion was more of the Committee's view of a pragmatic compromise between the scope of the rights to tax on source and residence basis.

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<sup>12</sup> LONs' 1925 Report (n 10) 5.

<sup>13</sup> *ibid.*

<sup>14</sup> *ibid.* 15. The task of the LONs' 1925 Committee of Technical Experts was 'to bring about a more equitable international assignment of taxation, to prevent the evil effects of double taxation and to check tax evasion'. Nowhere does the Committee's report, however, discuss equity in the assignment of taxing rights between countries or how the division proposed by the Committee was fair or equitable.

As seen in the preceding paragraphs, up till the LONs' 1925 Committee of Technical Experts, developing countries were largely missing from the LONs' work on the rules for assignment of taxing rights between countries. This undermines an integral indicator of fairness in the rule-making process from developing countries' perspective. It further meant that these countries hardly had a role in shaping the agenda of the LONs' engagement with these rules. This, in turn, reflects adversely on the effectiveness of their involvement in the process of establishment of the foundations of the existing international rules for division of taxing rights. The following two sections (a) and (b) explore how subsequent developments in the process of evolution of these rules under the LONs fared on the parameters of participation and effectiveness of participation. This is done by focusing on the two aspects integral to the allocation of rights to tax active business income between countries, which is the focus of this thesis. These are: the rules for determination of a host country's right to tax active business income; and the rules for apportionment of profits between related entities.

**a. The process of evolution of the rules for determining a host country's right to tax active business income**

In 1899, the first international bilateral tax treaty signed between Austria-Hungary and Prussia used the concept of 'Permanent Establishment' (PE) for establishing the economic nexus for host country taxation of active business income.<sup>15</sup> The host country could tax active business income of a non-resident enterprise only if the

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<sup>15</sup> Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation 1991) 75. For an insight into the development of the different aspects of the existing concept of PE see also John F Avery Jones and others, 'The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States' (2006) 60 *Bulletin for Int'l Taxation* 220, 233-38.

enterprise had a PE in the country. In the absence of the non-resident enterprise's PE in the host country, the rights to tax the enterprise's income lay entirely with the enterprise's home country. This made the concept of PE critical.

The concept of PE in this treaty included the 'fixed place of business' requirement and several examples, all of which would create a PE if they served a 'business activity of the non-resident enterprise, his partner, or an agent of these in the host State'.<sup>16</sup> These examples included a 'place of business maintained in the host State for purchasing' and 'all permanent agencies'.<sup>17</sup> The 1925 Committee of Technical Experts excluded 'place of business for purchasing' from the list of industrial and commercial establishments, active business income arising from which the host country could tax.<sup>18</sup> The definition of PE in the LONs' 1927 Committee of Technical Experts' proposed draft bilateral Convention for prevention of double taxation narrowed the scope of 'permanent representatives' that could constitute an enterprise's PE in a country.<sup>19</sup> The draft Convention stated that a 'bona fide agent of independent status' would not give rise to an enterprise's PE in a country.<sup>20</sup> Thus arose the distinction between a dependent and an independent agent's ability to result in an enterprise's PE in a country. The LONs' 1928 General Meeting of Government Experts' Model Conventions dropped 'associated enterprises' from the definition of

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<sup>16</sup> *ibid.*

<sup>17</sup> *ibid* 76.

<sup>18</sup> LONs' 1925 Report (n 10) 31. The report's idea of 'industrial and commercial establishments' covered a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative.

<sup>19</sup> LONs, Committee of Technical Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion: Report* (C216.M85, LONs 1927) 11. The LONs' 1925 Committee of Technical Experts was enlarged in 1927 and representatives from Japan, Argentina, Poland, and Venezuela became a part of it.

<sup>20</sup> Skaar (n 15) 82.

PE.<sup>21</sup> The scope of the concept of PE was again reduced when the 1933 draft treaty of the LONs' Fiscal Committee did not include a 'subsidiary company' in the definition of PE.<sup>22</sup>

Up till now, few developing countries had participated consistently in the process of evolution of the international rules for division of taxing rights between countries.<sup>23</sup> A majority in their representation in this process was, however, realised in the 1940 and the 1943 regional conferences of the LONs' Fiscal Committee in Mexico.<sup>24</sup> Thus, the resulting Mexico Model was effectively the first strong expression of these countries' position on the concept of PE. The Mexico Model provided for a host country's right to tax active business income of a non-resident enterprise if the enterprise carried out its business or activities therein, provided such activities did not constitute merely isolated or occasional transactions.<sup>25</sup> The PE rule (and accordingly the concept of PE), rather than being the only nexus (and threshold)

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<sup>21</sup> LONs, General Meeting of Government Experts, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion* (C562.M178.1928II, LONs 1928) 8, 12, 16, 19. The 1928 General Meeting of the Government Experts included experts from developing countries like China (the first BIC country to participate in LONs' work on the international framework for allocation of taxing rights), South Africa, Bulgaria, Hungary, Latvia, Romania, and Russia.

<sup>22</sup> LONs, Fiscal Committee, *Report to the Council on the Fourth Session of the Committee* (C399.M204.1933.IIA, LONs 1933) 6.

<sup>23</sup> For countries that had participated in the LONs' work till 1928 see n 8, 9, and 19, and text to n 6 and n 7. From 1930-1939, the Reports of the LONs' Fiscal Committee reflect almost regular participation of members from the following countries: the US, the UK, France, Belgium, Netherlands, Italy, Spain, Greece, and Switzerland. In the 1930 Report, there is mention of a Latin American liaison. There is no such subsequent reference till 1935. Presence of a member from Peru in 1936 and 1938 is clear. The 1937 Report of the Fiscal Committee in turn shows the involvement of members from Canada, Sweden, and Austria. Several new members are mentioned in the 1939 report. These were from: Portugal, Poland, Hungary, Romania, Yugoslavia, Estonia, Egypt, Uruguay, Argentina, and Mexico.

<sup>24</sup> The countries represented included: Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the US, Uruguay, and Venezuela.

<sup>25</sup> LONs, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text* (C88.M.88.1946.IIA, LONs 1946) 13, 60.

for host country taxation, was just another instance giving the host country the right to tax profits of a non-resident enterprise.<sup>26</sup>

This position was in contrast to the above-discussed developments that were in the direction of narrowing the scope of the host country's right to tax active business income.<sup>27</sup> The arguments given in favour of this stance were: 1) limiting a host country's right to tax active business income based on the existence of the non-resident's PE in the country would mean loss of revenue for the host country from business activities that could be carried out within the country's borders without having a PE therein; 2) the Mexico Model's basis for determining a host country's right to tax active business income would discourage tax avoidance resulting from enterprises trying to carry out business in a country without meeting the PE threshold in the country; and 3) it would also help check tax evasion by enterprises trying to hide the existence of a PE.<sup>28</sup>

Considering the preceding paragraphs in terms of the parameters for assessing fairness in the rule-making process, the work on the Mexico Model involved greater participation of developing countries. It also gave these countries the opportunity to express their positions on the international rules for allocation of taxing rights between countries. This enhanced the fairness of the international taxation rule-making process under the LONs' from the developing countries' standpoint. This change, however, did not last for long. The Mexico Model's divergences from the

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<sup>26</sup> *ibid* 60. See also Skaar (n 15) 88.

<sup>27</sup> UN Department of Economic and Social Affairs (DESA), *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries* (UN 2003) 28. See also Ke C Wang, 'International Double Taxation of Income: Relief Through International Agreement – 1921-1945' (1945) 59 *Harvard L Rev* 73, 95-96.

<sup>28</sup> London and Mexico Draft Conventions and Commentary (n 25) 13-14.

LONs' previous work on these rules were largely rejected at the LONs' London conference of 1945, where the participants were mainly from developed, capital-exporting countries.<sup>29</sup>

The reasons given for the reversion to the concept of PE being the sole determinant of a country's right to tax active business income of a non-resident enterprise were: 1) the concept of PE, as defined in the LONs' previous work, was contained in nearly all bilateral tax treaties in existence at that time; 2) this concept could not be used as an anti-avoidance tool because the total tax liability of an international enterprise remained the same regardless of how its profits were divided between the enterprise's home country and the host country; 3) detection of enterprises concealing their business from the tax authorities was essentially a matter for the tax administration of a country; and 4) past experience had shown that it was extremely difficult to tax non-resident enterprises 'efficiently and equitably' when they did not have a PE in the host country.<sup>30</sup>

The London Model's swift rejection of the Mexico Model's position on when a host country could tax active business income of a non-resident enterprise reflects the absence of developing countries' influence in the final decision-making process under the LONs. It thus falls foul of another important indicator of effective participation in the rule-making process. In the end, the London Model's definition of PE was largely identical to that used in the 1933 and 1935 draft treaties of the LONs' Fiscal

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<sup>29</sup> The countries represented included: the US, the UK, Belgium, Netherlands, Norway, Switzerland, Sweden, Canada, and Mexico.

<sup>30</sup> London and Mexico Draft Conventions and Commentary (n 25) 14.

Committee.<sup>31</sup> Article V (1) of the Protocol, and more clearly the Commentary to the London Model, laid out the two basic requirements for an establishment to meet the PE threshold. These were the existence of a fixed place of business; and that such a place must have a ‘productive character’ – i.e., it must contribute to business earnings.<sup>32</sup> As these were cumulative conditions, establishments that did not contribute to business earnings such as ‘research laboratories, experimental plants, information bureaux, storehouses, purchasing offices, advertising displays, and showrooms where no goods are sold’ did not constitute a PE.<sup>33</sup>

#### **b. The process of selection of the basis for apportionment of profits between related entities**

It is interesting to note that when the LONs dealt with the issue of apportionment of profits between related entities, PEs were the focus and the rules devised for them were extended to associated but legally separate enterprises.<sup>34</sup> The draft treaty of the LONs’ 1927 Committee of Experts stipulated that if an enterprise had a PE in each of the two treaty partner countries, then in the ‘absence of accounts showing the income separately and in proper form, the competent administrations’ of the two countries shall ‘come to an arrangement as to the rules for apportionment’.<sup>35</sup>

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<sup>31</sup> *ibid* 74-77. The London and Mexico Models differed significantly in their approach to allocation of rights to tax business profits and their use of the concept of PE. The definition of the term PE was, however, the same in both the Models.

<sup>32</sup> *ibid* 14, 74, 77. A new addition to the definition of PE was a provision stating that a building or a construction site could be considered a PE if it was ‘destined’ to last for more than 12 months.

<sup>33</sup> *ibid*.

<sup>34</sup> Richard Vann, ‘Do We Need 7(3)? History and Purpose of the Business Profits Deduction Rule in Tax Treaties’ in John Tiley (ed), *Studies In The History Of Tax Law* (Hart Publishing 2011) vol 5, 393, 396-410. See also LONs’ 1933 Report (n 22) 3-6.

<sup>35</sup> LONs’ 1927 Report (n 19) 11, 15.

The Model treaties approved by the LONs' 1928 General Meeting of Government Experts dropped the reference to separate accounts.<sup>36</sup> The Commentary to these treaties discussed that the basis for apportioning the income could vary according to the enterprise concerned, and that in certain countries, considering this aspect, account was taken of the amount of capital involved, the number of workers, the wages paid, the receipts etc.<sup>37</sup> The Commentary also mentioned that in cases where the products of factories are sold abroad, a distinction is often made between 'manufacturing' and 'merchanting' profits, where the latter is the difference in the price in the home market and the sale price abroad, less the cost of transport.<sup>38</sup>

The above-discussed method of apportionment of profits between PEs and other parts of the enterprise was far from arm's length principle (ALP)-based separate accounting that was selected as the LONs' preferred mechanism for this purpose.<sup>39</sup> This development is attributable to a 1933 report by Mitchell B Carroll (the Carroll report), work on which started owing to a grant made by the Rockefeller Foundation to the LONs' Fiscal Committee in the 1930s. While giving the grant, one of the recommendations made to the Committee was to consider ALP-based separate accounting, empirical approaches, and also fractional apportionment as methods of

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<sup>36</sup> LONs' 1928 Report (n 21) 8, 12, 16, 19.

<sup>37</sup> *ibid* 12, 18, 21.

<sup>38</sup> *ibid*.

<sup>39</sup> As the arm's length principle (ALP) involves treating related entities as independent enterprises entering into transactions under the same or similar conditions, accounts maintained by an entity are the starting point for determining its taxable profits.

ascertaining how much of the profits of an enterprise having PEs in several countries could each country tax.<sup>40</sup>

Carroll studied tax practices of over 27 countries to extract general rules followed by the majority of countries that could form the basis of international agreement in this area.<sup>41</sup> The Carroll report states that ‘the adoption of separate accounting as the primary method of allocating income to various countries in which an enterprise has PEs is preferred by the great majority of Governments, business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups’.<sup>42</sup> The report further favoured this method on the grounds that it was followed by countries such as the UK and the US that had the ‘largest experience’ in the taxation of cross-border income and ‘accountants of highest professional standing’, who had developed accounting practices to keep abreast with complex structures of business organisations.<sup>43</sup>

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<sup>40</sup> LONs, Fiscal Committee, *Report to the Council on the Work of the Second Session of the Committee* (C340.M140.1930.II, LONs 1930) 7.

<sup>41</sup> The countries whose tax practices were examined by Carroll were: Austria, Australia, Belgium, Czechoslovakia, Canada, Free City of Danzig, Greece, France, Hungary, Italy, Irish Free State, Latvia, Luxembourg, Netherlands, Romania, Switzerland, Spain, British India, Canada, Germany, Japan, Netherlands East Indies, Union of South Africa, Japan, Mexico, the UK, and the US (position in the Federal Law and also in the States of Massachusetts, New York, and Wisconsin).

<sup>42</sup> Mitchell B Carroll, *Taxation of Foreign and National Enterprises: Methods of Allocating Taxable Income* (LONs 1933) vol IV, para 671. Following the Carroll Report, Article III of the LONs’ revised Draft Convention for the Allocation of Business Income Between States for the Purposes of Taxation provided that if a PE did not maintain separate accounts, or if the accounts did not reflect the normal usages of the trade in the country in which the PE was located, or if the accounts could not be rectified to reflect the arm’s length price, the fiscal authorities were to determine the PE’s profits by applying a percentage to the turnover of the PE. If both these methods were inapplicable, the total income of the enterprise was to be allocated based on factors that could ensure a result which was proximate to that ALP-based separate accounting would have delivered. See LONs, Fiscal Committee, *Report to the Council on the Fifth Session of the Committee* (C252.M124.1935.IIA, LONs 1935) 6.

<sup>43</sup> The Carroll Report (n 42) para 128.

The second of these rationales was not relevant to developing countries. In fact, the application of the first one to these countries was also doubtful. This is due to two reasons. First, not many developing countries were studied by Carroll. Second, as many such countries were either under colonial rule or had recently become independent, it is unclear whether the basis for apportionment of profits between related entities prevalent in those countries reflected a preference based on the experience of those countries or was another colonial legacy.

The Carroll report admitted that there could be conflicting views over what a fair transfer price is.<sup>44</sup> According to the report, this was, however, an issue for an ‘export manager or other officers of a company’.<sup>45</sup> Therefore, the report did not engage with it any further. In comparison, the Carroll report discussed the potential concerns regarding unitary taxation and formulary apportionment at length.<sup>46</sup> These included the difficulty in reaching an agreement among countries on the computation of the total net income of an enterprise and the basis for apportionment of the enterprise’s profits among them.<sup>47</sup> The Carroll report observed that the requirements under fiscal or commercial laws for maintaining accounts, the differences in accounting methods, in language, in currency, and the incidental problems of evaluation and exchange, all supported ALP-based separate accounting.<sup>48</sup>

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<sup>44</sup> *ibid* para 129.

<sup>45</sup> *ibid*.

<sup>46</sup> *ibid* para 664, 127. Carroll Report’s discussion of the merits of this alternative to ALP-based separate accounting was limited to highlighting what advocates of the same contended.

<sup>47</sup> *ibid* para 670.

<sup>48</sup> *ibid* para 669. In view of the introduction of the US transfer pricing regulations in 1934 - a year after the Carroll Report, and the influence of the US in the LONs’ work on the international rules for division of taxing rights between countries, it has been suggested that Carroll’s role was ‘to ensure’ that the LONs adopted ALP-based separate accounting as the method for apportionment of profits between related entities. See Stanley I Langbein, ‘The Unitary Method and the Myth of Arm’s Length’ (17

The discussion in the preceding section highlighted the limited involvement of the BICs and other developing countries in the international taxation rule-making process under the LONs' up till the Mexico conferences of 1940 and 1943, which undermined a fundamental tenet of fairness in the rule-making process. This also meant that these countries had limited involvement in setting the agenda of the LONs' future work on the rules for allocation of taxing rights between countries. This included selection of the basis for apportionment of profits between related entities. Arguably, a stronger reflection of their participation in this work not being an effective one is, however, that the process of making this choice did not really engage with the potential difficulties that developing countries could encounter in applying the ALP and the analysis of the alternatives to it from their perspective. This was particularly important owing to the differences in resources and expertise between these countries and those whose successful experience had guided the LONs' adoption of the ALP as the basis of allocation of profits between related entities.

Considering that the Mexico Model followed this position, it could be contended that the position was, in any case, agreeable from a developing country point of view. Such inference must, however, be drawn with caution. This is because, as seen in the previous section, the Mexico Model did not have the concept of PE as the chief determinant of a host country's right to tax. Thus, arguably, the rules for allocation of profits between related entities were not as central to this Model as to its predecessors. Also, as shall be seen in chapter V, much depends on a country's practice of this principle. Further, even if the Mexico Model had presented an

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February 1986) 30 Tax Notes 625, 631-33, 638. See also Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (CUP 2011) 135.

alternative, in a previously stated deficiency from the standpoint of fairness in process, developing countries were not really involved in shaping the final outcome of the LONs' work on the international rules for assignment of taxing rights: the London Model. In this scenario, it is doubtful whether an option different from that supported by the long-held practices of the countries involved in this decision-making process could have survived.

The LONs' Fiscal Committee appears to have been aware that its concluding position on the rules for division of taxing rights between countries was not a result of effective participation of countries with diverse interests and concerns.<sup>49</sup> Thus, the Committee wanted its work to be 'usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically-advanced and less-advanced countries'.<sup>50</sup> It was, however, the OECD – a largely homogenous group of mainly capital-exporting countries – that succeeded the LONs' tax work.<sup>51</sup> Part II studies the process of drafting of the OECD Model and the UN Model that followed the OECD Model to assess whether that process could be considered fairer from the standpoint of the BICs primarily and developing countries more generally.

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<sup>49</sup> London and Mexico Draft Conventions and Commentary (n 25) 6.

<sup>50</sup> *ibid.*

<sup>51</sup> OECD, 'History' (OECD) <[www.oecd.org/history](http://www.oecd.org/history)> accessed 1 February 2012. See also Robert O Keohane and Joseph S Nye Jr, 'The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy' in Robert O Keohane, *Power and Governance in a Partially Globalized World* (Routledge 2002) 219-242.

## **II. Procedural fairness from the perspective of the BICs and other developing countries in the evolution of the OECD Model and the UN Model**

Post the LONs, the OECD countries were the ‘first to the table’, and for a long time, the only group at the table for shaping the rules for allocation of taxing rights between countries.<sup>52</sup> Reflecting the OECD countries’ consensus on the international division of taxing rights, the OECD Model, as introduced in 1963, rested on two propositions: (1) the country of residence will eliminate double taxation through a foreign tax credit or through an exemption, (2) in turn, the host country will reduce both - its jurisdiction to tax at source, and the rates of tax where the jurisdiction is retained.<sup>53</sup> As a result, the provisions of the OECD Model dealing with taxation on source basis were greatly limited in scope. Taxing rights in the case of sources of income not covered under the Model or residual taxing rights were also given to the country of residence of the enterprise.<sup>54</sup>

As recognised by the Fiscal Committee of the OECD itself, such a position was more suited for use between countries that had designed the OECD Model and not for treaties between developed and developing countries that eventually started to be

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<sup>52</sup> Frances M Horner, ‘Do We Need an International Tax Organisation?’ (8 October 2001) 24 Tax Notes Int’l 179, 182-183.

<sup>53</sup> Charles R Irish, ‘International Double Taxation Agreements and Income Taxation at Source’ (1974) 23 The Int’l & Comparative L Quarterly 292, 293-96; Chang H Lee, ‘Impact of E-Commerce on Allocation of Tax Revenue between Developed and Developing Countries’ (2004) 4 Journal of Korean L 19, 30; Kim Brooks, ‘Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia’s Policies’ (2007) 5 eJournal of Tax Research 169, 174-175 < [www.austlii.edu.au/au/journals/eJTR/2007/8.pdf](http://www.austlii.edu.au/au/journals/eJTR/2007/8.pdf)> accessed 11 January 2014.

<sup>54</sup> OECD, *Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (OECD 1963).

based on the OECD Model.<sup>55</sup> With reciprocal flows of trade and investment and similar levels of development, reduction in source taxing rights was offset mutually.<sup>56</sup> By the same logic, this position was bound to result in unequal revenue sacrifice where the investment inflows between countries were largely one-sided, such as between developed and developing countries.<sup>57</sup>

The 1967 ECOSOC Resolution recognised that the UN must play a role in balancing the objective of encouraging investment in developing countries with sufficient source country taxing rights over activities economically connected with these countries.<sup>58</sup> The UN's Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries (UN's Ad-Hoc Group of Experts) that was set up to achieve this goal comprised of equal numbers of tax experts and administrators (together referred to as experts) from both developed and developing countries.<sup>59</sup> Although these individuals were government nominees, they were expected to act in

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<sup>55</sup> OECD, *Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee* (OECD 1965) para 163-165.

<sup>56</sup> Hope Ashiabor, 'The Taxation of Foreign Investments in Developing Countries under the Treaty Regime: The African Experience' (1996) 22 *Int'l Tax J* 69, 74-75.

<sup>57</sup> Honey L Goldberg, 'Conventions for the Elimination of International Double Taxation: Toward a Developing Country Model' (1983) 15 *L & Policy in Int'l Business* 833, 835-836; Veronika Daurer and Richard Krever, 'Choosing Between the UN and OECD Tax Policy Models: An African Case Study' (2014) 22 *African Journal of Int'l and Comparative L* 1, 1-2.

<sup>58</sup> UN Economic and Social Council (ECOSOC) Resolution 1273 (XLIII) (4 August 1967) as reproduced in UN ECOSOC, *Tax Treaties between Developed and Developing Countries, First Report* (1969) E/4614 ST/ECA/110, Annex I.

<sup>59</sup> The Group had 20 experts (10 nominated by developed countries and 10 from developing countries). The countries that they came from were: Argentina, Brazil, Chile, France, Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, the UK, and the US. Thus, from the BICs, experts from India and Brazil participated in drafting of the UN Model. Experts from China and Russia have been involved in the UN's work on the international rules for allocation of taxing rights between countries since 1980. Meetings of the UN's Ad-Hoc Group of Experts were also attended by observers from Austria, Belgium, Finland, the Republic of Korea, Mexico, Nigeria, Spain, Swaziland, and Venezuela, and from the following international organisations: the International Monetary Fund (IMF), the International Fiscal Association, the OECD, the Organization of American States, and the ICC.

their personal capacity as tax experts.<sup>60</sup> Viewed strictly, this will not amount to participation of a country in the rule-making process, which as discussed in chapter II, is the first parameter for assessing fairness in process from a country's perspective. This was nevertheless better than the OECD where developing countries were not involved in rule-making at all.<sup>61</sup> Thus, the obvious anticipation was that the process of drafting of the UN Model would be fairer from developing countries' standpoint. A lot, however, depended on the effectiveness of these countries' participation in the process.

The following sections (a) and (b) explore this aspect. For this purpose, they focus again on the process of development of the same two areas central to this thesis: the rules for determining a host country's right to tax active business income; and the apportionment of profits between related entities.

#### **a. The process of evolution of the rules for determining a host country's right to tax active business income under the OECD Model and the UN Model**

As after the work of the LONs, the OECD countries were the first to shape the international rules for allocation of taxing rights between countries, the OECD Model reinforced and refined the positions that these countries had preferred during the time

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<sup>60</sup> See UN First Report (n 58) 26.

<sup>61</sup> This is also considering that the experts proposed by governments were largely officials directly in charge of treaty negotiations for their countries. Further, governmental representatives, along with individuals from non-governmental organisations and specialised international agencies could attend the meetings of the UN's Ad-Hoc Group of Experts as observers. See Stanley S Surrey, 'United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries' (1978) 19 Harvard Int'l L Journal 1, 6.

of the LONs.<sup>62</sup> For instance, PE remained the basis for allowing a host country the right to tax active business income of a non-resident enterprise and the concept of PE was developed further to make this threshold for host country taxation more precise.<sup>63</sup>

Article 5(1) of the existing OECD Model sets out the general rule with respect to a PE: there must be a fixed place of business of the non-resident enterprise through which the enterprise's business is wholly or partly carried on.<sup>64</sup> The existing Commentary to Article 5 of the OECD Model states that the 'place of business' covers any premises, facilities or installation used for carrying on the business of an enterprise, whether or not it is used exclusively for this purpose.<sup>65</sup> The main aspect is that the place must be 'at the disposal of the enterprise'.<sup>66</sup> This is generally interpreted as the enterprise having some right to use the premises for the purposes of its own business and not solely for the purposes of the project undertaken on behalf of the owner of the premises.<sup>67</sup> Such a place of business must be 'fixed', which means that it must be established at a distinct physical location.<sup>68</sup> Additionally, it must have a certain degree of 'permanence' in terms of the time period of its existence at that

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<sup>62</sup> Michael Lennard, 'The Purpose and Current Status of the United Nations Tax Work' (2008) 14 Asia-Pacific Tax Bulletin 23.

<sup>63</sup> OECD Model 1963 (n 54) Article 5.

<sup>64</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Commentary to Article 5, para 3. Unlike the LONs' concept of PE, this formulation of PE does not require the fixed place of business to have a productive character. See also Philip Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital* (Sweet and Maxwell 2001) para 5B.02.

<sup>65</sup> OECD Model 2014 (n 64) Commentary to Article 5, para 4.

<sup>66</sup> *ibid.*

<sup>67</sup> Baker (n 64) para 5B.09. See also *R v Dudley* (2000) FCJ No 230 (FCA).

<sup>68</sup> OECD Model 2014 (n 64) Commentary to Article 5, para 5. According to para 5.1, business activities of an enterprise that are moved between neighbouring locations can constitute a 'distinct place of business' if there is geographical and commercial coherence between them.

place.<sup>69</sup> In the OECD Model, based on the practices of the member States, 6 months has been considered to be the minimum time period sufficient in this regard.<sup>70</sup> Finally, the business of an enterprise must wholly or partly be carried out from the fixed place of business. This means that the entrepreneur or persons who are in a paid employment relationship with the enterprise and receive instructions from the enterprise, such as employees or personnel, must use such a ‘fixed place of business’ for carrying on the business activities of the enterprise.<sup>71</sup>

Article 5(2) of the OECD Model enlists places of business that would *prima facie* constitute PEs.<sup>72</sup> These places must satisfy the requirements of Article 5(1).<sup>73</sup> Under Article 5(3) of the OECD Model, building sites, or construction or installation projects, can constitute a PE only if they last for more than 12 months. Article 5(4) of the OECD Model in turn enlists activities, which even if carried out through a fixed place of business, would not give rise to a PE. The common attribute of these activities is that they are of a ‘preparatory or auxiliary’ nature. Or, in other words, these are activities that may contribute to the productivity of an enterprise but are so ‘remote from the actual realisation of profits by the enterprise that it is considered difficult to allocate any profit to a fixed place’ carrying them out.<sup>74</sup>

Under the OECD Model, a dependent agent acting on behalf of an enterprise who has, and habitually exercises, authority to conclude contracts in the name of the

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<sup>69</sup> *ibid* para 6.

<sup>70</sup> *ibid*. Recurring activities and a business that is of a short duration due to its nature and is carried on exclusively in the country are acceptable exceptions.

<sup>71</sup> *ibid* para 10.

<sup>72</sup> *ibid* para 12.

<sup>73</sup> *ibid*. See also Baker (n 64) para 5B.14.

<sup>74</sup> OECD Model 2014 (n 64) Commentary to Article 5, para 21, para 23.

enterprise in a country, is ‘deemed’ to be a PE of the enterprise in the country irrespective of whether the requirements of Article 5(1) are met.<sup>75</sup> Such a deemed agency PE, however, does not exist if the business of an enterprise is carried on through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.<sup>76</sup> Article 5 of the OECD Model also clarifies that a controlled subsidiary, just for that reason, does not constitute a PE of the parent company.<sup>77</sup>

The object of the concept of PE as contained in Article 5 of the OECD Model is twofold. The first is to specify the degree of physical presence and the level of business activity of an enterprise in a country at which the enterprise’s participation in the economic life of the country would be considered sufficient to allow the country the right to tax the enterprise’s active business income.<sup>78</sup> The second is to limit the scope of active business income generated by a non-resident enterprise that a country can tax. This is because under the PE rule contained in Article 7 of the OECD Model, the host country can tax only the amount of active business income of a non-resident enterprise that is attributable to the PE.<sup>79</sup>

The above-discussed concept of PE in Article 5 of the OECD Model has remained largely unchanged since it was first introduced in the 1963 draft of the

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<sup>75</sup> *ibid* para 32. The preparatory and auxiliary activities limitation under Article 5(4) also applies in the case of agency PE.

<sup>76</sup> *ibid* para 36.

<sup>77</sup> *ibid* para 40.

<sup>78</sup> *ibid* Commentary to Article 7, para 11.

<sup>79</sup> Thus, under the OECD Model, the concept of PE establishes the nexus and threshold for the purpose of host country taxation of active business income and is also the source rule.

OECD Model.<sup>80</sup> As stated before, the BICs or other developing countries did not participate in the OECD's work that led to this concept of PE and the PE rule. Expectedly, concerns held by these countries in relation to these central aspects of the division of rights to tax active business income between countries were not really a part of the process of development of the OECD Model. Resultantly, after the Mexico Model, the BICs and other developing countries' first opportunity to express their positions on the PE rule and the notion of PE came only when the UN started its tax work.

The UN's Ad-Hoc Group of Experts, however, decided to use the OECD Model as their 'main reference text'.<sup>81</sup> Arguments given to support this choice included the desire to take advantage of the technical expertise embodied in the OECD Model and its Commentary.<sup>82</sup> They also covered potential convenience, as the Model was already being used by developed countries for negotiating bilateral tax treaties with both developed and developing countries.<sup>83</sup> Although these reasons can be understood from a practical point of view, this effectively meant that the UN's Ad-Hoc Group of Experts was to work on a pre-set agenda. This undermined a key indicator of fairness in process from the standpoint of developing countries, and limited what they could achieve from the UN Model.

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<sup>80</sup> The limited changes to the concept introduced over the years have been through the Commentary to Article 5.

<sup>81</sup> UN DESA, *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2001) x.

<sup>82</sup> *ibid.*

<sup>83</sup> *ibid.*

For instance, during the initial meetings of the UN's Ad-Hoc Group of Experts, some members from developing countries expressed reservations on the concept of PE, which, according to them, 'except in certain cases' covered thereunder, 'precluded taxation of business income by the source country'.<sup>84</sup> These members were of the view that rather than 'attempting to adapt the concept of PE' to provide for all situations that were continually arising with developments in technology and business practices, the 'correct approach' would be to give 'full taxing jurisdiction to the source country' except where taxation was 'specifically precluded by its internal legislation or agreed upon in its bilateral tax treaties'.<sup>85</sup>

The limits set by the OECD Model, however, did not allow for any serious consideration of such views. Aware of this, these members acknowledged that their position was 'not shared by industrialised countries' that had largely shaped the development of the PE rule and the concept of PE.<sup>86</sup> As the work of the UN's Ad-Hoc Group of Experts could have proceeded only through finding solutions agreeable to both groups of countries, these members expressed that 'while a better solution was being studied'; they would accept a 'modified definition of PE which was broad enough to give recognition to the principle of source'.<sup>87</sup>

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<sup>84</sup> UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Second Report* (1970) E/4939 ST/ECA/137, para 19. The Reports of the meetings of the UN's Ad-Hoc Group of Experts use the phrases 'members from developed countries' and 'members from developing countries' when discussing the differing positions of experts from these two groups of countries. For this reason, the same phrases have been used in this chapter to refer to their views.

<sup>85</sup> *ibid* para 20. These members took note of the argument that tax administrations in developing countries would have 'difficulty in determining net income from temporary activities of non-resident enterprises'. According to them, it was, however, not sufficient to override their concerns with respect to the concept of PE. See UN First Report (n 58) para 34.

<sup>86</sup> UN Second Report (n 84) para 20.

<sup>87</sup> *ibid*.

In comparison, the members from developed countries emphasised that the concept of PE facilitated reaching a balance between raising tax revenue through taxation of non-resident enterprises and promoting international trade and investment. This is because it allowed a country to tax active business income only if an enterprise had ‘significant and continuous business operations’ in the country, which according to them, were reflected only through the existence of the enterprise’s PE in the country.<sup>88</sup> Therefore, these members ‘warned against a tendency to erode’ the concept.<sup>89</sup>

When the UN’s Ad-Hoc Group of Experts started work on broadening the idea of a PE, they focussed on the two main aspects of the concept – the degree of physical presence of a non-resident enterprise in the host country, and the threshold of activities the enterprise must carry out in the country for a PE to exist. Regarding the first aspect, the concerns of the members from developing countries revolved around activities that could be carried out profitably in a country without having a fixed place of business therein, or needed such a place for only a short duration. A particular issue in this regard was the taxation of profits of non-resident enterprises rendering services in these countries.

Some members from developing countries pointed out that large profits were derived by ‘corporations from industrialised countries’ by furnishing ‘consultancy and like services in their territories’.<sup>90</sup> Members from developing countries recognised that ‘management and consultancy services, and so on’ were not as important when

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<sup>88</sup> UN First Report (n 58) para 35.

<sup>89</sup> *ibid.*

<sup>90</sup> UN Second Report (n 84) para 65.

the OECD Model was finalised.<sup>91</sup> Thus, the OECD Model did not have a specific provision for host country taxation of profits arising from such services.<sup>92</sup> They believed that, therefore, a provision dealing with taxation of income from ‘other services’, or services not dealt with under specific Articles of the OECD Model, was ‘by far the most important’ addition to the OECD Model’s list of places constituting a PE.<sup>93</sup> Members from developing countries did not want the sought for provision to have any kind of limitations on the taxing power of the State in which the services were rendered.<sup>94</sup> They further argued for the same treatment for services performed by individuals and corporations.<sup>95</sup>

In comparison, some members from developed countries rejected the addition of a provision for this purpose in the UN Model. According to them, the furnishing of services by an enterprise was already addressed in Article 7 combined with Article 5, along with Article 14, which provided for taxation of income from independent personal services.<sup>96</sup> Other members from developed countries were more agreeable to the change. They, however, believed that at least a time-based threshold was necessary to demonstrate ‘permanence’ in the activities of a non-resident in the host

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<sup>91</sup> *ibid.*

<sup>92</sup> *ibid.*

<sup>93</sup> *ibid.* Like the 2014 version of the OECD Model, the 1963 draft of the OECD Model also covered taxation of income from certain specific types of services under its various Articles. These included: Article 15 - income from employment, Article 16 – remuneration of directors of a company resident in a country, Article 17 - income derived by artists and sportspersons, Article 18 – Pensions, and Article 19 - Income from government services. Article 14 of the 1963 draft of the OECD Model, which dealt with taxation of income from independent personal services, was deleted from the Model in 2000.

<sup>94</sup> UN Second Report (n 84) para 63, para 69.

<sup>95</sup> *ibid* para 63.

<sup>96</sup> *ibid* para 72. Independent personal services were not defined in the 1963 draft of the OECD Model. Article 14 (1), however, discussed them as ‘professional services and other independent activities of similar character’. Article 14(2) illustrated the meaning of professional services with some examples of ‘typical liberal professions’. The Commentary to Article 14 excluded industrial and commercial activities, services performed in employment (covered under Article 15), and the services of artists and sportspersons (covered under Article 17) from the definition of independent personal services.

country, which is an important feature of a PE.<sup>97</sup> As a compromise, a time requirement of 6 months that could be reduced to not less than 3 months was agreed to.<sup>98</sup> It was also agreed that ‘only profits’ and not gross payments for services should be taxable by the State.<sup>99</sup>

Some members from developed countries preferred a further modification that the services must be rendered in the host country ‘for the same or connected project’.<sup>100</sup> According to them, it was ‘undesirable to add two unrelated projects’ of the same enterprise together as it led to ‘uncertainty’.<sup>101</sup> Other members found such a limitation as either ‘too easy to manipulate’ or ‘too narrow’ in that it might exclude a continuous number of separate projects each lasting four to five months from host country taxation.<sup>102</sup> Eventually, the ‘same or connected project requirement’ was accepted as a part of Article 5(3)(b) of the UN Model. This provision, which is unique to the UN Model, stipulates that if an enterprise ‘furnishes’ services in a State, ‘including consultancy services’, through employees or other personnel engaged by the enterprise, whose activities continue for the ‘same or connected project in the State for more than 183-days in a year’, then that enterprise would be ‘deemed’ to have a PE in the State.<sup>103</sup>

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<sup>97</sup> UN Second Report (n 84) para 68.

<sup>98</sup> *ibid* para 70.

<sup>99</sup> *ibid* para 63.

<sup>100</sup> *ibid* para 68.

<sup>101</sup> *ibid* para 71.

<sup>102</sup> *ibid*. See also UN DESA, *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011) Commentary to Article 5, para 12.

<sup>103</sup> Until 2010, Article 5(3)(b) of the UN Model used the time threshold of 6 months in any 12 month period. The 2011 update of the UN Model changed this to 183 days in any 12 month period to maintain consistency with Article 14 of the UN Model (that deals with taxation of independent personal services). See UN Model 2011 (n 102) Commentary to Article 5, para 9.

Another area in relation to which members from developing countries raised concerns regarding the requirement of physical presence under the concept of PE in Article 5 of the OECD Model was taxation of profits arising from building and construction activities. According to these members, it was ‘inequitable’ to deny them taxing rights over active business income arising from these activities just because such activities could be carried out profitably in a country in a short duration.<sup>104</sup> A number of members from developing countries sought for performance of these activities in a country to be considered sufficient to grant the country taxing rights over profits arising from such activities.<sup>105</sup> In comparison, members from developed countries argued for a time-based threshold, as according to them, a time requirement encouraged enterprises to initiate preparatory or ancillary operations in the host country without immediately becoming subject to taxation in the country, which facilitated a more permanent and larger commitment by enterprises at a later stage.<sup>106</sup> The compromise reached was a reduced time threshold of 6 months in Article 5(3)(a) of the UN Model as compared to the 12 months requirement under Article 5(3) of the OECD Model, which could be reduced to not less than 3 months through bilateral tax treaty negotiations.<sup>107</sup>

Moving to the second facet of the concept of PE: the threshold of activities that must be carried out through a fixed place of business for it to constitute a PE. Members from developing countries were of the view that whenever the contracting countries are not at the ‘same level of economic development’, the scope of

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<sup>104</sup> UN First Report (n 58) para 37; UN Second Report (n 84) para 22.

<sup>105</sup> UN Second Report (n 84) para 22.

<sup>106</sup> *ibid* para 24. See also UN Model 2011 (n 102) Commentary to Article 5, para 10.

<sup>107</sup> UN Second Report (n 84) para 30.

preparatory or auxiliary activities should be ‘examined with great care’.<sup>108</sup> One of their main concerns in this regard was ‘delivery’.<sup>109</sup> These members pointed out that the presence of a stock of goods for prompt delivery facilitated sales, and thereby earning of profit in the host country.<sup>110</sup> They believed that considering this ‘close connection’; the existence of such a stock of goods at a fixed place of business should give rise to a PE.<sup>111</sup> The member from India proposed the addition of ‘warehouse or other facilities for maintenance of stock of goods from which orders are fulfilled’ in Article 5(2) of the OECD Model that lists places that would *prima facie* constitute a PE. This insertion was to be accompanied with the deletion of ‘delivery’ from the list of preparatory and auxiliary activities.<sup>112</sup> The members from other developing countries supported this proposal.<sup>113</sup>

Members from developed countries were of the view that, since normally only a small amount of income would be allocated to such a place of business, it would serve no purpose to make this change.<sup>114</sup> Members from developing countries, however, argued that the determination of the proper amount of income attributable to a PE

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<sup>108</sup> UN First Report (n 58) para 44.

<sup>109</sup> *ibid* para 44. Some members from developing countries also wanted stock of goods maintained for the purpose of ‘processing’ by another enterprise, and a fixed place of business ‘solely for the purpose of purchasing goods or merchandise’, to qualify as a PE. These activities, however, continue to be preparatory and auxiliary under Article 5(4) of both the OECD and the UN Model.

<sup>110</sup> UN Second Report (n 84) para 33.

<sup>111</sup> *ibid* para 33.

<sup>112</sup> UN First Report (n 58) para 43 and Annex V - Suggestions of the member from India. For more insight into India’s position on the concept of PE, particularly India’s concerns with respect to the abuse of the concept, see paper titled ‘Tax Avoidance and Tax Evasion in India’ in UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Third Report (1972) ST/ECA/166*, 135, 144. See also UN First Report (n 58) Annex V - Suggestions of the member from Israel.

<sup>113</sup> UN Second Report (n 84) para 33.

<sup>114</sup> *ibid* para 33.

should be left as a separate matter.<sup>115</sup> Considering this divergence of views, the proposal made by the member from India was partially rejected. ‘Warehouse’ was not added to Article 5(2). It was, however, agreed to eliminate ‘delivery’ from the list of preparatory and auxiliary activities in Article 5(4) of the UN Model.<sup>116</sup>

These attempts to increase the scope of a host country’s taxing rights through changes in the two broad aspects of the notion of PE are also reflected in the discussions around the concept of agency PE. Resultantly, a dependant agent under Article 5(5) of the UN Model includes an agent of a non-resident enterprise that does not have the authority to conclude contracts in the name of the enterprise in the host country, but habitually maintains a stock of goods or merchandise from which the agent regularly delivers goods or merchandise on behalf of the enterprise.<sup>117</sup>

Further, Article 5(6) of the UN Model states that an insurance provider, except with regards to re-insurance, shall be deemed to have a PE in a country if the enterprise carries out its business in the country through a person other than an independent agent.<sup>118</sup> Under Article 5 (7) of the UN Model, an independent agent may also constitute an agency PE if the activities of such an agent are devoted wholly or

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<sup>115</sup> *ibid.*

<sup>116</sup> *ibid.*

<sup>117</sup> *ibid* para 39. See also UN First Report (n 58) Annex V - Suggestions of the member from India, Suggestions of the member from Pakistan.

<sup>118</sup> UN Second Report (n 84) para 48, para 49. See also UN First Report (n 58) Annex V - Suggestions of the member from India. Members from developing countries were of the view that because of the nature of insurance business, agents could, on part-time basis, represent companies, making it difficult to distinguish between dependent and independent insurance agents. They also emphasised the location of risk being the key factor in insurance business. Therefore, they sought that in the case of insurance business, a PE should be deemed to exist in a country even by virtue of the activities of independent agents. As the members from developed countries opposed this, the matter was left to be determined through bilateral negotiations.

almost wholly to a particular enterprise and the agent is not dealing with the enterprise on an arm's length basis.<sup>119</sup>

Viewing these developments in light of the indicators for assessing fairness in the rule-making process, at least two of the BICs, and even other developing countries, were participating in shaping the UN Model. They were voicing their positions on the rules for allocation of taxing rights between countries, which were deliberated upon with members from developed countries. This eventually resulted in the concept of PE under the UN Model being wider than that contained in Article 5 of the OECD Model. As stated before, the effectiveness of their participation in the process had, however, already been undermined by the limitation on what was 'on and off the negotiating table'.<sup>120</sup> Thus, arguably, this result was the only possible positive end for them, with there being no opportunity to debate their concerns regarding the primary issue of the suitability of the concept of PE as the chief determinant of a host country's right to tax active business income.

**b. The process of development of the rules for attribution of profits to PEs and for apportionment of profits between associated enterprises under the OECD Model and the UN Model**

Under Article 7(1) of the OECD Model, only profits attributable to a PE are taxable in the source country. Article 7(2) of the 1963 draft of the OECD Model stipulated that

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<sup>119</sup> UN Second Report (n 84) para 44. See also UN First Report (n 58) Annex V - Suggestions of the member from Israel; UN Model 2011 (n 102) Commentary to Article 5, para 32-33.

<sup>120</sup> Horner (n 52) 185. Horner argues that effective participation of developing countries in the international taxation rule-making process cannot take place if some issues of concern or interest to them are not open for discussion.

those profits were to be ascertained by treating the PE as a distinct and a separate enterprise, transacting with the head office and other parts of the enterprise on an arm's length basis.<sup>121</sup> Article 7(3) of the 1963 draft of the OECD Model in turn allowed deduction of expenses incurred for the purposes of the PE, including executive and general expenses, whether in the country in which the PE was located, or elsewhere, in determining the profits of the PE.<sup>122</sup> The Commentary to the provision stated that no deduction was permissible in the case of notional payments of interests (except for banking enterprises), royalties, and commission for services received and for management, made by the PE to its head office or vice-versa.<sup>123</sup>

The Commentary gave no rationale for taking this position in relation to interests and royalties. The later versions of the OECD Model mention the theoretical and practical difficulties in assigning ownership of intangibles as well as transferring capital between within one legal entity and extracting payments for the same.<sup>124</sup> In its discussion on payment for services, the Commentary to Article 7(3) of the 1963 draft of the OECD Model stated that 'if the PE and the head office were entirely separate and independent', the PE would be reimbursed for expenses incurred in providing services and also paid a notional commission.<sup>125</sup> Owing to the 'cumbersome' nature of determining the percentage to be used in calculating this notional commission, and re-writing the PE's accounts when the commission was settled, the Commentary

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<sup>121</sup> OECD Model 1963 (n 54) Commentary to Article 7, para 10. As shall be seen in chapter V, a new Article 7 was introduced in the OECD Model in 2010. Because Article 7 of the UN Model was based on the pre-1980 Article 7 of the OECD Model, that provision is discussed in the text.

<sup>122</sup> In 1977, Article 7(2) of the OECD Model was made 'subject to' Article 7(3).

<sup>123</sup> OECD Model 1963 (n 54) Commentary to Article 7, para 15-18.

<sup>124</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2005) Commentary to Article 5, para 17.4, para 18.

<sup>125</sup> OECD Model 1963 (n 54) Commentary to Article 7, para 16-17.

rejected the deduction of commission for services received in determining the profits attributable to a PE.<sup>126</sup> Practical difficulties were also given as the reason for denying deduction of profits paid to the head office or any other part of the enterprise for good management, even though these payments would have been deductible if they were paid to an independent managing agency.<sup>127</sup>

The above-discussed approach differed from the LONs' position on allocating profits to a PE. This is because although the LONs' work appeared to disapprove, *albeit* without much clarity, the deduction of interest paid by PEs to head offices (except in the case of banking enterprises), it did not mention anything with respect to intra-entity payments of royalties and fees for specific services or for management.<sup>128</sup> In fact, among the draft Conventions produced under the LONs, only the London Model and the Mexico Model contained a specific deduction rule. The idea underlying this rule was to allow the deduction of expenses incurred by a PE as well as the expenses properly apportioned to the PE to 'achieve the object of separate accounting', which was 'to place branches of foreign enterprises on the same footing as domestic enterprises'.<sup>129</sup>

Article 7(4) of the 1963 draft of the OECD Model permitted the determination of profits attributable to a PE on the basis of apportionment of the total profits of an

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<sup>126</sup> *ibid* para 17.

<sup>127</sup> *ibid* para 18.

<sup>128</sup> LONs' 1933 Report (n 22) 6. See also Raffaella Russo, 'Report on the Historical Development of Article 7 of the OECD Model' in International Fiscal Association (IFA) (ed), *The Attribution of Profits to Permanent Establishments*, Cahiers de Droit Fiscal International Vol 91B (IFA 2006) 89, 92.

<sup>129</sup> London and Mexico Draft Conventions and Commentary (n 25) 21. Note, however, that unlike Article 7(3) of the 1963 draft of the OECD Model, the London and Mexico Models and their Commentaries did not specifically reject geographical limitation on expenses deductible for determining the profits attributable to PEs.

enterprise to its various parts in different countries. The Commentary to the provision emphasised that such a method was ‘generally not as appropriate as a method which has regard only to the activities of the PE, and should be used only where, exceptionally, it was customary to do so’.<sup>130</sup> The provision also required the result to be in accordance with the ALP. Article 7(5) provided for disregarding profits and expenses relating to purchasing activity performed by a PE in ascertaining the profits attributable to the PE.<sup>131</sup> Finally, Article 7(7) stated that ‘profits’ would not include items of income that were covered under other provisions of the Model.

When the UN’s Ad-Hoc Group of Experts discussed Article 7, the first issue that members from developing countries raised was the extent to which profits not derived through a PE in a country should be taxable in the country.<sup>132</sup> It had been noted during the meetings of the Fiscal Committee of the Organisation of the European Economic Cooperation (OEEC, which later became the OECD), that some countries were of the view that when a foreign enterprise sets up a PE in a country, it brings itself within the country’s fiscal jurisdiction to such a degree that the country could tax all the profits derived by the enterprise in the country.<sup>133</sup> This was regardless of whether the profits were attributable to a PE or not. It was observed that many of these countries were not OEEC countries and some of them ‘tend[ed] to cast their tax net very wide’.<sup>134</sup> These countries had further argued that allowing taxation of income of non-resident enterprises in the host country based on such a ‘force of

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<sup>130</sup> OECD Model 1963 (n 54) Commentary to Article 7, para 22.

<sup>131</sup> *ibid* para 27.

<sup>132</sup> UN First Report (n 58) para 55.

<sup>133</sup> Organisation for European Economic Cooperation (OEEC), *The Elimination of Double Taxation - Third Report of the Fiscal Committee* (1960) C(60)157, para 4.

<sup>134</sup> *ibid* para 5.

attraction' principle could also help check tax avoidance facilitated by the concept of PE.<sup>135</sup>

The Fiscal Committee of the OEEC was, however, of the view that reaching out to different business activities undertaken in a country by an enterprise having a PE in the country in this manner was a disproportionate response to tax avoidance and evasion concerns.<sup>136</sup> Apart from the proper extent of fiscal jurisdiction of the host country, the Committee also believed that applying the PE test to separate sources of profits derived by an enterprise in a country was conducive to simple and efficient administration.<sup>137</sup> Further, taxing income from different business activities in a country in which the enterprise had a PE was seen as a potential interference to ordinary commercial processes of MNEs, which at that time were largely based in the OECD countries, and were only expected to grow in number.<sup>138</sup>

In contrast to this position, during the second meeting of the UN's Ad-Hoc Group of Experts, members from several developing countries, including India and Brazil, expressed themselves in favour of the force of attraction principle.<sup>139</sup> These members pointed out that the principle removed some administrative problems in that it made it unnecessary to determine whether particular activities were related to a PE and whether the income involved was attributable to those activities.<sup>140</sup> In comparison, some members from developed countries pointed out that the 'force of

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<sup>135</sup> *ibid* para 6.

<sup>136</sup> *ibid* para 8-9.

<sup>137</sup> *ibid* para 7.

<sup>138</sup> *ibid*.

<sup>139</sup> UN Second Report (n 84) para 74, Annex V - Suggestions of the member from India.

<sup>140</sup> UN Second Report (n 84) para 75.

attraction' rule had been found 'unsatisfactory' and had been abandoned in the recent treaties concluded by them.<sup>141</sup> These members also emphasised on the uncertainty that this approach would create for taxpayers.<sup>142</sup> After much discussion, a 'limited force of attraction rule' was agreed to. This is restricted to taxation of profits arising from the sales of goods or merchandise of the same or similar kind as sold through the PE, and activities of the same or similar kind as affected through the PE.<sup>143</sup> To this extent, the scope of a non-resident enterprise's profits a host country can tax is wider under Article 7(1) of the UN Model as compared to Article 7(1) of the OECD Model.

The second issue concerning Article 7 dealt with taxation of profits arising from a PE's purchasing activities. Owing to developing countries' traditional role as suppliers of raw materials, members from developing countries were in favour of such profits being attributable to the PE.<sup>144</sup> Accordingly, some members from developing countries argued for non-inclusion of paragraph 5 of Article 7 of the OECD Model in the UN Model. In comparison, members from developed countries found it desirable to follow the OECD position.<sup>145</sup> As the issue could not be resolved, Article 7 of the UN Model leaves it to be settled through bilateral negotiations between countries.<sup>146</sup>

Another issue left unsettled by the UN's Ad-Hoc Group of Experts was the scope of business profits covered under Article 7. Members from developing countries, including India, sought to eliminate items of income such as fees for

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<sup>141</sup> *ibid* para 74.

<sup>142</sup> *ibid*.

<sup>143</sup> *ibid* para 76.

<sup>144</sup> *ibid* para 92. See also UN First Report (n 58) para 62.

<sup>145</sup> UN Second Report (n 84) para 94.

<sup>146</sup> UN Model 2011 (n 102) Note to Article 7.

management or technical services, which were not covered under other provisions of the OECD Model, from 'business profits' under Article 7 so that these items of income could be taxed in a country even in the absence of a PE.<sup>147</sup> This proposal was, however, not realised in the UN Model. The member from India also drew attention to the fact that when a PE carries on some but not all of the profit generating activities of an enterprise in a country (for instance where the purchase of goods takes place in one country and sale in another), there is scope for dispute as to the quantum of profits attributable to the PE. To address such a scenario, the member from India suggested inserting a basis for apportionment of profits in specified percentages in the Model.<sup>148</sup> This suggestion too never made it to the UN Model, where the position under Article 7 remains the same as that under Article 7 of the 1963 draft of the OECD Model. Resultantly, recourse to such methods of apportionment is permissible only when it is customary in a country to do so and only if the results are in accordance with the ALP.

However, a suggestion made by the member from India that was accepted was to specify the above-discussed position in the Commentary to Article 7(3) of the OECD Model regarding non-deductibility and non-inclusion of certain payments in determining the profits attributable to a PE in the provision itself. Thus, Article 7(3) of the UN Model elaborately lays out the non-consideration of amounts paid to or by a PE to the head office, other than towards reimbursement of actual expense, by way of royalties, commission for specific services performed or management, and interest

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<sup>147</sup> UN First Report (n 58) para 55, Annex V - Suggestions of the member from India.

<sup>148</sup> *ibid* para 61, Annex V - Suggestions of the member from India.

in ascertaining the PE's profits.<sup>149</sup> The objective behind urging for this change was to make this 'rational and sound' position clear to countries not represented in the Group, and also to the taxpayers so that they could 'be more fully informed of their fiscal obligations'.<sup>150</sup> As this position was taken from the Commentary to Article 7(3) of the OECD Model, members from developed countries were prepared to accept it. A suggestion by some members from developing countries to disallow deduction for expenses incurred outside the country in which the PE was located was, however, not accepted.<sup>151</sup>

The above discussion highlights the extent of modifications to Article 7 sought by the members from the BICs and other developing countries, and the narrow alterations they succeeded in achieving. This comparison is even more acute in the case of the process of agreeing on Article 9 of the UN Model. The report of the Secretary General from the fifth meeting of the UN's Ad-Hoc Group of Experts discussed that by judging transactions between related entities from the standpoint of dealings between independent enterprises, the ALP expected MNEs to behave against the rationale of minimising costs and maximising advantages by internalising operations, which drove their rise in the first place.<sup>152</sup> This made the operation of the standard inherently prone to abuse by MNEs. The report also mentioned the 'chronic difficulties' in complying with and administering a rule based on comparable

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<sup>149</sup> *ibid* para 58 and Annex V - Suggestions of the member from India. See also UN Second Report (n 84) para 82.

<sup>150</sup> UN First Report (n 58) para 58. See also UN Second Report (n 84) para 79.

<sup>151</sup> UN First Report (n 58) para 58. Some members from developing countries, while not rejecting the deduction entirely, pointed out the difficulties in determining the expenses incurred by the foreign head office specifically for the purposes of the PE.

<sup>152</sup> UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Fifth Report* (1975) ST/ESA/18, para 249.

transactions, particularly in industries where comparables might not exist.<sup>153</sup> Members from developing countries were particularly concerned about transactions involving interest, royalties, and fees for services paid by subsidiaries in their countries to associated enterprises in other countries because these payments were often found by their tax administrations to be excessive. These members also emphasised on the difference in capabilities of developed and developing countries to deal with manipulations in transfer prices.<sup>154</sup>

In view of these issues the UN's Ad-Hoc Group of Experts considered devising some sort of safe harbours.<sup>155</sup> The Group believed that such a concept would not only enable the competent authorities to take proper decisions, but would also give a forehand knowledge to enterprises of the parameters within which they could operate.<sup>156</sup> Other than this position, which the Group in any case did not give effect to, the UN's Ad-Hoc Group of Experts did not diverge much from the guidelines for the application of the ALP followed by developed economies like the US, whose successful example was an important influence on the Group's work on this issue.<sup>157</sup> Accordingly, the Group agreed to the primacy of the traditional transactional approaches to assess whether transfer prices between related entities reflected arm's

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<sup>153</sup> *ibid* para 250. See also UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Sixth Report* (1976) ST/ESA/42, 138.

<sup>154</sup> UN Fifth Report (n 152) para 64.

<sup>155</sup> UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Seventh Report* (1978) ST/ESA/79, 29. Safe harbours are provisions that relieve certain taxpayers or transactions from the ambit of transfer pricing laws.

<sup>156</sup> *ibid*.

<sup>157</sup> UN Fifth Report (n 152) para 150-188, para 248-297.

length pricing.<sup>158</sup> It was accepted that only if the arm's length value of a transaction could not be established with reasonable accuracy using the traditional transactional methods, then either the overall apportionment of profits method, or the application of a fair rate percentage, as disclosed by similarly placed taxpayers, could be adopted.<sup>159</sup>

Due to their decision to follow the OECD Model as their starting point, the UN's Ad-Hoc Group of Experts had no room to engage with alternatives to ALP-based separate accounting for apportionment of profits between associated enterprises. The report of the Secretary General from the seventh meeting of the Group of Experts nevertheless referred to a paper discussing unitary taxation and formulary apportionment.<sup>160</sup> Focusing on the flaws of this option, the report pointed out the difficulty in deciding what or who would determine the overall profits of an enterprise; what factors should be chosen in the formula for apportionment of those profits; and who should measure those factors and make the division.<sup>161</sup> Narrowing the application of the formulary approach to particular transactions between units of an enterprise in two countries, or only to certain activities, was also mentioned.<sup>162</sup> Even in these cases, the report confined itself to stating that their practical success would depend on whether the profits to be allocated could be determined, and whether a proper method for dividing those profits could be devised.<sup>163</sup>

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<sup>158</sup> *ibid* para 105. See also UN Seventh Report (n 155) 29. The three traditional transactional approaches are the comparable uncontrolled price method, the resale price method, and the cost plus method. These will be discussed in greater detail in chapter V.

<sup>159</sup> UN Fifth Report (n 152) para 105. See also UN Seventh Report (n 155) 33-35.

<sup>160</sup> UN Seventh Report (n 155) 34. The paper discussed in the report was later published as Stanley S Surrey, 'Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions' (1978) 10 L & Policy in Int'l Business 409.

<sup>161</sup> UN Seventh Report (n 155) 34.

<sup>162</sup> *ibid* 34-35.

<sup>163</sup> *ibid* 35.

From the reports of the UN's Ad-Hoc Group of Experts, the specific views held by members from developing countries on this alternative are unclear. It is, however, evident that with the limited expertise and resources of their tax administrations, members from these countries were more open to ways of apportioning profits that were cheaper and easier to administer than traditional transactional methods.<sup>164</sup> According to some members from developing countries, such methods were also potentially better at checking tax avoidance and evasion through transfer pricing manipulations.<sup>165</sup>

Further, the 1977 version of the OECD Model introduced Article 9(2), which provided for corresponding or correlative adjustment by a Contracting State where the other Contracting State had rectified the accounts of an enterprise to reflect the arm's length price of a transaction. The Contracting State making such adjustment was required to do so only when it considered that the rectification made in the first place was justified, in principle and with regards to the amount.<sup>166</sup> Members from developing countries raised the issue of lack of means to accommodate a correlative adjustment requirement and a concomitant refund of taxes if there were no time limit on such requests.<sup>167</sup> The provision nevertheless made it to the UN Model.

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<sup>164</sup> UN Fifth Report (n 152) para 323; UN Sixth Report (n 153) 78-79, 95-96. Some of these included determination of profits taxable in a country as a fair percentage of the gross receipts, or as a fraction of the turnover.

<sup>165</sup> UN Fifth Report (n 152) para 323.

<sup>166</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 1977) Commentary to Article 9, para 2-8.

<sup>167</sup> UN Fifth Report (n 152) para 294.

Overall, as stated before, owing to the BICs' and other developing countries' participation, the opportunity to express their positions, and have them deliberated upon by other members, the process of development of the UN Model was fairer than that leading to the drafting of the OECD Model. The UN's Ad-Hoc Group of Experts' pre-set agenda in terms of following the OECD Model, however, meant that some things were entirely off the negotiating table. Among the issues discussed in this section, the key ones were the choice of the ALP as the basis for attribution of profits to PEs under Article 7 and for apportionment of profits between associated enterprises in Article 9, and also, largely, the practice of the ALP in these areas.

With regards to Article 7, in the form of a clear expression of non-consideration of certain notional payments in determining a PE's profits, developing countries were at least able to advance a position that potentially better suited their revenue interests and administrative capabilities. The fact that the same was already a part of the Commentary to Article 7 of the OECD Model had an important role to play in this development. In this sense, the insertion of the limited force of attraction rule in Article 7(1) was a bigger achievement from the standpoint of members from developing countries.

Such success was, however, not replicated in the case of Article 9. The greater experience of members from developed countries with the application of the ALP meant that they were more influential in shaping the UN's position on apportionment of profits between associated enterprises. Resultantly, Article 9 of the UN Model followed Article 9 of the OECD Model in its entirety. Additionally, as there was no

UN guidance in the area, it was obvious that both developed and developing countries were to follow the OECD's position on the use of that provision.<sup>168</sup>

Such developments support the view that the OECD Model produced a 'lock-in' effect that induced potentially similar developments to converge towards it.<sup>169</sup> More critically, they raise questions about the extent to which the UN Model achieved the original intent behind commencement of work on it, which was to attain a more balanced international division of taxing rights from the perspective of developing countries.<sup>170</sup>

## **Conclusion**

This chapter examined fairness in the process of evolution of the international framework for allocation of rights to tax active business income between countries under the LONs and then the OECD and the UN from the perspective of the BICs and other developing countries. This evaluation was based on the parameters laid out for this purpose in chapter II. As was seen through the two parts, the BICs and other developing countries were effectively the 'norm-takers' in this area. These countries were either completely or largely absent when the foundations of the prevailing international set-up for assignment of rights to tax active business income were being established by the LONs and then when they were reinforced by the OECD, or their

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<sup>168</sup> UN Model 2001 (n 81) Commentary to Article 9, para 3. The 1999 update of the Commentary to Article 9 of the UN Model, in fact, recommended countries to follow the OECD's Transfer Pricing Guidelines. As shall be discussed in chapter V, particularly in light of the introduction of the UN's Transfer Pricing Manual in 2012, this position is being reconsidered.

<sup>169</sup> Eduardo Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications' [2008] BTR 352, 359.

<sup>170</sup> Miranda Stewart, 'Global Trajectories of Tax Reform - The Discourse of Tax Reform in Developing and Transition Countries' (2003) 44 *Harvard Int'l L J* 139, 147.

participation in the process was not effective. Participation of members from the BICs and other developing countries made the process of development of the UN Model fairer from their perspective. The effectiveness of their participation, however, remained an issue through out the drafting of the UN Model.

Chapters IV and V analyse the existing international rules for determining a host country's right to tax active business income, the rules for attribution of profits to PEs, and the rules for apportionment of profits between associated enterprises from the BICs' standpoint. As stated in chapter I, this study will also give an opportunity to examine fairness in the international taxation rule-making process at the level of both the OECD and the UN since the advent of their respective Model Conventions up to the Base Erosion and Profit Shifting (BEPS) project from the BICs' perspective. Chapters VI and VII will use findings on both substantive and procedural fairness from these chapters and the parameters laid down in chapter II to evaluate some options for a fairer framework for allocation of rights to tax active business income from the BICs' viewpoint specifically and other developing countries more generally that could be realised in the short and medium terms.

## Chapter IV

### **The Right to Tax Active Business Income of Non-Resident Service Providers and the BICs: A Case Study**

Chapter III highlighted that despite developing countries' opposition to the concept of Permanent Establishment (PE) being the only determinant of a country's right to tax active business income of non-resident enterprises, the London Model and the OECD Model retained this position. In view of the agenda for the UN's engagement with the rules for allocation of taxing rights between countries and the manner in which the UN's work on them was to proceed, the only option before developing countries was to focus on suitable alterations to the OECD Model's notion of PE. The sought changes revolved around lowering the degree of physical presence as well as the level of business activity a non-resident enterprise must have in a country for the active business income generated by the enterprise to be taxable in the country. For developing countries, a crucial and distinctive part of the 'compromise' attained in the UN Model was the idea of a deemed service PE in Article 5(3)(b) of the Model.

More than three decades after the advent of the UN Model, on the one hand services constitute over 20% of the world's trade, around 2/3 of the world's GDP, and 1/3 of global employment.<sup>1</sup> On the other hand, progress in information technology, and the greater mobility of people has meant that a service provider does not need to be physically present in a country to furnish services in the country.<sup>2</sup> Have the existing international rules for determining a country's right to tax active business

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<sup>1</sup> World Trade Organisation (WTO), 'Measuring Trade in Services' (WTO 2010) 7-9 <[www.wto.org/english/res\\_e/statis\\_e/services\\_training\\_module\\_e.pdf](http://www.wto.org/english/res_e/statis_e/services_training_module_e.pdf)> accessed 10 January 2014.

<sup>2</sup> Marsha L Reid, 'The New Services PE Provision of the Canada-US Tax Treaty' (2010) 58 Canadian Tax Journal 845, 858-859.

income of non-resident enterprises matched pace with changes in cross-border trade in services? How have the BICs reacted to these advances, and what do those responses reflect in terms of fairness of the existing nexus and threshold for host country taxation of active business income? How successful have the BICs been in influencing the international developments in the area? These questions, which are particularly timely in light of the BEPS project, are explored in this chapter.

Part I of this chapter sets the backdrop for this study by briefly highlighting the importance of cross-border services for the BICs. Parts II and III present the main findings from the author's study of the BICs' positions on the application of the concept of PE to taxation of active business income of non-resident service providers. Parts II and III also analyse some of the key developments in the notion of PE since the introduction of the UN Model. Part IV examines the OECD's and the UN's on-going work on the rules for ascertaining a country's right to tax active business income, including that undertaken in the BEPS project. Together with parts II and III, this will help assess the potential of the OECD and the UN to offer the BICs a fairer international taxation rule-making process.

## **I. Cross-border trade in services and the BICs**

Neither the OECD Model and the UN Model, nor the World Trade Organisation's (WTO) General Agreement on Trade in Services (GATS) explains the term 'services'. Black's Law dictionary, which defines 'service' as the act of doing something useful

for a person or company for a fee, however, provides a good basic understanding of the focus of this chapter.<sup>3</sup>

The OECD Model and the UN Model have a complex scheme for taxation of income from services.<sup>4</sup> Separate provisions of the OECD Model cover taxation of income from construction services, services relating to shipping, inland waterways and air transport, dependant personal services, services of directors of companies, services of artists and sportsmen, and government services.<sup>5</sup> In addition, different articles of the UN Model cover taxation of income from insurance services, independent personal services, and services of top-level managerial officials.<sup>6</sup> The pre-requisites for host country taxation of income from these services vary from time limits for which the service must be rendered in the country to mere performance of the service in the country.<sup>7</sup> Host country taxation of income not covered under these limited categories is subject to both the Models' concept of PE. This chapter concentrates on taxation of this income.

The WTO classifies services into: business services, which cover, among others, professional, computer and related, research and development (R&D), real estate, and rental/leasing services; communication services; construction and related engineering services; distribution services; franchising; educational services; environmental

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<sup>3</sup> *Black's Law Dictionary* (9th edn, West 2009) 1491.

<sup>4</sup> Brian J Arnold, 'The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess' (2011) 65 *Bulletin for Int'l Taxation* 59.

<sup>5</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Articles 5(3), 8, 15, 16, 17, and 19.

<sup>6</sup> UN Department of Economic and Social Affairs (DESA), *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011) Articles 5(6), 8, 14, and 16.

<sup>7</sup> For example see OECD Model 2014 (n 5) Articles 5(3), 15, and 17. See also UN Model 2011 (n 6) Articles 5(3)(b), 14, 15, and 17.

services; financial services encompassing all insurance and insurance-related services, and banking services; health-related and social services; tourism and related services; recreational, cultural, and sporting services; and transport services.<sup>8</sup> A *prima facie* look at this list reveals the limited number of services covered under specific provisions of the OECD Model and the UN Model. This, in turn, highlights the breadth of active business income generated by non-resident service providers that is subject to host country taxation only if the service provider has a PE in the country.

Over the years, Brazil has remained a net importer of services, with the country's imports in 2014 being more than twice its exports.<sup>9</sup> Similarly, China has witnessed a persistent deficit between imports and exports of services, which was 160 billion USD in 2014.<sup>10</sup> Over the last decade, India has maintained a positive balance in trade in services. The country's import of services has, however, also grown consistently.<sup>11</sup> In view of these trading positions, the BICs can be expected to be concerned about host State taxation of active business income of non-resident service providers.

The author studied the BICs' reactions to their concerns regarding the application of the concept of PE to taxation of active business income of non-resident service providers. The main sources for this examination were: the BICs' bilateral tax

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<sup>8</sup> WTO, 'Services Sectoral Classification List' (10 July 1991) MTN.GNS/W/120.

<sup>9</sup> This conclusion was derived from a study of Brazil's trade in services from 1980-2014. The statistics needed for this analysis were obtained from the database on international trade in goods and services maintained by the UN Conference on Trade and Development (UNCTAD). This database can be accessed at <<http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx>>.

<sup>10</sup> This conclusion was derived from a study of mainland China's trade in services from 1980-2014. The data for this was obtained from the database mentioned in n 9.

<sup>11</sup> This conclusion was derived from a study of India's trade in services from 1980-2014. The data for this was obtained from the database mentioned in n 9.

treaties;<sup>12</sup> the positions taken by representatives and members from the BICs at the two prime international taxation rule-making forums - the OECD and the UN; and key developments in these countries' domestic laws in the recent years. Two related findings relevant from the standpoint of fairness in the international rules for division of rights to tax active business income were obtained.

The first is the BICs' opposition to the degree of physical presence a non-resident enterprise must have in a country before the country can tax the active business income generated by the enterprise from providing services in the country. The second is the BICs' emphasis on recognition of their consumer base in determining the BICs' right to tax active business income generated by non-resident service providers operating in these countries. These results are explored in parts II and III of this chapter.

## **II. The degree of physical presence envisaged under the concept of PE and the BICs**

### **a. No physical presence required for deeming the existence of a service PE**

The author's empirical study of India's bilateral tax treaties shows that approximately 35% of these treaties have a deemed service PE provision along the lines of Article

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<sup>12</sup> The author studied the deemed service PE provision and other mechanisms employed for taxation of active business income of non-resident service providers in the BICs' bilateral tax treaties that are in force and their previous versions, as well as those treaties that have been signed but are not in force yet. Annexures I, II, and III lay out the results of this study in the case of Brazil, India, and China respectively. The percentages discussed in the text are, however, based on only those treaties that were in force on 1 December 2014. These will be discussed by referring to the particular Annexure from which they were derived. All the treaties were accessed through the IBFD database. For clarity and simplicity, all percentages used in this thesis were rounded off at .5.

5(3)(b) of the UN Model.<sup>13</sup> As discussed in chapter III, under Article 5(3)(b), host country taxation of active business income of non-resident service providers does not depend on the existence of their fixed place of business in the country. Instead, they are deemed to have a PE in the country if activities pursuant to the services furnished by the enterprise through its employees or other personnel continue in the country for 183 days in a 12 month period for the same or connected project. Approximately 85% of China's bilateral tax treaties also contain a deemed service PE provision based largely on Article 5(3)(b) of the UN Model.<sup>14</sup>

These positions of India and China diverge from Article 5 of the OECD Model that, as seen in chapter III, does not contain a deemed service PE provision. As discussed in chapter II, the idea of gain or loss in national wealth, which is at the heart of the Musgraves' construct of INE, provides a rough yet useful standard for assessing whether the existing rules for division of taxing rights between countries could be considered fair from the standpoint of a country. This is because if the rules lead to an acceptable gain or loss in a country's national wealth, the country is likely to comply with them. In comparison, a possible reason behind the country's divergence from the rules could be the country's dissatisfaction with how the rules impact the gain or loss in its national wealth. Or, in other words, a country's deviation from the rules could be seen as an attempt to achieve a more equitable assignment of taxing rights from its perspective than that delivered by the rules.

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<sup>13</sup> Annexure II.

<sup>14</sup> Annexure III.

In 2008, the OECD introduced a deemed service PE alternative in the Commentary to Article 5 of the OECD Model.<sup>15</sup> The OECD's deemed service PE formulation deals with 'performance' of services in a country.<sup>16</sup> Linked to this, the provision sets out thresholds for host country taxation of active business income of non-resident service providers that envisage a certain degree of physical presence of a non-resident enterprise in the country. India's official position on this development is clear that 'furnishing of services', which is the phrase used in Article 5(3)(b) of the UN Model, as opposed to their 'performance' in the country, 'is sufficient for the creation of a service PE'.<sup>17</sup>

This was further established by the views expressed by the Committee expert from India, Anita Kapur, at the Eighth Session (2012) of the UN Tax Committee.<sup>18</sup> Kapur asserted that because Article 5(3)(b) of the UN Model uses the word furnishing as opposed to performance, the requirement in Article 5(3)(b) that 'activities of that nature continue within a Contracting State' would be met even if the services were

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<sup>15</sup> Hans Pijl, 'The OECD Services Permanent Establishment Alternative' (2008) 49 *European Taxation* 472. For an insight into the number of existing bilateral tax treaties following the UN's and the OECD's deemed service PE formulations see Wim Wijnen, Jan de Goede, and Andrea Alessi, 'The Treatment of Services in Tax Treaties' (2012) 66 *Bulletin for Int'l Taxation* 27, 29-31.

<sup>16</sup> OECD Model 2014 (n 5) Commentary to Article 5, para 42.23.

<sup>17</sup> *ibid* Non-OECD Economies' Positions on the OECD Model Tax Convention: Positions on Article 5 (PE) and its Commentary, para 35. Since 1997, positions of a number of non-member countries on the provisions of the OECD Model and the Commentary thereto have been included in the full-length version of the Model. This was done in recognition of the growing influence of the OECD Model beyond the OECD countries. In the case of the BICs, this opportunity has, however, largely been used for expressing their rejection of, or dissatisfaction with, the various Articles of the OECD Model and/or their Commentary.

<sup>18</sup> In 1980, the UN's Ad-Hoc Group of Experts was renamed UN's Ad-Hoc Group of Experts on International Cooperation in Tax Matters and its membership was increased to 25. Ten experts were to be from developed countries and 15 from developing countries. For the first time, an expert from China joined the Group. Since then, all the three BIC countries have been active at the UN front and were involved in the work on the 1999 as well as the 2011 updates to the UN Model. In 2005, the Group was elevated to its existing permanent Committee status. As stated in chapter III, the Committee members are nominated by their governments. However, they participate in the Committee in their capacity as experts. Therefore, to get a more accurate idea of the official positions of the BICs on the international taxation issues discussed in this work, an attempt was made to reflect on the views of the governmental representatives from these countries present at the Committee meetings as observers.

provided from outside a country.<sup>19</sup> Accordingly, under Article 5(3)(b), physical presence of employees or personnel of a non-resident enterprise in a country is not a pre-requisite for deeming the existence of the enterprise's service PE in the country.<sup>20</sup> The representative of the Government of India and the Committee members from Brazil and Nigeria supported Kapur's position.<sup>21</sup>

At the Ninth Session (2013) of the UN Tax Committee, the Committee expert from China, Tizhong Liao, gave a presentation on taxation of income arising from cross-border services, which highlighted: 1) the ease of manipulation of deemed service PE thresholds by non-resident enterprises, particularly because of the high mobility of people and capital; 2) the difficulty in identifying and substantiating the nexus between commercial activity and creation of taxable presence in the source country; and 3) that in carrying out some services, physical presence of the non-resident enterprise in the country may not even be required.<sup>22</sup>

To address these issues, Liao, who is also the Director General of China's State Administration of Taxation (SAT), proposed a revision of the UN Model to reflect advancements in the global economy and the different modes of delivering services from one country to another.<sup>23</sup> According to Liao, until that happens, considering the

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<sup>19</sup> UN Tax Committee, 'Report on the Eighth Session' (2013) E/2012/45-E/C.18/2012/6, para 66. Kapur was then also a member of the Subcommittee on services.

<sup>20</sup> *ibid.*

<sup>21</sup> In addition to the limited references in the reports of the UN Tax Committee to the positions adopted by a particular country, country specific viewpoints presented in this chapter are based on the minutes of the meeting of the Eighth (2012) and Ninth (2013) sessions of the Committee taken by the author who was present at these meetings as an observer. Hereinafter, these are referred to as: Minutes of the Eighth Session 2012; and Minutes of the Ninth Session 2013.

<sup>22</sup> UN Tax Committee, 'Report on the Ninth Session' (2014) E/2013/45-E/C.18/2013/6, para 50, para 17, and para 53.

<sup>23</sup> *ibid* para 54.

above aspects, Article 5(3)(b) of the UN Model should be interpreted as not requiring performance of services by a non-resident enterprise in a country for deeming the existence of the enterprise's service PE in the country.<sup>24</sup> The Committee experts from Ghana and Malaysia supported Liao's position.<sup>25</sup>

In April 2014, the State Tax Bureau of China's Jiangsu province released an Administrative Plan, which was effectively the first official position on the BEPS project coming from the country. In line with the views expressed by Liao at the UN, this stated that considering the developments in information technology, which enable enterprises to interact substantially with an economy despite limited or no physical presence in the country, 'a new understanding of source taxation would be required to maintain fairness in the international division of taxing rights'.<sup>26</sup> The paper mentioned 'certain design, consultancy, and technology services' as an area of particular concern in this regard.<sup>27</sup>

In both India and China, domestically, the deemed service PE issue has largely arisen in the context of cross-border secondment arrangements.<sup>28</sup> Therefore, it is difficult to say how India's and China's above-discussed positions will manifest

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<sup>24</sup> Minutes of the Ninth Session 2013 (n 21). See also UN Report on the Ninth Session 2013 (n 22) para 16.

<sup>25</sup> Minutes of the Ninth Session 2013 (n 21).

<sup>26</sup> Jiangsu State Tax Bureau (JSTB), 'Administrative Plan on International Tax Compliance – 2014 - 2015' (JSTB 2014) 6 <[www.dbriefsap.com/bytes/6June2014\\_BEPS.pdf](http://www.dbriefsap.com/bytes/6June2014_BEPS.pdf)> accessed 30 October 2014.

<sup>27</sup> *ibid.*

<sup>28</sup> *Director of Income Tax, Mumbai v Morgan Stanley and Company Inc* (2007) 7 SCC 1 (Supreme Court of India); *M/S Centrica India Private Limited v Commissioner of Income Tax and Others* (2014) 364 ITR 336 (High Court of Delhi); State Administration of Taxation (SAT), 'Announcement of the State Administration of Taxation on Relevant Issues Concerning the Imposition of Enterprise Income Tax on Services Provided in China by Dispatched Staff of Non-Resident Enterprises' (SAT 2013) <<http://bit.ly/1NmVGji>> accessed 11 December 2014. See also Dongmei Qiu, 'Permanent Establishment: An Evolving Concept under China's Tax Treaties (1983-2013)' [2014] BTR 274, 286.

themselves. Considering these per se, a fundamental deviation from the OECD's approach to deeming the existence of a non-resident service provider's PE in the country is, however, observed. Viewing this scenario in light of the Musgraves' above recapitulated construct of INE, from the perspective of India and China, the OECD's deemed service PE formulation could also be seen as incapable of resulting in a fair assignment of rights to tax active business income generated by non-resident service providers. In fact, as seen above, India and China seek to interpret even Article 5(3)(b) of the UN Model in a way that gives importance to the economic as opposed to physical presence of non-resident enterprises furnishing services.

It is acknowledged that there must be some minimal level of an enterprise's participation in the economy of a country before the country can tax the enterprise's active business income. As discussed by Arnold, such a threshold is vital to ensure administrative feasibility in ascertaining tax liability of non-resident enterprises and tax collection.<sup>29</sup> From the taxpayers' perspective, it is important for certainty and ease of compliance, which in turn contribute towards facilitating cross-border trade.<sup>30</sup> What is questionable, however, is the association of this threshold with a degree of physical presence when the economic activity is such that it can take place profitably without such presence.

A growing body of academic literature supports focusing more on a non-resident enterprise's economic presence rather than physical presence in a country for determining the country's right to tax the active business income generated by the

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<sup>29</sup> Brian J Arnold, 'Threshold Requirements for Taxing Business Profits Under Tax Treaties' (2003) 57 Bulletin for Int'l Taxation 476, 482.

<sup>30</sup> *ibid* 482.

enterprise.<sup>31</sup> Authors like Sasseville and Wichmann, who have approached the subject more reservedly, are largely driven by pragmatic concerns relating to enforcement and tax collection.<sup>32</sup> As stated above, these issues are important but, arguably, not insurmountable once the need to investigate options furthering this idea gains wider acceptance and efforts are invested in scrutinising the possible alternatives at the global level.

**b. Lesser thresholds for the level of activity that must continue in the host country for deeming the existence of a service PE**

In addition to reacting against the requirement of physical presence, India has also sought a lower threshold of ‘activities’ that must continue in a country pursuant to the furnished services for deeming the existence of an enterprise’s service PE in the country. One key aspect of this threshold in Article 5(3)(b) (and also in the second paragraph of the deemed service PE formulation in the Commentary to Article 5 of the OECD Model), is that the activities must relate to the ‘same or connected project’.

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<sup>31</sup> Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International 1991) 573; Reuven S Avi-Yonah, ‘International Taxation of Electronic Commerce’ (1997) 52 Tax L Rev 507, 510-516; Charles E McLure Jr, ‘Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws’ (1997) 52 Tax L Rev 269, 295-296; Steven J Forte, ‘Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?’ (1997) 15 John Marshall Journal of Computer & Information L 203, 205; Charles E McLure Jr, ‘Source-Based Taxation and Alternatives to PEs’ in Canadian Tax Foundation (CTF) (ed), *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (CTF 2000) 6.1-6.6; Annet Wanyana Oguttu and Sebo Tladi, ‘E-Commerce: A Critique on the Determination of a ‘Permanent Establishment’ for Income Tax Purposes from a South African Perspective’ (2009) 20 Stellenbosch L Rev 74, 90-95.

<sup>32</sup> Jacques Sasseville, ‘The Future of the Treaty Rules for Taxing Business Profits’ in CTF, *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (n 31) 5.1-5.3; Michael Wichmann, ‘The Taxation of Services: Is the Permanent Establishment the Appropriate Threshold?’ (2004) 58 Bulletin for Int’l Taxation 201, 203.

The author's empirical study of India's bilateral tax treaties having a deemed service PE provision shows that approximately 20% of these treaties do not include the same or connected project limitation.<sup>33</sup> In the Eighth Session of the UN Tax Committee, the Committee expert from Belgium presented a paper on interpretation of this limitation, which is not discussed in the Commentary to Article 5(3)(b) of the UN Model. Following paragraphs 42.40 and 42.41 of the Commentary to Article 5 of the OECD Model, the paper recommended that whether an enterprise has furnished services for the 'same' or 'connected' project should be considered from the enterprise's perspective and not the consumer's.<sup>34</sup>

Anita Kapur, the Committee expert from India, was critical of this position.<sup>35</sup> She rightly emphasised that the UN's Ad-Hoc Group of Experts' objective behind introducing a deemed service PE provision in the UN Model was to ensure that if activities pursuant to the furnished services persist in a country for a stipulated time period, the country must have the right to tax the active business income generated by such activities even if the fixed place of business threshold is not met.<sup>36</sup> Kapur stated that, accordingly, the same or connected project limitation should not have been there in Article 5(3)(b) in the first place, and was concerned that attempts were now being made to qualify it further.<sup>37</sup> Contrary to the paper, Kapur argued that whether the projects are same or connected must be determined based on the perspectives of both

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<sup>33</sup> Annexure II.

<sup>34</sup> UN Report on the Eighth Session 2012 (n 19) para 71 and para 72. The Committee expert from Chile, who was then the head of the subcommittee on services, pointed out that para 42.10 of the Commentary to Article 5 of the OECD Model takes this view only with respect to determination of the 'same' project, and that this view cannot automatically be assumed to be valid for interpreting 'connected' projects.

<sup>35</sup> Minutes of the Eighth Session 2012 (n 21).

<sup>36</sup> *ibid.*

<sup>37</sup> *ibid.*

the non-resident enterprise and the consumer in the source country.<sup>38</sup> The Committee experts from Brazil and Ghana and, importantly, the representative of the Government of India, supported Kapur's position.<sup>39</sup>

Nitikman has contended that merely carrying out activities in a country, no matter for how long, has never been sufficient to form a PE.<sup>40</sup> This, however, is not true. A befitting example, *albeit* rejected simplistically as an exception by Nitikman, is agency PE.<sup>41</sup> Also, arguably, making or defending this point should not rest on other examples. The deemed service PE provision originated as an alternative to the fixed place of business PE notion for ascertaining a host country's right to tax active business income of non-resident service providers. This endeavour was driven by the recognition of the different nature of services as compared to cross-border trade in goods in relation to which the concept of PE had emerged. If in this case a time requirement can provide for sufficient administrative ease in host State taxation, then the rationale for any additional limitation should be subject to strict scrutiny.

The Commentary to Article 5(3)(b) of the UN Model states that the words 'same or connected project' were included because 'it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of 95 days duration and another enterprise with two unrelated projects, each of 95

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<sup>38</sup> UN Report on the Eighth Session 2012 (n 19) para 74. See also OECD Model 2014 (n 5) Non-OECD Economies' Positions on the OECD Model Tax Convention: Positions on Art 5 (PE) and its Commentary, para 40.

<sup>39</sup> UN Report on the Eighth Session 2012 (n 19) para 74.

<sup>40</sup> Joel Nitikman, 'More on Service PEs - What is a Connected Project?' (2014) 62 Canadian Tax Journal 317, 346.

<sup>41</sup> *ibid.*

days duration, one following the other'.<sup>42</sup> As argued by Arnold, it is potentially more certain if all the days on which services are furnished in the country are counted.<sup>43</sup> Accordingly, it is more undesirable to distinguish between an enterprise with unrelated projects lasting over 183 days, and an enterprise with one or more connected projects for the same duration.<sup>44</sup> Further, the Commentary to Article 5(3)(b) itself notes that, owing to this aspect, some countries find the same or connected project limitation too 'easy to manipulate'.<sup>45</sup>

As seen in chapter III, in the meetings of the UN's Ad-Hoc Group of Experts, members from developing countries had opposed the addition of the 'same or connected project' limitation in Article 5(3)(b) of the UN Model. Viewing this together with the above-discussed criticisms of the UN Model's justifications for this requirement, Kapur's and Government of India's representative's concerns against allowing it to have a potentially more restrictive impact on a host country's taxing rights become understandable.<sup>46</sup>

Moving on, another key aspect of the threshold of activities that must continue in a country for deeming the existence of a non-resident service provider's PE in the country under both Article 5(3)(b) of the UN Model and the OECD's deemed service PE formulation, is the time requirement of 183 days. Approximately 48% of deemed service PE provisions in India's bilateral tax treaties use time thresholds less than 183

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<sup>42</sup> UN Model 2011 (n 6) Commentary to Article 5, para 12.

<sup>43</sup> Brian J Arnold, 'Time Thresholds in Tax Treaties' (2008) 62 Bulletin for Int'l Taxation 218, 228.

<sup>44</sup> *ibid* 229.

<sup>45</sup> UN Model 2011 (n 6) Commentary to Article 5, para 12.

<sup>46</sup> UN ECOSOC, *Tax Treaties between Developed and Developing Countries, Second Report* (1970) E/4939 ST/ECA/137, para 71.

days.<sup>47</sup> It was highlighted in chapter III that the UN's Ad-Hoc Group of Experts considered the use of a time threshold less than six months acceptable if it was applied through bilateral negotiations between treaty partners.<sup>48</sup> However, this was not to go below three months, the minimum time limitation observed in India's bilateral tax treaties.<sup>49</sup> This wording is not found in the Commentary to Article 5(3)(b) of the UN Model.<sup>50</sup> Based on the discussions of the UN's Ad-Hoc Group of Experts, it could, however, be argued that a time threshold less than 183 days is not a very strong deviation from the provision.

This, however, cannot be said about the OECD's deemed service PE alternative because the Commentary to Article 5 of the OECD Model makes no mention of time thresholds less than 183 days. Viewing this divergence together with that discussed in the case of the same or connected project requirement in light of the previously applied Musgraves' construct of INE, the threshold for host State taxation of active business income of non-resident service providers in the OECD's deemed service PE formulation could be considered incapable of leading to a fair division of taxing rights in this case from India's perspective.

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<sup>47</sup> Annexure II.

<sup>48</sup> UN Second Report (n 46) para 70.

<sup>49</sup> *ibid.*

<sup>50</sup> The Commentary to the UN Model now states this specifically with respect to Article 5(3)(a), which deals with PEs in the case of building and construction activities.

### **III. Seeking recognition of the ‘demand’ factor in the rules for determining a host country’s right to tax active business income**

It was stated at the start of this chapter that with developments in technology and business methods, an enterprise does not need a fixed place of business in a country to operate profitably in the country. It can generate substantial profits by interacting with consumers in the country. The existing rules for host country taxation of active business income, however, do not recognise the supply-demand approach to taxation, which suggests that profits are generated through the interaction of demand and supply. Thus, tax base should be divided between the jurisdictions where the income producing activity takes place and where the product is used or consumed, irrespective of the degree of physical presence of the non-resident enterprise in the country.<sup>51</sup> Instead, the prevailing rules for assignment of rights to tax active business income are based on the supply approach. Under this, income has its source where the factors giving rise to the income, such as land, labour, and capital, interact.<sup>52</sup> This idea necessitates physical presence of a non-resident enterprise in the country.

Deviating from the supply approach, Brazil’s taxation of active business income of non-resident service providers reflects the Indian and Chinese focus on economic as opposed to physical presence of the non-resident enterprise in Brazil. In fact, Brazil’s position is clearly centered around Brazilian consumers. Article 685 of

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<sup>51</sup> Peggy B Musgrave, ‘Principles for Dividing the State Corporate Tax Base’ in Charles E McLure Jr (ed), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover Institution Press 1984) 228, 234; OECD, ‘Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?—Final Report’ (OECD 2004) para 40-42 <[www.oecd.org/ctp/treaties/35869032.pdf](http://www.oecd.org/ctp/treaties/35869032.pdf)> accessed 2 November 2012.

<sup>52</sup> Peggy B Musgrave, ‘Principles for Dividing the State Corporate Tax Base’ (n 51) 234; OECD, ‘Are the Current Treaty Rules for Taxing Business Profits appropriate for E - commerce?’ (n 51) para 40.

Brazil's Income Tax Regulations 1999 (RIR/99) embodies the source of payment rule, which provides that all income, capital gains, and other benefits, including payments for services, are subject to withholding tax in Brazil if they are paid, credited, delivered, or remitted to a non-resident by a resident of Brazil.<sup>53</sup> This is regardless of where the income is produced or where the services are performed or the payment made.<sup>54</sup> This position is in conflict with Brazil's 32 bilateral tax treaties because in all of these, except the treaty with China, the concept of PE is based largely on Article 5 of the OECD Model.<sup>55</sup> Nevertheless, the Receita Federal (RF), which is the governmental body responsible for administration of taxes, has for long found justifications to apply it to all non-resident enterprises furnishing services in Brazil.

Previously, this was achieved through the use of the 'other income' provision in Brazil's bilateral tax treaties for taxation of income from 'technical services and technical assistance not involving transfer of know-how'. In the majority of Brazil's bilateral tax treaties, the Article dealing with taxation of other income, or income not covered under any other provision of the tax treaty, is modelled on Article 21 of the UN Model. This Article allows both treaty partners to tax such income depending on

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<sup>53</sup> Decree 3000 of 26 March 1999 (Income Tax Regulations). Depending on the type of income earned and on whether the payment has been made to a tax haven, the rate of tax can vary from 15% to 25%. For services in general, as per Article 685 II (a), it is 25% in all cases.

<sup>54</sup> Rubens Branco, 'Brazil' in International Fiscal Association (IFA) (ed), *Source and Residence: A New Configuration of their Principles*, Cahiers de Droit Fiscal International Vol 90A (IFA 2005) 205, 210.

<sup>55</sup> Article 5 of Brazil's bilateral tax treaty with China contains a deemed service PE provision modelled on Article 5(3)(b) of the UN Model. Therefore, the provision could be considered more proximate to Article 5 of the UN Model.

‘where it arises’. This is to be determined based on the source rules in the domestic tax law of the country.<sup>56</sup>

In 2000, the Normative Declaratory Act 01/2000 was introduced, which stated that income from ‘technical services and technical assistance not involving transfer of know-how’ was ‘other income’. As these services are not defined in Brazil’s bilateral tax treaties, recourse was taken to the domestic law for interpreting them.<sup>57</sup> Under Brazilian law, technical services mean ‘any work, endeavor, or project whose execution depends on the service provider’s technical expertise as a member of a particular field, such as a profession, art, or craft’.<sup>58</sup> Technical assistance, in turn, implies ‘ongoing advice provided by the transferor of a process or a secret formula to the recipient by way of technical drawings, studies, and instructions, and other similar services that facilitate their effective use’.<sup>59</sup> *Prima facie*, these definitions are broad enough to cover a range of services furnished by non-resident service providers in the country.<sup>60</sup> Accordingly, the Normative Declaratory Act 01/2000 was applied to bring income from services varying from public relations, advertising, planning, consulting, budgeting and development, administration and human resources, strategic studies,

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<sup>56</sup> UN Model 2011 (n 6) Commentary to Article 21, para 5. This is an important distinction between the OECD Model and the UN Model, because under the OECD Model such income is taxable exclusively in the country of residence of the enterprise.

<sup>57</sup> Since Brazil’s bilateral tax treaties are largely based on the OECD Model, they contain an equivalent of Article 3(2) of the Model. It provides that if the treaty does not define a term, then to establish the meaning of the term, recourse can be had to the applying State’s domestic law for the purposes of the taxes to which the treaty applies. The UN Model also contains a provision to this effect.

<sup>58</sup> Normative Instruction No 252 of 3 December 2002, Article 17, para 2(a).

<sup>59</sup> *ibid* Article 17, para 1, II (b).

<sup>60</sup> Sergio Andre Rocha, ‘Enterprise Services – Brazil’ in IFA (ed), *Enterprise Services*, Cahiers de Droit Fiscal International Vol 97A (IFA 2012) 155, 158, and 160. Rocha explains that the definition of technical services is sufficiently wide to cover almost any service requiring special skills, and if a service does not constitute technical service, tax authorities usually tax it as technical or administrative assistance. This is because under the Brazilian law all these services are taxable in the same manner. Importantly, Rocha points out that even when the non-resident enterprise has a PE in Brazil, because of the very high taxation of services permitted through the source of payment rule, in practice, in most cases the local tax authorities tax the remittance of funds, instead of attributing the income to the PE.

legal and accounting, to technology, engineering, research support, leasing, purchase assistance, and supply management under Brazil's tax net. This was despite the absence of the non-resident service provider's PE in Brazil or even when the services were rendered completely from outside Brazil.

Expectedly, this invited challenges for bilateral tax treaty violation. The decisions in favour of the RF saw payments for technical services and technical assistance not involving transfer of know-how as a part of the enterprise's total income, which may constitute the enterprise's profits. This was to be determined in the enterprise's home country after additions, deletions, or compensations in accordance with the law of that country.<sup>61</sup> As such payments were then not covered under any provision of Brazil's bilateral tax treaties, they were 'other income', taxable in Brazil based on the previously mentioned source of payment rule.<sup>62</sup> Interestingly, this position was taken even when there was no provision dealing with other income in the concerned tax treaty.<sup>63</sup>

In 2012, in its first decision on the issue, Brazil's Superior Court of Justice ruled that for the purposes of Article 7 of Brazil's bilateral tax treaties, 'profit' should be interpreted as 'operating profit'. This is defined in Article 11 of Decree Law 1,598 of

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<sup>61</sup> Especializada Tribunal Regional Federal da 2ª Região, Processo n 2004.51.01.003852-0, 6 de Novembro de 2009 (The Devon Energy case) <<http://bit.ly/1JmcP1O>> accessed 30 July 2013; Especializada Tribunal Regional Federal da 2ª Região, Processo n 2002.51.01.002701-0, 14 de Abril de 2010 (The PCI do Brasil Ltd case) <<http://bit.ly/1KtzBQ6>> accessed 30 July 2013.

<sup>62</sup> The Devon Energy case (n 61). The decision takes this position without really discussing any provisions of the domestic law that deal with the definition of income or profits. On this point, the PCI do Brasil Ltd case largely followed the Devon Energy case.

<sup>63</sup> The Devon Energy case as well as the PCI do Brasil Ltd case concerned the Brazil-France tax treaty, which does not have an Article dealing with taxation of 'other income'.

1977 as the consideration or remuneration received in respect of business activities.<sup>64</sup> The court held that if the term were equated to ‘taxable income’, Article 7 of these treaties would never cover remittances for business transactions.<sup>65</sup> In response to this decision, the Interpretative Declaratory Act 05/2014 was introduced, which has replaced the Normative Declaratory Act 01/2000 with a more acceptable treaty mechanism for pursuing the end achieved by that Article.

The Interpretative Declaratory Act 05/2014 provides that if the definition of royalties in Brazil’s bilateral tax treaties covers technical services and technical assistance, then irrespective of whether a transfer of technology or know-how is involved, payments for such services will be taxable in Brazil based on the source of payment rule.<sup>66</sup> Accordingly, such payments will be subject to a withholding tax in Brazil whenever they are made by a resident of Brazil, or incurred in relation to a non-resident’s PE or fixed base in Brazil and borne by the PE or fixed base.<sup>67</sup> The author’s empirical study of Brazil’s treaty network shows that in more than 84% of Brazil’s bilateral tax treaties, the definition of royalties includes technical services and technical assistance.<sup>68</sup> As none of these treaties define these two terms, recourse would again be had to their previously elucidated wide interpretations.

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<sup>64</sup> Recurso Especial No 1,161,467 – RS (2009/0198051-2), 28 de Novembro de 2012. See also Decree Law No 1598 of 26 December 1977, Article 11.

<sup>65</sup> Decree Law No 1598 of 26 December 1977 (n 64) Article 6.

<sup>66</sup> Interpretative Declaratory Act No 5 of 16 June 2014, Article 3. With regards to the Brazil-Spain tax treaty, this position has existed since 2004.

<sup>67</sup> The term ‘fixed base’ was not defined in the now deleted Article 14 of the OECD Model. It is also not defined in Article 14 of the UN Model. For an insight into its meaning see *R v Dudley* (2000) FCJ No 230 (FCA).

<sup>68</sup> Annexure I.

Further, all of Brazil's bilateral tax treaties contain a provision for taxation of 'professional services and other activities of an independent character' or independent personal services. Like in Article 14 of the UN Model, and Article 14 of the OECD Model, which was deleted from the Model in 2000, professional services in Brazil's bilateral tax treaties include 'independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants'.<sup>69</sup> Article 14 of the OECD Model provided for host country taxation of income arising from independent personal services if the non-resident had a 'fixed base regularly available to him' in the country for performing his activities.<sup>70</sup> The removal of Article 14 from the OECD Model reinforced the concept of PE under Article 5 of the Model as the main threshold for host country taxation of all business activities, including cross-border services.<sup>71</sup> Article 14(1)(a) of the UN Model has, however, retained the fixed base condition for taxation of income from independent personal services. Additionally, Article 14(1)(b) of the UN Model enables a country to tax income from such services if the non-resident's stay in the country is for a period amounting to or exceeding 183 days in a 12 month period.<sup>72</sup> The continuing existence of this provision in the UN Model is

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<sup>69</sup> For example see Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Brazil-Italy) (concluded 3 October 1978, entered into force 24 April 1981) Article 14(2).

<sup>70</sup> OECD, *Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* (OECD 1963) Article 14.

<sup>71</sup> Edwin van der Bruggen, 'Developing Countries and the Removal of Article 14 from the OECD Model' (2001) 55 *Bulletin for Int'l Taxation* 601, 605-607; Keefe Han, 'The Mistaken Removal of Article 14 from the OECD Model Tax Convention' (2010) 16 *Auckland University L Rev* 192, 199-204.

<sup>72</sup> Article 14 of the UN Model of 1980 also contained a monetary threshold, which was deleted in 1997.

driven by developing countries' concerns that the higher threshold under the concept of PE will narrow their taxing rights vis-à-vis income from these services.<sup>73</sup>

Approximately 97% of Brazil's bilateral tax treaties have a provision for taxation of income from independent personal services which, either along side these conditions or otherwise, provides for taxation of such income based on the source of payment rule.<sup>74</sup> Importantly, in the UN Model at least, Article 14 has generally been considered to deal with services provided by individuals as opposed to enterprises.<sup>75</sup> In contrast, the author's empirical analysis of Brazil's bilateral tax treaties shows that about 47% of these treaties cover independent personal services rendered by both individuals and enterprises.<sup>76</sup> This gives Brazil another treaty mechanism to tax active business income of non-resident service providers regardless of their physical presence in Brazil and, as stated above, in many cases based on the demand element offered by the country.

India, in turn, has for long had a treaty mechanism serving both these ends: the provision for taxation of 'fees for technical services' (FTS). The term FTS is used in India's bilateral tax treaties in two ways. The narrow approach, where it is called 'Fees for included services' (FIS), limits the scope of 'technical services' to services 'ancillary or subsidiary to the application or enjoyment of the right, property or

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<sup>73</sup> UN Tax Committee, 'Report on the Fourth Session' (2008) E/C.18/2008/6, para 33. See also UN Model 2011 (n 6) Commentary to Article 5, para 15.3.

<sup>74</sup> Annexure I.

<sup>75</sup> UN Model 2011 (n 6) Commentary to Article 14, para 9. One of the reasons given for deleting Article 14 of the OECD Model was the lack of clarity as to the entities to which it applied.

<sup>76</sup> Annexure I.

information’ for which ‘royalties’, as defined in the treaty, are received.<sup>77</sup> Or alternatively, to services that ‘make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design’.<sup>78</sup>

On the other hand, the wider definition of FTS covers payments for services of a ‘managerial, technical, or consultancy’ nature. In most cases, the wider approach to FTS also includes payments for ‘provision of services of technical or other personnel’.<sup>79</sup> In an Income Tax Appellate Tribunal (ITAT) decision, technical services were discussed as involving expertise in technology and providing the client with such technical expertise; managerial services as concerning management and running of the client’s business; and consultancy services as services wherein necessary advice and consultation is given for the purpose of the client’s business.<sup>80</sup> Thus, income arising from a variety of services can be brought under the umbrella term of FTS.

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<sup>77</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (India-United States of America (US)) (concluded 12 September 1989, entered into force 18 December 1990) Article 12. This treaty introduced the concept of fees for included services (FIS) in India’s bilateral tax treaty network.

<sup>78</sup> *ibid.*

<sup>79</sup> In all of India’s bilateral tax treaties, FTS specifically excludes payments for independent personal services and income from services performed in employment.

<sup>80</sup> *TUV Bayren (India) Ltd & TUV Management Service GmbH v Deputy Commissioner of Income Tax* (2012) Income Tax Appeal (ITA) No 4944/Mum/2002 (Income Tax Appellate Tribunal (ITAT), Mumbai) para 10.2. These notions of technical and consultancy services were upheld in a recent decision of the Supreme Court of India (SC). See *GVK Industries Ltd and Anr v The Income Tax Officer and Anr* (2015) 2 SCALE 534, para 33-36. As reflected from this decision, and also from *Commissioner of Income Tax v Bharti Cellular Ltd* (2011) 330 ITR 239 (SC), managerial, consultancy, and technical services have generally been understood as involving human intervention.

Since 1959, India's bilateral tax treaties have provided for taxation of FTS.<sup>81</sup> In fact, five out of India's eight early treaties (signed between 1958 and the 1970s) covered taxation of FTS.<sup>82</sup> With the exception of the treaty with Germany, which contained the afore-mentioned wider definition of FTS, none of these treaties defined FTS.<sup>83</sup> Further, in all these treaties, again except for the treaty with Germany, the only nexus and threshold for host State taxation was performance of services in the country. The provision for taxation of FTS in the treaty with Germany dispensed with the performance requirement, and allowed treaty partners to tax FTS on the basis of the source of payment rule. Accordingly, either State could tax FTS if the payer was the State or a resident of the State. FTS was also taxable in a State if the payments were incurred in connection with a non-resident's PE or fixed base in the State and were borne by the PE or the fixed base.<sup>84</sup> Whereas all the other initial treaties provided for taxation of such income on net basis, gross payments made for technical services were taxable under the Germany-India tax treaty.

Over the years, India has consolidated the position contained in the Germany-India tax treaty of 1959. At present, about 80% of India's bilateral tax treaties contain a provision for taxation of FTS. According to the author's empirical analysis, approximately 90% of these treaties define FTS widely. All these treaties permit taxation of gross payments for technical services in India based on the source of

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<sup>81</sup> This was a year after India signed its first bilateral tax treaty with Sweden.

<sup>82</sup> These were India's treaties with: Norway, Germany, Austria, Japan, France, Greece, and Belgium.

<sup>83</sup> Agreement for Avoidance of Double Taxation (Germany-India) (concluded 18 March 1959, entered into force 13 October 1960) Article VIII A (4).

<sup>84</sup> *ibid* Article VIII A (6).

payment rule.<sup>85</sup> Arguably, the Indian Income Tax Act, 1961 (IT Act), which also uses the wider notion of FTS, applies a less prone to abuse basis for determining taxability of such income in India.<sup>86</sup> This is because Section 9(1)(vii) of the Act requires that the services, whether paid for by a resident or a non-resident, must be utilised in India for the income generated by the non-resident service provider to be taxable in India.

Despite Section 9(1)(vii) not mentioning anything about performance of services in India, in a 2007 decision the Supreme Court of India (SC) held that services must be both rendered and utilised in India for FTS to be taxable in India.<sup>87</sup> The SC's view was based on the 'internationally accepted principle of territorial nexus'.<sup>88</sup> The judgment, however, did not discuss what this principle meant or entailed. To restore the original scope of taxing rights under Section 9(1)(vii) elucidated in the preceding paragraph, the Government of India amended the IT Act in the same year, with retrospective effect from 1 June 1976. An Explanation was added to Section 9, which stated that income arising by way of FTS would be deemed to accrue or arise in India, whether or not the 'non-resident has a residence or a place of business or a business connection in India'.<sup>89</sup>

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<sup>85</sup> As an exception, in addition to the source of payment rule, the India-Finland tax treaty provides that if such income relates to services performed in one of the Contracting States, FTS shall be deemed to have arisen in that State. In distinction, India's bilateral tax treaty with the US, Estonia, Iceland, Luxembourg, Mexico, Taiwan, Georgia, and Ethiopia contains a 'secondary condition' that if the FTS has not been paid for by a resident of a treaty partner or by a PE or a fixed base in the treaty partners, such income shall be considered as having arisen in the State where the services are performed.

<sup>86</sup> Income Tax Act 1961 (Act 43 of 1961), Section 9(1)(vii) Explanation 2.

<sup>87</sup> *Ishikawajima-Harima Heavy Industries v Director of Income Tax, Mumbai* (2007) 288 ITR 408 (SC).

<sup>88</sup> *ibid* para 49.

<sup>89</sup> Income Tax Act 1961 (n 86) Section 9 Explanation (i).

The Explanatory Notes accompanying this amendment made it clear that Section 9(1)(vii) was inserted in the IT Act with the intent to introduce the ‘source rule’, which allows income to be taxed in the country where it is earned. The Notes further explained that, accordingly, a legal fiction was created whereby, irrespective of the ‘situs of services’, tax jurisdiction was to be determined by the ‘situs of the payer and the situs of utilisation of services’.<sup>90</sup> The Notes reject the SC’s above-mentioned interpretation of Section 9(1)(vii) in light of the ‘narrow principle of territorial nexus’ that restricts India’s taxing rights to FTS generated by services performed in India.<sup>91</sup>

From the judicial decisions that followed the amendment, it was clear that the lower courts were interpreting the amendment as having rejected the degree of physical presence envisaged by the requirements of ‘residence, place of business, or business connection’. They did not, however, view the amendment as having removed the performance condition altogether.<sup>92</sup> Resultantly, the Government of India amended the IT Act again. The amendment provided additional Explanation in Section 9 with effect from 1 June 1976, which clarified that under section 9(1)(vii), income shall be deemed to accrue or arise in India ‘whether or not the non-resident has rendered any services in India’.<sup>93</sup>

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<sup>90</sup> Central Board of Direct Taxes (CBDT), ‘Explanatory Notes to the Provisions of the Finance Act, 2007’ (Circular No 3/ 2008, Government of India 12 March 2008) para 7.2 <[http://law.incometaxindia.gov.in/dittaxmann/circular/cir3\\_2008.htm](http://law.incometaxindia.gov.in/dittaxmann/circular/cir3_2008.htm)> accessed 30 January 2013.

<sup>91</sup> *ibid* para 7.3.

<sup>92</sup> *Clifford Chance v Deputy Commissioner of Income Tax* (2009) 318 ITR 237 (High Court of Maharashtra); *Jindal Thermal Power Company Limited (Ltd) v Deputy Commissioner of Income Tax* (2010) 321 ITR 31 (High Court of Karnataka).

<sup>93</sup> Subsequent judicial decisions reflect that this position is now firmly established in the domestic law. See the SC’s judgment in *GVK Industries Ltd* (n 80) para 25-26.

The Commentary to Article 5 of the OECD Model specifically states that ‘provisions that are sometimes included in bilateral conventions to allow a State to tax the gross amount of the fees paid for certain services if the payer of the fees is a resident of that State’ are not an appropriate way of taxing services.<sup>94</sup> The Commentary gives two reasons for this position. The first is that the mere fact that the payer of the consideration for services is a resident of the country, or that such consideration is borne by a PE situated in the country, or that the result of the services is used within the country, ‘does not constitute a sufficient nexus to allocate taxing rights in the case of business profits to that State’.<sup>95</sup> According to the Commentary, the OECD Model’s basic position that sale of goods that are merely imported by a resident of a country, and are neither produced nor distributed through a PE in the country, are not taxable therein, should apply to services as well.<sup>96</sup> The second reason is that such provisions allow for gross-based taxation of income generated by cross-border services.

The Brazilian and Indian approaches discussed in this part permit gross-based taxation of active business income of non-resident service providers regardless of their physical presence in these countries, as long as the services are paid for by residents of these countries or/and are utilised or consumed in these countries. In this way, the Brazilian and Indian positions diverge fundamentally from the OECD view elucidated in the preceding paragraph. While that is based on the supply approach, Brazil and India seek recognition for contribution of a consumer base in the profits generated by non-resident service providers. In light of the Musgraves’ construct of

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<sup>94</sup> OECD Model 2014 (n 5) Commentary to Article 5, para 42.19.

<sup>95</sup> *ibid* para 42.18.

<sup>96</sup> *ibid*.

INE, this response to the OECD's stand on determination of a country's right to tax active business income of non-resident enterprises rendering services could be seen as an attempt towards a fairer international division of taxing rights from the perspective of these countries.

Schön argues that the existence of a customer base leading to transfer of financial means from a country 'forges a genuine link' between the supplier of the goods and services and the country, which fulfills the requirement of 'economic allegiance'.<sup>97</sup> Consequently, he supports limited tax liability of an enterprise, 'starting from the first market contact, gradually moving up with intensified market penetration'.<sup>98</sup> Rocha rightly observes that one of the greatest attractions in the global economy is the presence of a consumer base with purchasing power.<sup>99</sup> Thus, in line with Schön, Rocha contends that, 'it is natural that a country should defend its right to tax income corresponding to the decrease of wealth in its national territory relating to the exploitation of the country's market'.<sup>100</sup>

As stated by Vogel, it cannot convincingly be denied that the market or demand State does play a role in generation of an enterprise's profits.<sup>101</sup> Accordingly, recognising the contribution of that State in the allocation of rights to tax those profits

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<sup>97</sup> Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)' (2009) 1 World Tax Journal 67, 92, 100.

<sup>98</sup> *ibid* 100.

<sup>99</sup> Sergio André Rocha, 'International Fiscal Imperialism and the "Principle" of the Permanent Establishment' (2014) 68 Bulletin of Int'l Taxation 83, 86.

<sup>100</sup> *ibid*.

<sup>101</sup> Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III)' (1988) 16 Intertax 393, 401.

becomes important from an INE point of view.<sup>102</sup> Vogel suggests that the argument becomes stronger in certain cases such as services, where the income producing activity would not have taken place had the consumer not demanded the service.<sup>103</sup> For the same reason, Kuźniacki believes that it would be unfair to deny taxing rights to the country where the consumer is based only because the enterprise providing the service does not have a physical presence in the country.<sup>104</sup>

In the recent years, such voices as well as international taxation reform proposals recognising the demand State's claim to tax income derived by non-residents from accessing its market have increased.<sup>105</sup> Most such contributions highlight that in determining how best to accommodate the demand State's taxing rights, there will be challenges of compliance, enforcement, and potential impact on cross-border trade. As argued before in this chapter, these would, however, be the second level of concerns, to be addressed once the fundamental opposition to the supply-demand approach is overcome.

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<sup>102</sup> *ibid* 401.

<sup>103</sup> *ibid* 400-401.

<sup>104</sup> Błażej Kuźniacki, 'The Service PE Concept in the Light of the Poland-Norway Income Tax Treaty (2009)' (2014) 54 *European Taxation* 16, 21.

<sup>105</sup> Reuven S Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard L Rev* 1573, 1672-1673; Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policy' (2001) 54 *Tax L Rev* 261, 317; Arthur J Cockfield, 'Designing Tax Policy for the Digital Biosphere: How Internet is Changing Tax Laws' (2002) 34 *Connecticut L Rev* 333, 386-387; Arthur J Cockfield, 'Jurisdiction to Tax: A Law and Technology Perspective' (2003) 38 *Georgia L Rev* 85, 97; Arnold, 'Threshold Requirements for Taxing Business Profits Under Tax Treaties' (n 29) 491; Benjamin Hoffart, 'Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Market Proxy Approach' (2007) 6 *Northwestern Journal of Technology and Intellectual Property* 107, 117-121; Annet Wanyana Oguttu and Sebo Tladi (n 31) 92-95.

#### **IV. International developments in the rules for determining a country's right to tax active business income and reflections for fairness in the international taxation rule-making process from the BICs' perspective**

The OECD's membership is still almost exclusively limited to 'developed' countries.<sup>106</sup> In 2004, China, and in 2007, India, were invited to be regular observers on the OECD's Committee of Fiscal Affairs (CFA).<sup>107</sup> An important function of the Committee, which sets the OECD's tax programme, is overseeing developments in the OECD Model and the OECD's Transfer Pricing Guidelines (OECD TPG).<sup>108</sup> As regular observers on the Committee, China's and India's participation in the meetings of the CFA or parts thereof could be excluded by the Chair of the OECD Council.<sup>109</sup> Also, unless specified otherwise, the offer to participate as regular observers did not include involvement in the meetings of the Committee's subsidiary bodies,<sup>110</sup> and the meetings at the Ministerial level.<sup>111</sup> Representatives from these countries could make

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<sup>106</sup> OECD, 'Members and Partners' (*OECD*) <[www.oecd.org/about/membersandpartners/](http://www.oecd.org/about/membersandpartners/)> accessed 24 May 2014. Out of the OECD's 34 members, only Hungary and Turkey do not qualify as high-income economies (according to the World Bank's classification).

<sup>107</sup> OECD, 'China and South Africa to Participate in Work of OECD's Committee on Fiscal Affairs' (*OECD*, 2004) <<http://bit.ly/1y3FPoS>> accessed 15 December 2011; OECD, 'OECD Invites India to Participate in its Committee on Fiscal Affairs' (*OECD*, 2007) <<http://bit.ly/1JnpKvA>> accessed 15 December 2011. Since 2007, through its 'enhanced engagement' programme, the OECD has sought to maintain close relations with the BICs, Indonesia, and South Africa. This is also 'with a view to possible OECD membership' of these countries. See OECD, 'Council Resolution on Enlargement and Enhanced Engagement' (16 May 2007) C/MIN(2007)4/FINAL, 2; OECD, 'Enhanced Engagement: Towards a Stronger Partnership between Major Emerging Economies and the OECD' (25 July 2008) C/MIN(2008)5/FINAL.

<sup>108</sup> OECD, 'The Current Tax Agenda of the OECD – 2012' (OECD 2012) 10 <[www.oecd.org/tax/OECDCurrentTaxAgenda2012.pdf](http://www.oecd.org/tax/OECDCurrentTaxAgenda2012.pdf)> accessed 30 July 2013.

<sup>109</sup> OECD, 'Resolution of the Council Concerning the Participation of Non-Members in the Work of Subsidiary Bodies of the Organisation' (8 July 2004) C(2004)132/FINAL, 9. In the OECD's tripartite structure, the OECD Council is the highest decision-making body.

<sup>110</sup> The Committee of Fiscal Affairs' (CFA) subsidiary bodies have included Working Parties on various issues, such as on Tax Conventions and Related Questions, Permanent Establishments, Taxation of MNEs, Tax Policy Analysis, and Tax Statistics.

<sup>111</sup> OECD, 'Resolution of the Council Concerning the Participation of Non-Members in the Work of Subsidiary Bodies of the Organisation' (n 109) 8.

statements on the subjects being discussed, but at the discretion of the chair of the Committee.<sup>112</sup> They were also not empowered to place questions on the agenda or take part in the Committee's decision-making process.<sup>113</sup>

In 2012, new rules on non-members' participation in OECD bodies were introduced.<sup>114</sup> The BICs became the OECD's 'key partners'.<sup>115</sup> China and India were invited to have 'participant status' in the CFA's meetings.<sup>116</sup> As participants, they may attend all the meetings of the CFA.<sup>117</sup> If their invitation so provides, the meetings of the CFA's subsidiary bodies and those at the Ministerial level are also open to them.<sup>118</sup> Their representatives can, however, still be excluded from any discussion at the discretion of the Chair of the Council and also if the CFA's chair marks the discussion as confidential.<sup>119</sup> Similarly, even now, they cannot take part in the OECD's decision-making process.<sup>120</sup> They are, however, entitled to propose agenda items and intervene in discussions.

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<sup>112</sup> *ibid* 9. This discretion was to be exercised to maximise mutual benefits of the non-member's participation.

<sup>113</sup> *ibid*.

<sup>114</sup> OECD, 'Resolution of the Council on Partnerships in OECD Bodies' (9 October 2012) C(2012)100/FINAL. This resolution provides the legal and institutional framework for participation in all the subsidiary bodies of the OECD except Standing Committees (subject to any specific conditions decided by the OECD Council). This development was in line with the OECD's 2011 Vision Statement that called for a 'more effective and inclusive global policy network'. See OECD, 'OECD 50<sup>th</sup> Anniversary Vision Statement' (25 May 2011) C/MIN(2011)6/FINAL, 2 .

<sup>115</sup> OECD, 'The OECD's Relations with its Key Partners' (*OECD*) <[www.oecd.org/general/theoecdrelationswithitskeypartners.htm](http://www.oecd.org/general/theoecdrelationswithitskeypartners.htm)> accessed 24 May 2014. The other key partners include countries that were a part of the enhanced engagement programme of 2007.

<sup>116</sup> Non-members can now participate in the CFA's work as invitees, participants, or associates. In 2012, the UN was also invited to be an observer.

<sup>117</sup> OECD, 'Resolution of the Council on Partnerships in OECD Bodies' (n 114) 3. This position is subject to a biennial review by the CFA.

<sup>118</sup> *ibid* 7.

<sup>119</sup> *ibid*.

<sup>120</sup> *ibid*.

Considering the singular example of the deemed service PE alternative, India's and China's participation in the OECD's tax work since attaining observer status could have influenced the OECD's acknowledgment of the possibility of taxing non-resident service providers in a country in the absence of a PE as envisaged in Article 5 of the OECD Model in the country. However, as compared to the UN Model, the OECD's deemed service PE features only as an option in the Commentary to Article 5. The Commentary, in fact, emphasises that the concept of PE in Article 5 of the OECD Model remains the main determinant of a host country's right to tax active business income.<sup>121</sup> It explains that, 'the provision of services, including independent personal services, as a general rule subject to a few exceptions for services covered under other specific provisions of the Model, should be treated in the same way as other business activities'.<sup>122</sup> Thus, it should be subject to the same PE threshold for taxation.<sup>123</sup> According to the Commentary, the deemed service PE alternative does not reflect 'optimal tax treaty policy',<sup>124</sup> and was introduced only to 'circumscribe the circumstances' in which non-OECD, and also some OECD countries, that seek to tax profits of non-resident service providers generated in the absence of their PE in the country should do so.<sup>125</sup>

As discussed in this chapter, two of these circumstances that the BICs disagree with are: the non-taxation of services rendered from outside the country; and the requirement of a certain degree of physical presence of a non-resident enterprise in

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<sup>121</sup> OECD Model 2014 (n 5) Commentary to Article 5, para 42.11.

<sup>122</sup> *ibid.*

<sup>123</sup> *ibid.*

<sup>124</sup> *ibid* para 42.13.

<sup>125</sup> *ibid* para 42.21.

the country before the country can tax the active business income of the enterprise.<sup>126</sup> Diverging from the third condition as well, Brazil and India allow gross-based taxation of income arising from a range of services.<sup>127</sup> From Brazil's standpoint, this persisting gap in the OECD's and Brazil's positions on taxation of active business income of non-resident service providers could be explained by the lack of Brazil's direct input in the OECD's work on the international rules for allocation of taxing rights between countries.

For India and China, that were actually involved when the deemed service PE formulation was introduced in the Commentary to Article 5, a plausible explanation is the lack of their participation in the final decision-making process.<sup>128</sup> From India's perspective, considering the time point at which it got involved in the CFA's work, the country also had little room to shape the agenda leading to this development. In this way, in the case of all three countries, integral indicators of fairness in the rule-making process set out in chapter II have been undermined.

In comparison, at the UN, for almost the last 10 years, members from the BICs have been involved on an equal footing with those from other countries in all stages of the international taxation rule-making process – from agenda-setting to decision-taking. It was stated in chapter III that, owing to the UN Tax Committee members'

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<sup>126</sup> *ibid* para 42.22.

<sup>127</sup> *ibid*.

<sup>128</sup> Ring has argued that participation of non-members in the rule-making process through a body that does not put them on an equal footing with members, and which can be limited at the body's discretion, cannot be considered effective. See Diane Ring, 'Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World' (2009) 33 *Fordham Int'l L Journal* 649, 673. See also Philipp Genschel and Thomas Rixen, 'The International Tax Regime: Historical Evolution and Political Change' in Gregory Shaffer and Terrence C Halliday (eds), *Transnational Legal Orders* (CUP 2014) 154, 167.

capacity as experts, technically, their involvement does not equate to a country's participation in the rule-making process. In the existing international taxation framework, this must nevertheless be credited as the only possibility of equal status of developed and developing countries in this process.<sup>129</sup> Further, as highlighted before in this chapter, governmental representatives can also attend the meetings of the UN Tax Committee as observers. Like observers in the meetings of the OECD's CFA and its subsidiary bodies, these representatives can be invited to present their positions but do not take part in the decision-making process. At least on the issues discussed in this chapter, this framework appears to have delivered the results desired by the BICs.

Since its Seventh Session (2011), the UN Tax Committee has been working on introducing a provision for taxation of FTS in the UN Model. In the Tenth Session of the Committee (2014), a paper containing the draft Article and the Commentary to it was presented for the Committee's consideration.<sup>130</sup> The draft Commentary acknowledges that, 'with rapid changes in modern economies, particularly with respect to cross-border services', it is now possible for a non-resident enterprise to be substantially involved in another State's economy without having a PE or a fixed base in the State, or without even being physically present in the State.<sup>131</sup> The draft Commentary points out that a country suffers a double loss when the payments made by the residents of the country or a non-resident's PE or fixed base in the country are

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<sup>129</sup> Further, as seen in this chapter, as these experts are governmental nominees and generally hold key offices in the Revenue departments of their countries, they can often be seen advancing the same positions that their countries take or seek to take on international taxation issues.

<sup>130</sup> UN Tax Committee, 'Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services' (2014) E/C.18/2014/CRP.8. While finalising this thesis for submission, a paper on the draft Article and its potential Commentary prepared for the Eleventh Session (2015) of the UN Tax Committee was released. The following footnotes also give the relevant references from that paper.

<sup>131</sup> *ibid* para 2. See also UN Tax Committee, 'Revised Draft Article XX and Commentary - United Nations Model Convention' (2015) E/C.18/2015/CRP.5, para 2.

deductible against the country's tax base, but are not taxable in the country.<sup>132</sup> The Commentary also raises the issue of profit shifting owing to excessive payments for intra-group services.<sup>133</sup> According to the draft Commentary, developing countries are generally substantial importers of services and do not have the administrative capacity to check such base erosion and profit shifting.<sup>134</sup>

The provision proposed by the UN seeks to address these concerns. It adopts a wide definition of 'technical services'. Like in India's bilateral tax treaties, this term encompasses managerial, technical, and consultancy services.<sup>135</sup> Managerial services involve expenditure of a service provider's specialised knowledge, skills, or expertise towards control or administration of a commercial enterprise or organisation.<sup>136</sup> In line with the Brazilian approach, technical services per se, are services applied with respect to a particular art, science, profession, or occupation.<sup>137</sup> Thus, services of regulated professionals, such as doctors, lawyers, architects, engineers, accountants etc. will be covered under technical services.<sup>138</sup> Consultancy services are discussed as concerning the provision of advice or services of a specialised nature.<sup>139</sup>

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<sup>132</sup> UN Tax Committee, 'Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services 2014' (n 130) para 11 and 13; UN Tax Committee, 'Revised Draft Article XX and Commentary - United Nations Model Convention 2015' (n 131) para 10 and 12.

<sup>133</sup> *ibid* para 12; *ibid* para 11.

<sup>134</sup> *ibid* para 14; *ibid* para 13.

<sup>135</sup> *ibid* para 50; *ibid* para 51.

<sup>136</sup> *ibid* para 51; *ibid* para 52.

<sup>137</sup> *ibid* para 52; *ibid* para 53.

<sup>138</sup> *ibid*; *ibid*.

<sup>139</sup> *ibid* para 54; *ibid* para 55. The draft Commentary in both the 2014 and 2015 papers acknowledges that a service can fall under one or more of these categories.

The income generated from this broad range of services will be taxable in the host country based on the source of payment rule – i.e., if the services are paid for by a resident of the country, or incurred in relation to a non-resident’s PE or fixed base in the country and borne by such a PE or fixed base. The draft Commentary expressly rejects what it calls the ‘fundamental principle’ underlying the OECD Model.<sup>140</sup> This is the principle of host country taxation of only income generated by services physically performed by non-resident service providers in the country.<sup>141</sup> According to the Commentary, the above-mentioned base erosion is a sufficient nexus for taxation in the case of cross-border services.<sup>142</sup>

The draft Commentary justifies the absence of any threshold for host country taxation on the grounds of modern methods of delivery of services that allow non-residents to furnish services with limited or even no physical presence in the country, and the previously stated base erosion and profit shifting concerns. The draft Commentary also defends gross-based taxation of payments for technical services based on the limited administrative capacity of many developing countries. The draft Commentary explains that a withholding tax on gross payments of services made by residents, or PEs or fixed bases of non-residents, provides a ‘simple, reliable, and efficient’ method of enforcing tax on income derived by non-resident service providers from these countries.<sup>143</sup> It also makes compliance for non-resident service providers easier because they are neither required to compute their net profits, nor file

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<sup>140</sup> *ibid* para 16; *ibid* para 16.

<sup>141</sup> *ibid*; *ibid*.

<sup>142</sup> *ibid*; *ibid*.

<sup>143</sup> *ibid* para 17; *ibid* para 21.

tax returns.<sup>144</sup> The draft Commentary also rightly points out that, in any case, enterprises which are substantially involved in the economy of a country have the option of setting up a PE or a fixed base if they want the payments for technical services to be taxable on net basis.<sup>145</sup>

The report of the Tenth Session of the UN Tax Committee reflects that the discussions did not really reach the point of considering the draft Commentary.<sup>146</sup> Therefore, it is difficult to say how much of the Commentary, which departs from the supply approach, will form a part of the final Commentary to the UN Model's proposed provision for taxation of payments for technical services.<sup>147</sup> The decision to include a provision of the above-discussed nature in the UN Model was, however, clear in the Ninth Session itself.<sup>148</sup>

From the standpoint of countries like Brazil and India, and even other developing countries, such as Ghana, Nigeria, Senegal, and Morocco, it could be said that it is the equal participation of experts from these countries in all stages of the UN's work on the international taxation rules that has enabled this development. Experts from OECD countries, such as the UK, Belgium, Germany, and the US were equally involved in the process. They opposed this development on the ground that the provision would be a fundamental change from the prevailing basis for

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<sup>144</sup> *ibid*; *ibid*.

<sup>145</sup> *ibid*; *ibid*.

<sup>146</sup> UN Tax Committee, 'Report on the Tenth Session' (2014) E/2014/45-E/C.18/2014/6, para 74-91.

<sup>147</sup> At the time of finalising this thesis, the report of the Eleventh Session of the UN Tax Committee had not been released.

<sup>148</sup> UN Report on the Ninth Session 2013 (n 22) para 59 and para 62.

ascertaining a country's right to tax active business income.<sup>149</sup> This argument, however, did not garner majority in the UN Tax Committee.

Further, at the Ninth Session of the Committee, in line with the Indian position, it was also decided that the viewpoints of both the non-resident enterprise rendering the services and the consumer in the source country were relevant in deciding what constitutes a same or connected project under Article 5(3)(b).<sup>150</sup> It was also agreed that although the conventional interpretation of Article 5(3)(b) did not support deeming the existence of an enterprise's service PE in a country in the absence of the services being performed in the country, such a position could be considered in view of the difficulties posed by the digital economy.<sup>151</sup> It was rightly clarified in the Tenth Session of the Committee that the need for such a reading of Article 5(3)(b) is reduced in light of the UN's above-discussed work on taxation of FTS.<sup>152</sup>

The preceding paragraphs reflect the impact that effective participation in the rule-making process, as compared to selective involvement it, can have on the outcome. Addressing this drawback at the OECD level, the BEPS project offers the BICs participation on an equal footing with the OECD members. Not just India and China, but also Brazil is an associate in the project.<sup>153</sup> Invitation as an associate applies to the CFA, its subsidiary bodies, and Ministerial level meetings, as well as

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<sup>149</sup> Minutes of the Eighth Session 2012 (n 21). See also UN Report on the Eighth Session 2012 (n 19) para 57. Another reason for their opposition was the potential for double taxation in gross taxation of highly skilled services that involve large amounts of remuneration. They were of the view that such taxation of income from services should be avoided completely or should at least be at a low rate.

<sup>150</sup> UN Report on the Ninth Session 2013 (n 22) para 18.

<sup>151</sup> *ibid* para 16.

<sup>152</sup> UN Report on the Tenth Session 2014 (n 146) para 21.

<sup>153</sup> Other associates include Colombia, Latvia, Russia, Indonesia, South Africa, Argentina, and Saudi Arabia. Unless stated otherwise, these countries are expected to associate themselves with the outcome of the project.

joint meetings of the CFA with other OECD bodies.<sup>154</sup> It also includes participation in the decision-making process.<sup>155</sup> From the BICs' perspective, as far as the rules for determining a country's right to tax active business income are concerned, this model for rule-making appeared to have borne a positive start.

The BEPS report of 2013 acknowledged that it is now 'possible to be heavily involved in the economic life of another country without having a taxable presence (such as a substantial physical presence or a dependent agent)' in the country.<sup>156</sup> Pursuing this issue, in 2014, the BEPS project report on Action Point 1 was released.<sup>157</sup> This report had the capacity to change the existing international rules for ascertaining a host country's right to tax active business of non-resident enterprises at two levels. The first level comprised of actions to tackle BEPS in the digital economy.<sup>158</sup>

At this level, several changes to Article 5 of the OECD Model were envisaged. An important one was modifying Articles 5(5) and 5(6) of the OECD Model to check avoidance of agency PE status in a State through commissionaire arrangements, and other similar structures.<sup>159</sup> Another key issue was dealing with scenarios where the

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<sup>154</sup> OECD, 'Resolution of the Council on Partnerships in OECD Bodies' (n 114) 7.

<sup>155</sup> *ibid.*

<sup>156</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 35-36.

<sup>157</sup> OECD, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014) 11. The report discussed digital economy as the more general changes brought in business methods through developments in information and communication technology. The position has been maintained in the 2015 final report of the BEPS project on Action Point 1. See OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (OECD 2015) 11.

<sup>158</sup> OECD, *Addressing the Tax Challenges of the Digital Economy* 2014 (n 157) chapter 6.

<sup>159</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 157) para 6.2.1.2. A 'commissionaire arrangement' may be defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner

core activities of a particular business fall under ‘preparatory or auxiliary activities’. Hence, even if these activities are carried out in a country through a non-resident’s fixed place of business or a dependent agent in the country, the PE threshold is not met.<sup>160</sup> A befitting example is of Amazon UK. One of Amazon’s explanations behind the low taxes paid in the UK was that storage and delivery operations carried out through its UK warehouses were preparatory and auxiliary activities. Thus, these activities did not result in a PE in the country.<sup>161</sup>

These two aspects of the existing concept of PE, which the OECD was already reviewing, were covered more specifically in the BEPS project’s work on Action Point 7.<sup>162</sup> Action Point 7, which dealt with artificial avoidance of PE status, also sought to check fragmentation of a cohesive business operation by a non-resident enterprise in a country to escape the PE threshold in the country,<sup>163</sup> and abuse of the time threshold for deeming the existence of a construction PE in a country under Article 5(3) of the OECD Model by splitting contracts between closely related enterprises.<sup>164</sup>

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of these products. See OECD, *Preventing the Artificial Avoidance of PE Status, Action Point 7 – 2015 Final Report* (OECD 2015) para 5 and para 7.

<sup>160</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 157) para 6.2.1.2.

<sup>161</sup> Ian Griffiths, ‘Amazon: £7bn Sales and No UK Corporation Tax’ *The Guardian* (4 Apr 2012) <[www.theguardian.com/technology/2012/apr/04/amazon-british-operation-corporation-tax](http://www.theguardian.com/technology/2012/apr/04/amazon-british-operation-corporation-tax)> accessed 18 September 2013; Ian Griffiths and Simon Bowers, ‘Fresh Questions for Amazon over Pittance it Pays in Tax’ *The Guardian* (16 May 2013) <[www.theguardian.com/technology/2013/may/15/amazon-tax-bill-new-questions](http://www.theguardian.com/technology/2013/may/15/amazon-tax-bill-new-questions)> accessed 18 September 2013.

<sup>162</sup> OECD, ‘BEPS Action 7: Preventing the Artificial Avoidance of PE Status’ (Public Discussion Draft, OECD 31 October, 2014 - 9 January, 2015) para 32-34 <[www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf](http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf)> accessed 10 January 2015. For an insight into the overlap in the OECD’s pre-BEPS work on the concept of PE and the issues relating to the same covered in the BEPS project see Richard Collier, ‘BEPS Action Plan, Action 7: Preventing the Artificial Avoidance of PE Status’ [2013] BTR 638, 640-641.

<sup>163</sup> OECD, ‘Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status 2014’ (n 162) para 29-31.

<sup>164</sup> *ibid* para 32-24.

Addressing issues such as those mentioned in the preceding two paragraphs would help host countries, particularly where extensive sales take place, recover tax base lost due to circumvention of the existing concept of PE.<sup>165</sup> However, this is nowhere close to facilitating host country taxation of non-resident enterprises based on their economic as opposed to physical presence in the country, and providing wider recognition to the contribution of a consumer base in the division of taxing rights between countries.

At the second level, the 2014 report of the BEPS project on Action Point 1 discussed the broader tax challenges raised by the digital economy, such as the appropriateness of the prevailing rules for determining nexus for host country taxation.<sup>166</sup> Reforms discussed at this level included the afore-mentioned modification to the preparatory and auxiliary activity exemptions, and a final withholding tax on payments made by residents of a country for digital goods or services provided by a foreign entity.<sup>167</sup> Among the more radical options highlighted in the 2014 report on Action Point 1 were the idea of taxing businesses that exceed a minimum threshold of annual bandwidth use, and the ‘significant digital presence test’.<sup>168</sup>

The latter envisaged a set of factors that would form the nexus for host State taxation only in the case of enterprises that require minimal physical elements in a

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<sup>165</sup> Several modifications to the existing concept of PE have been agreed to deal with these issues. See OECD, *Preventing the Artificial Avoidance of PE Status, Action Point 7 – 2015 Final Report* (n 159) para 5-18.

<sup>166</sup> OECD, *Addressing the Tax Challenges of the Digital Economy 2014* (n 157) para 7.2.

<sup>167</sup> *ibid* para 8.2.1.1 and para 8.2.1.4.

<sup>168</sup> *ibid* para 8.2.1.5 and para 8.2.1.2.

country for performance of their core activities.<sup>169</sup> The indicators of significant on-going interaction of such enterprises with the economy of a country ranged from the number of contracts for digital goods and services concluded remotely by the enterprise to the overall level of consumption of such goods and services of the enterprise in the country.<sup>170</sup>

A broader proposal for change contained in the 2014 report on Action Point 1, however, was to replace the concept of PE with a ‘significant presence’ test.<sup>171</sup> Like the significant digital presence test, this would involve establishing nexus for host State taxation based on certain parameters reflecting substantial involvement of an enterprise in the economy of a country. The difference was that the test was to be applicable to all enterprises. Therefore, the potential factors also included some element of physical presence of an enterprise in a country, whether direct or through a dependent agent.<sup>172</sup>

As can be seen, other than the alteration of the preparatory and auxiliary activity exemptions, all second level changes envisaged in the 2014 report on Action Point 1 were a shift away from reliance on physical presence for host State taxation. They also held greater promise of recognition of the demand side contribution of a country in the profitability of an enterprise as compared to the first level reform options contained in the 2014 report on Action Point 1 and the work on Action Point 7. In this way, they were better suited to advance the BICs’ positions discussed in this chapter.

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<sup>169</sup> *ibid* para 8.2.1.2.

<sup>170</sup> *ibid* para 8.2.1.2.

<sup>171</sup> *ibid* para 8.2.1.3.

<sup>172</sup> *ibid*.

The BEPS project's 2015 report on Action Point 1, however, makes it clear that such stronger deviations from the existing rules for ascertaining a host country's right to tax active business income remain a distant prospect.<sup>173</sup> Accordingly, the only changes to these rules that can be expected in the near future are the modifications to the concept of PE envisaged under the first set of reforms discussed in the 2014 report on Action Point 1 and the work done under Action Point 7.

One way of rationalising this result is the BEPS project's reluctance to deal with matters that go beyond addressing BEPS and impact the division of taxing rights between countries.<sup>174</sup> Such an approach is likely to influence the BICs' perception of the OECD's future potential to offer them a fairer international taxation rule-making process. This is because if some issues continue to remain off the negotiating table, then even technically equal participation in the rule-making process will not mean an even chance to advance their interests.

## **Conclusion**

Chapter IV explored whether the existing international rules for determining a country's right to tax active business income of non-resident service providers could be considered fair from the BICs' perspective. As discussed in part I of this chapter, this issue is of relevance to countries such as the BICs, which are substantial

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<sup>173</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 157) para 383.

<sup>174</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 11.

importers of services. Two key points of departure between these rules, as contained in the OECD Model and the UN Model, and the BICs' positions, were identified.

The first relates to the emphasis on physical presence for determining a country's right to tax active business income of non-resident service providers. The second concerns the BICs' focus on seeking recognition of a consumer base or the supply-demand approach in the division of rights to tax active business income between countries. Based on the Musgraves' construct of INE, these could be considered as areas for working on a fairer international assignment of rights to tax active business income from the BICs' standpoint.

Part IV of this chapter showed that, as compared to the OECD, effective participation, and hence fairer international taxation rule-making process at the UN, has enabled greater recognition of the BICs' concerns through the work of the UN Tax Committee. Participation on an equal footing with OECD members in the BEPS project offered the BICs the same prospect at the OECD front. The reforms to the existing rules for determining a country's right to tax active business income that the project will deliver, however, do not represent a significant advance on the above stated aspects.

This result can be attributed to the project's limited focus on addressing BEPS. If in this way, certain issues remain closed for genuine consideration, then even technically equal participation of the BICs in the OECD's tax work is unlikely to lead to a fairer international taxation rule-making process at the OECD from these countries' standpoint.

## Chapter V

### **Apportionment of Profits between Associated Enterprises, Attribution of Profits to PEs, and the Arm's Length Principle: A Case Study from the Perspective of the BICs**

In 2009, there were approximately 82,000 multi-national enterprises (MNEs) in existence, with 810,000 foreign affiliates across the world.<sup>1</sup> It is estimated that about one-third of the world's trade is intra-group.<sup>2</sup> The market can be expected to fix optimal prices of transfer of goods, services, or rights between unrelated parties. Owing to unity of control and overall interests, it is, however, difficult to determine the appropriateness of such transfer prices between related entities. From a country's perspective, this issue needs to be resolved effectively as it is central to ascertaining the taxable profits of an MNE group in the country. As seen in chapter III, the League of Nations (LONs) decided that the arm's length principle (ALP) was a befitting basis for this purpose. This in turn made the ALP the focal point in answering the second key question in the division of rights to tax active business income between countries: how much of an MNE's profits can a country tax?

This chapter focuses primarily on the BICs' positions vis-à-vis the theory and the practice of the ALP for assessing transfer prices between associated enterprises. While the former is contained in Article 9 of the OECD Model and the UN Model,<sup>3</sup>

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<sup>1</sup> United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2009 – Transnational Corporations, Agricultural Production, and Development* (UN 2009) 17.

<sup>2</sup> Rainer Lanz and Sébastien Miroudot, 'Intra-Firm Trade: Patterns, Determinants and Policy Implications' (2011) OECD Trade Policy Working Paper No 114, 13 <<http://bit.ly/1SdgikB>> accessed 3 March 2015. See also UN, *World Economic Situation and Prospects – 2013* (UN 2013) 39.

<sup>3</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Commentary to Article 9, para 1; UN Department of Economic and Social Affairs (DESA), *UN Model Double Taxation*

the latter is elucidated in the OECD's Transfer Pricing Guidelines (OECD TPG) and the UN's Transfer Pricing Manual (UN TPM).<sup>4</sup> The UN TPM, which was introduced in 2012, largely follows the OECD TPG. It does, however, make an effort to offer more detailed and easy to use guidance on transfer pricing issues that are particularly important to developing countries.<sup>5</sup> Another key distinguishing feature of the UN TPM is its chapter 10. This non-consensus portion of the UN TPM lays out the BICs' positions on the ALP and its application for determining correctness of transfer prices between associated enterprises in different countries, or in other words, for appropriate apportionment of profits arising from transactions concerning such enterprises between countries.

The author explored these positions. Apart from the BICs' bilateral tax treaties and their domestic laws, a key source of understanding the BICs' perspective on these issues was chapter 10 of the UN TPM itself.<sup>6</sup> This is because chapter 10 can be considered the first clear and comprehensive articulation of the BICs' dissatisfaction with various aspects of the OECD TPG. The then experts from the BICs on the UN Tax Committee drafted the relevant parts of this chapter. At the time of writing, these

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*Convention between Developed and Developing Countries* (UN 2011) Commentary to Article 9, para 1 and para 2.

<sup>4</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010); UN, *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2013).

<sup>5</sup> UN TPM (n 4) v.

<sup>6</sup> The author studied the provision for apportionment of profits between associated enterprises in the BICs' bilateral tax treaties that are in force, the previous versions of these treaties, as well as the treaties that have been signed but are not yet in force. Annexures IV, V, and VI lay out the various aspects of this provision that were a part of this analysis in the case of Brazil, India, and China respectively. The results discussed in the text are, however, based on only those treaties that were in force on 1 December 2014. These results have been rounded off at .5 and will be discussed by referring to the particular Annexure based on which they have been derived. All the treaties were accessed through the IBFD database.

experts also held key offices in their respective tax administrations.<sup>7</sup> Whereas Brazil's and China's section of chapter 10 of the UN TPM projects their official transfer pricing positions, the Indian presentation is careful in attributing the ideas discussed in the chapter to the Indian Revenue Service (IR). Therefore, this thesis has maintained particular care in examining the extent to which the approaches mentioned in the Indian section have been accepted within India's domestic legal framework.

This chapter also highlights the BICs' standpoint on the application of the ALP for attribution of profits to Permanent Establishments (PEs). As seen in chapter III, apart from a few alterations, Article 7 of the UN Model of 1980 followed the then existing Article 7 of the OECD Model. After the introduction of a new Article 7 in the OECD Model in 2010, the degree to which both the Models use the ALP for attribution of profits to PEs, however, varies materially. The author studied the BICs' positions on Article 7 of both the Models as reflected from the official stands expressed by the BICs on these provisions at the OECD and UN fronts, their bilateral tax treaties, and their domestic laws.<sup>8</sup>

Two broad findings emerge from this examination of the theory and practice of the ALP for apportionment of profits between associated enterprises and for attribution of profits to PEs that are relevant from the viewpoint of fairness in the

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<sup>7</sup> Marcos Aurélio Pereira Valadão, who is the Chair of the 2nd Chamber of the 3rd Section of Brazil's Administrative Court of Appeals, wrote the chapter on Brazil. Tizhong Liao, who was then the Deputy Director of the International Taxation Department of China's State Administration of Taxation (SAT), authored the chapter on China. In 2013, he was promoted to the post of Director General of International Taxation. His co-author was Wang Xiaoyue, who is the Director of the Anti-Avoidance Division of the International Taxation Department of the SAT. Anita Kapur, who was then a member and later the head of the Central Board of Direct Taxes (CBDT) of India, drafted the chapter on India.

<sup>8</sup> The results of the author's analysis of the provision for attribution of profits to PEs in the BICs' bilateral tax treaties are also presented in Annexures IV, V, and VI mentioned in n 6 of this chapter. The approach taken for this study and for discussing its findings in the text is the same as that elucidated in n 6.

international framework for allocation of rights to tax active business income. The first is the BICs' opposition to some of the fundamentals of the existing international practice of the ALP in both these areas that can undermine the BICs' tax base as a host country. The second, particular to India and China, is seeking recognition of their distinct contribution to the profitability of MNEs, particularly their lucrative markets, in the profits apportioned to enterprises operating there.

Parts I and II of this chapter explore these results. Part III examines key developments in the application of the ALP at the OECD and the UN levels, including those covered in the BEPS project from the BICs' perspective, and the BICs' role in shaping them. Like in chapter IV, this will help in gaining insight into the OECD and the UN's potential to offer the BICs a fairer international taxation rule-making process in the future.

## **I. The BICs' opposition to aspects of the existing practice of the ALP that undermine their tax base as a host country**

### **a. Brazil's use of profit margins pre-fixed by law – A response to the problems in the selection and use of comparables for establishing the arm's length price**

The author's empirical analysis of Brazil's bilateral tax treaties establishes that Article 9(1) of these treaties aligns with Article 9(1) of the OECD Model and the UN Model.<sup>9</sup> Thus, *prima facie*, Brazil accepts the theory of the ALP. None of these treaties, however, have a provision corresponding to Article 9(2) of the OECD Model and the

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<sup>9</sup> Annexure IV.

UN Model, which, as discussed in chapter III, deals with correlative adjustment. Thus, Brazil's bilateral tax treaties have also not adopted Article 9(3) of the UN Model, which eliminates the need for corresponding adjustment in certain cases.<sup>10</sup>

Brazilian transfer pricing legislation, Law 9430/96, was introduced in 1996. The objective was to provide a legal framework for checking erosion of Brazil's tax base owing to manipulation of transfer prices between Brazilian taxpayers and related entities located outside Brazil.<sup>11</sup> Although Law 9430/96 was declared to be in accordance with the OECD's practice of the ALP, to achieve this goal within the Brazilian tax administration's technical capacity and resources, several departures from the same were made. A key one among these is seen in Brazil's implementation of two of the three traditional transaction methods contained in the OECD TPG and the UN TPM for establishing arm's length price of a transaction between associated enterprises: the Resale Price Method (RPM) and the Cost-Plus Method (CPM).<sup>12</sup>

Under the OECD TPG and the UN TPM, to establish the arm's length price using the RPM, the price at which a product purchased from an associated enterprise is sold to an independent entity is reduced by a gross margin or the resale price

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<sup>10</sup> *ibid.*

<sup>11</sup> Law No 9430 of 27 December 1996 as amended by Law No 12,715 of 17 September 2012. See also Items 12 and 13 of the then Brazilian Government's reasoning behind Law 9430/96 as cited in Marcelo Ilarraz, 'Drawing Upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-Fixed Profit Margins or a Third Way?' [2014] BTR 218, 221. The concept of associated enterprises under Brazilian law is wider than that contained in Articles 9(1)(a) and 9(1)(b) of the two Models. Additionally, in line with the anti-avoidance aim of the Brazilian transfer pricing rules, Law 9430/96 also extends to transactions between a Brazilian taxpayer and a related or unrelated entity based in a low or no tax jurisdiction.

<sup>12</sup> The three traditional transaction methods are: the Comparable Uncontrolled Price (CUP) method, the Resale Price method (RPM), and the Cost-Plus method (CPM). The OECD TPG and the UN TPM also discuss two transactional profit methods - the Transactional Net Margin method (TNMM) and the Profit Split method (PSM).

margin.<sup>13</sup> This margin represents the amount the reseller would seek to cover its selling and operating expenses, and also make an appropriate profit based on the functions it undertakes, the assets it uses, and the risks it assumes, or in other words, its FAR profile.<sup>14</sup> The remainder after adjustment of costs linked to the purchased product can be considered the arm's length price for the original transaction between the associated enterprises.<sup>15</sup> Similarly, under the CPM, arms' length price is established by adding a mark-up to the cost of the transaction between the associated enterprises, which reflects an appropriate profit in light of the enterprises' FAR profiles and the market conditions.<sup>16</sup> Such resale price margins and cost mark-ups are to be determined using internal or external comparables.

An internal comparable is a transaction between one of the associated enterprises and an independent enterprise that is the same as or similar to the transaction between the associated enterprises.<sup>17</sup> An external comparable is a same or similar transaction between independent enterprises under the same or similar circumstances.<sup>18</sup> Two transactions are considered comparable if there are no material differences between them that could affect the condition being examined for determination of the arm's length price of the transaction. Or, if such differences exist, reasonably accurate adjustments can be made to eliminate their effect.<sup>19</sup> According to both the OECD TPG and the UN TPM, factors such as characteristics of

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<sup>13</sup> OECD TPG (n 4) para 2.21-2.22; UN TPM (n 4) para 6.2.6.

<sup>14</sup> *ibid*; *ibid*.

<sup>15</sup> *ibid*; *ibid*.

<sup>16</sup> *ibid* para 2.39-2.40; *ibid* para 6.2.7.

<sup>17</sup> *ibid* para 3.24; *ibid* para 5.3.4.1.

<sup>18</sup> *ibid*; *ibid*.

<sup>19</sup> *ibid* para 1.33; *ibid* para 5.1.5.

the property or services transferred, associated enterprises' FAR profiles, their economic circumstances, business strategies pursued by them, and the contractual terms between them are relevant for establishing comparability.<sup>20</sup>

Brazil's use of RPM and CPM eliminates the need to look for suitable comparables. This is because Brazil's application of these methods depends on margins pre-fixed by law. These margins are set differently for import and export transactions. For instance, under the Brazilian version of RPM, the benchmark price for import transactions is the average resale price of the imported goods, services, or rights less any unconditional discounts, taxes over sales, commissions, and the profit margin.<sup>21</sup> In 2012, in the case of imports, margins specific to diverse sectors of the economy were established.<sup>22</sup> Under the same method, the benchmark price for export transactions is the average sales price of identical or similar goods, services, or rights in the country of destination under similar payment conditions excluding the taxes levied, and a fixed profit margin of 15% in the case of a wholesale operation, and 30% for retail.<sup>23</sup>

Similarly, under the CPM, the benchmark price for import transactions is the average cost of the concerned or similar goods, services, or rights in the country where they originated, increased by a profit margin of 20% and any taxes paid in that

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<sup>20</sup> *ibid* para 1.36-1.63; *ibid* para 5.1.6 and para 5.3.2.

<sup>21</sup> Law 9430/96 (n 11) Article 18 (II). If the actual price of a transaction does not fall within 5% of the benchmark price calculated using any of the transfer pricing methods provided in the law, the tax authorities make a transfer pricing adjustment. See Normative Instruction No 1, 312 of 28 December 2012, Article 51 (1).

<sup>22</sup> Law 9430/96 (n 11) Article 18 (12).

<sup>23</sup> *ibid* Article 19 (3) (II) and (III).

country.<sup>24</sup> For export transactions, the benchmark price under CPM is the average cost of purchase or production of the exported goods, services, or rights increased by taxes charged in Brazil, plus a profit margin of 15%.<sup>25</sup> As can be seen, for both taxpayers and tax authorities, the ease of availability of the requisite data in Brazil is more for exports under the CPM and for imports under the RPM. Therefore, unsurprisingly, CPM is mainly used for computing the benchmark price for export transactions, and RPM for import transactions.<sup>26</sup>

The preceding paragraphs reflect a significant divergence in the OECD TPG's and the UN TPM's application of the RPM and the CPM and in Brazil's use of these methods for determining the arm's length prices of transactions between associated enterprises. Going back to the Musgraves' construct of INE, at the heart of this notion of fairness is the idea of gain or loss in a country's national wealth. As discussed in chapters II and IV, a possible reason behind a country's divergence from the prevailing international rules for allocation of taxing rights can be its dissatisfaction with the gain or loss in its national wealth that the rules result in. Or, in other words, the rules could be considered as delivering an unfair division of taxing rights from the country's perspective.

The UN TPM highlights that due to the absence of wide and open markets, developing countries often lack adequate appropriate comparables, which impedes their ability to apply the ALP for apportionment of profits between associated

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<sup>24</sup> *ibid* Article 18 (III).

<sup>25</sup> *ibid* Article 19 (3) (IV).

<sup>26</sup> UN TPM (n 4) para 10.2.5.2 and para 10.2.6.2.

enterprises.<sup>27</sup> This, in turn, has negative implications for their tax bases. Like the OECD TPG, the UN TPM suggests using foreign comparables.<sup>28</sup> The UN TPM recognises that, generally, developing countries also lack access to foreign databases.<sup>29</sup> Therefore, in line with the OECD TPG, it proposes the application of suitable local comparables from another industry sector.<sup>30</sup> Other ways of addressing this situation, which are mentioned in the OECD TPG as well, include gathering public information on third parties that are likely to be involved in uncontrolled comparable transactions, such as competitors.<sup>31</sup> The UN TPM points out that the problem is, however, an especially difficult one for developing countries because of factors like first-mover scenarios.<sup>32</sup>

Brazil's Administrative Taxpayers' Council has discussed the Brazilian approach to RPM and CPM as an adaptation of the ALP (as the margins pre-fixed by law only try to reproduce conditions of transactions between independent entities) to suit a developing country's concern regarding protection of its tax base in a manner that is administratively more feasible than the OECD TPG's and the UN TPM's application of the ALP.<sup>33</sup> According to Schoueri, selection and application of comparables is one of the great challenges of the existing transfer pricing rules.<sup>34</sup> It involves complex calculations requiring extensive data gathering and market

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<sup>27</sup> UN TPM (n 4) para 5.1.9 and para 5.4.3.3.

<sup>28</sup> OECD TPG (n 4) para 3.35; UN TPM (n 4) para 5.4.3.3.

<sup>29</sup> UN TPM (n 4) para 5.4.3.3.

<sup>30</sup> OECD TPG (n 4) para 3.38; UN TPM (n 4) para 5.4.3.4.

<sup>31</sup> *ibid* para 3.37; *ibid*.

<sup>32</sup> UN TPM (n 4) para 5.4.3.6.

<sup>33</sup> Isabel Calich and Joao Dacio Rolim, 'Transfer Pricing Disputes in Brazil' in Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012) 519, 537.

<sup>34</sup> Luis Eduardo Schoueri, 'Brazil' in Yariv Brauner and Pasquale Pistone (eds), *BRICS and the Emergence of International Tax Coordination* (IBFD 2015) 41, 63.

research.<sup>35</sup> This increases costs, which are further aggravated by MNEs' ability to manipulate prices of intra-company transactions and by cases where appropriate comparables might not even exist. As explained by Ilarraz, through margins pre-fixed by law, necessary comparability is established in advance of the chargeable event.<sup>36</sup> This checks the potential for distortion in transfer prices by taxpayers and thus, the costs the tax administration would otherwise incur to deal with this issue.<sup>37</sup>

Interestingly, there have been limited judicial decisions concerning transfer pricing issues in Brazil, and administrative disputes have also hardly involved any discussions on the margins *per se*.<sup>38</sup> Capital inflows too have not suffered any significant decline since the enactment of Brazil's transfer pricing legislation.<sup>39</sup> Ilarraz suggests that this could either mean that the margins reflect arm's length results, or that the system is acceptable to taxpayers because of the certainty and predictability it introduces.<sup>40</sup> This enables a taxpayer to better assess the tax costs of investing in Brazil.<sup>41</sup> Additionally, administrative simplicity inherent in the approach means less cumbersome documentation requirements and compliance costs.<sup>42</sup>

As discussed by Valadão and Lopes, all of these advantages of the pre-determined margins are particularly relevant for other developing countries, which are often stretched in terms of resources and technical expertise in performing the tight

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<sup>35</sup> *ibid.*

<sup>36</sup> Ilarraz (n 11) 227.

<sup>37</sup> *ibid.*

<sup>38</sup> Isabel Calich and Joao Dacio Rolim, 'Transfer Pricing Disputes in Brazil' (n 33) 531-532.

<sup>39</sup> Ilarraz (n 11) 225.

<sup>40</sup> *ibid* 221, 227-228.

<sup>41</sup> *ibid* 228.

<sup>42</sup> *ibid* 231.

balancing act of protecting their tax bases from transfer pricing manipulations and maintaining their investment attractiveness.<sup>43</sup> For the same reasons, the use of profit margins pre-fixed by law is a major part of Falcão's case for considering the Brazilian system as an alternative for developing countries.<sup>44</sup> As the second best option, Falcão recommends viewing the Brazilian approach as a stepping stone or an initial, simpler, and more objective set-up for developing countries to familiarise themselves with transfer pricing and develop domestic capacity in the area.<sup>45</sup>

There are some weaknesses of pre-determined margins. For instance, it could be argued that they introduce rigidity in Brazil's transfer pricing framework. This view is, however, not entirely correct because the margins can be altered. The Minister of Finance can do so under certain conditions, and also at the taxpayer's request, which must be supported with research demonstrating the practice of margins other than those stipulated by law.<sup>46</sup> Presumably, because of the costly and difficult nature of such a study, few requests for change have been made.<sup>47</sup> Further, pre-fixed margins increase the risk of double taxation where there is no access to competent authorities

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<sup>43</sup> Marcus Aurelia Pereira Valadão and Rodrigo Moreira Lopes, 'Transfer Pricing in Brazil and the Traditional OECD Approach' (2013) 9 Int'l Taxation 63, 65.

<sup>44</sup> Tatiana Falcão, 'Brazil's Approach to Transfer Pricing: A Viable Alternative to the Status Quo' (2012) 20 Tax Management Transfer Pricing Report 1. Other aspects relevant to her argument are the non-inclusion of royalties and payments for technical, scientific, or administrative assistance within the purview of Law 9430/96, and the extensive use of safe harbours.

<sup>45</sup> *ibid* 8.

<sup>46</sup> Law No 9430/96 (n 11) Article 20.

<sup>47</sup> Rodrigo B Machado and Aloysio M de Miranda Filho, 'Brazilian Report' in International Fiscal Association (IFA) (ed), *Cross Border Restructuring*, Cahiers de Droit Fiscal International Vol 96A (IFA 2011) 149, 154.

to negotiate relief.<sup>48</sup> They also involve a certain degree of arbitrariness because the margins apply regardless of the cost structures of taxpayers.<sup>49</sup>

However, as argued by Valadão and Lopes, these limitations have to be viewed along with the above-discussed advantages offered by the approach for taxpayers as well as tax administrations, which in turn make a case for working on the drawbacks of the system.<sup>50</sup> A possible area for reform could be making the procedure for seeking an adjustment to the pre-determined margins more taxpayer friendly.<sup>51</sup> Another area for improvement, where Brazil has already made advances, is the previously mentioned establishment of different profit margins for diverse sectors of the economy to achieve greater alignment between the margins and commercial reality.<sup>52</sup> Arguably, if genuine consideration of transfer pricing from developing countries' standpoint is the goal, working towards these and other ways of refining the Brazilian system and treating it as a notable example would be an important contribution.

**b. The existing practice of the ALP for determining prices of transactions between associated enterprises, and India's and China's attempts to align allocation of risk with economic activity**

The author's empirical analysis of India and China's bilateral tax treaties shows that all of these treaties contain an Article 9(1) along the lines of Article 9(1) of the OECD

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<sup>48</sup> UN TPM (n 4) para 10.2.7.2. See also João Marcus de Melo Rigoni, 'A Brazilian View on Base Erosion and Profit Shifting: An Alternative Path' (2014) 42 Intertax 730, 736.

<sup>49</sup> UN TPM (n 4) para 10.2.7.2.

<sup>50</sup> Valadão and Lopes (n 43) 66.

<sup>51</sup> Ilarraz (n 11) 234.

<sup>52</sup> *ibid.*

Model and the UN Model. Thus, both India and China agree with the theory of the ALP. Additionally, almost 68% of India's bilateral tax treaties have Article 9(2) that provides for correlative adjustment.<sup>53</sup> In comparison, almost 93% of China's bilateral tax treaties contain such a provision.<sup>54</sup> About 3% of India's bilateral tax treaties also have an Article 9(3) corresponding to Article 9(3) of the UN Model.<sup>55</sup> Only 2% of China's bilateral tax treaties have this provision.<sup>56</sup>

The domestic laws of India and China also reflect this allegiance to the ALP.<sup>57</sup> These countries have a broader view of associated enterprises for transfer pricing purposes.<sup>58</sup> They also permit the use of a transfer pricing method not outlined in the OECD TPG and the UN TPM as long as it complies with the ALP.<sup>59</sup> Other fundamentals in the practice of the ALP, such as the idea of comparability, relevant factors for establishing comparability, and the steps to be followed in choosing the most appropriate transfer pricing method, however, remain largely similar to those contained in the OECD TPG and the UN TPM.<sup>60</sup> Despite this proximity, India and China have reacted to the potential for the functions performed and the assets used by

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<sup>53</sup> Annexure V.

<sup>54</sup> Annexure VI.

<sup>55</sup> Annexure V.

<sup>56</sup> Annexure VI

<sup>57</sup> Income Tax Act 1961 (Act 43 of 1961), s 92; Enterprise Income Tax Law of the People's Republic of China 2007, Article 41.

<sup>58</sup> Income Tax Act 1961 (n 57) s 92A; Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law 2007, Article 109. See also Guo Shui Fa [2009] No 2 - Circular of the State Administration of Taxation on the Implementation Measures of Special Tax Adjustments 2009, Article 9.

<sup>59</sup> Income Tax Act 1961 (n 57) s 92C; Income Tax Rules 1962, Rule 10 AB; Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law 2007 (n 58) Article 111 and Article 115.

<sup>60</sup> Income Tax Act 1961 (n 57) s 92C; Income Tax Rules 1962 (n 59) Rule 10AB, Rule 10B(1), Rule 10B(2), and Rule 10C; Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law 2007 (n 58) Article 111; Circular 2 (n 58) Article 23-27.

enterprises operating in these countries being undermined by the treatment of risk in the existing practice of the ALP, particularly as discussed in the OECD TPG.

The OECD TPG point out that, as in the case of independent enterprises, taking on greater risks will be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.<sup>61</sup> The OECD TPG take the contractual allocation of risk between associated enterprises as the starting point for determining which party to the transaction bears the risk in relation to it.<sup>62</sup> In the absence of a written contract containing the agreed terms, this is to be deduced from the parties' conduct.<sup>63</sup> Tax administrations are entitled to challenge an assignment of risk between associated enterprises, if it is inconsistent with the economic substance of the transaction.<sup>64</sup>

When there are no suitable internal or external comparables to help make this assessment, the emphasis shifts to ascertaining whether the distribution of risk is that which independent parties in comparable circumstances might have agreed to.<sup>65</sup> The OECD TPG suggest 'control over risk' and the 'financial capacity to assume the risk' as the criteria relevant for this purpose.<sup>66</sup> Control over risk is explained as the capacity to decide to take on the risk, and whether and how to manage the risk.<sup>67</sup> This, in turn, requires having 'people – employees or directors', who have the authority to perform

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<sup>61</sup> OECD TPG (n 4) para 1.45.

<sup>62</sup> *ibid* para 9.11.

<sup>63</sup> *ibid*.

<sup>64</sup> *ibid* para 9.12.

<sup>65</sup> *ibid* para 9.19.

<sup>66</sup> *ibid* para 9.20.

<sup>67</sup> *ibid* para 9.23.

these control functions.<sup>68</sup> Financial capacity to assume the risk is elucidated as the fiscal capacity of the company at the time the risk is allocated to it to protect itself from the consequences of the risk materialising.<sup>69</sup>

Although the UN TPM's position on assignment of risks between associated enterprises is otherwise the same as the OECD's, the UN TPM's discussion on control of risks engages more extensively with functional profiles of the associated enterprises. According to the UN TPM, the factors relevant for determining which enterprise controls risk include: core functions; key responsibilities, such as formulation of plan and policy, budget, fixation of goals and targets etc.; strategic decisions or decisions that have a greater potential to impact an enterprise's ability to generate profits and the amount of profits; and the level of individual responsibility for such decisions.<sup>70</sup> The last aspect depends, among others, on the location of the core functions and the contribution to the central aspects of these functions.<sup>71</sup>

More in line with the preceding paragraph, the Indian Revenue Service's (IR) position in chapter 10 of the UN TPM is that, 'risk of an 'MNE is a by-product of its functions and ownership and exploitation or use of assets employed over a period of time. Accordingly, risk is not an independent element, but is similar in nature to functions and assets'.<sup>72</sup> Thus, 'it is unfair to give undue importance to risk in determining arm's length price in comparison to functions performed and assets

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<sup>68</sup> *ibid.*

<sup>69</sup> *ibid* para 9.29 and para 9.32.

<sup>70</sup> UN TPM (n 4) para 5.3.2.26.

<sup>71</sup> *ibid.*

<sup>72</sup> *ibid* para 10.4.4.1.

employed'.<sup>73</sup> The IR does not challenge the contractual freedom of associated enterprises to allocate risk among them. It, however, emphasises that conduct of the parties is key to ascertaining whether the actual assignment of risk conforms to the contractual division.<sup>74</sup>

The IR acknowledges that control over risk is important in this determination.<sup>75</sup> Like the UN TPM, it considers core functions, key responsibilities and decision-making, and the level of individual accountability for important decisions as the vital factors for identifying which party controls the risk.<sup>76</sup> In fact, going a step further, the IR disagrees that risk can be controlled remotely by the parent company when the core functions are located in India.<sup>77</sup> It believes that such functions require strategic decision-making by the management and the employees of the Indian entity in terms of design, direction, and monitoring.<sup>78</sup> This gives the Indian entity control over a substantial part of the risk.<sup>79</sup> Thus, the parent should receive appropriate returns for providing funds and overall direction.<sup>80</sup> Regardless of how the parties have split the risk contractually, the Indian entity should, however, be entitled to a suitable compensation for undertaking the core functions and the risks related to them, which is not reflected by a low cost-plus return.<sup>81</sup>

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<sup>73</sup> *ibid.*

<sup>74</sup> *ibid* para 10.4.4.2.

<sup>75</sup> *ibid.*

<sup>76</sup> *ibid.*

<sup>77</sup> *ibid* para 10.4.4.4.

<sup>78</sup> *ibid.*

<sup>79</sup> *ibid* para 10.4.4.4 and para 10.4.4.5.

<sup>80</sup> *ibid* para 10.4.4.5.

<sup>81</sup> *ibid.*

In practice, the IR has applied this position strongly in the case of contract research and development (R&D) centers in India.<sup>82</sup> In 2013, India's Central Board of Direct Taxes released Circular 6, which sets out the parameters for establishing whether an Indian contract R&D provider bears insignificant risk. The first of these factors is that the foreign principal either itself, or through its associated enterprises, performs most of the economically significant functions.<sup>83</sup> Another key parameter is that the Indian entity works under the direct supervision of the foreign principal or its associated enterprise, which has the capability to, and also actually controls and supervises, research or product development through strategic decisions to perform the core functions, as well as monitors activities on a regular basis.<sup>84</sup> Circular 6 directs the Revenue authorities to decide on the most appropriate transfer pricing method based on the totality of the facts and circumstances, and these guidelines. Also, according to the Circular, if the foreign principal is located in a low tax or no tax jurisdiction, it will be presumed that it does not control the risk.<sup>85</sup>

The Chinese position in the UN TPM elucidates the issue in a wider context. It states that in many areas, such as contract and toll manufacturing, contract R&D, and sales, marketing and distribution, the emphasis on risk undermines the contribution of

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<sup>82</sup> The position of the Indian Revenue Service (IR) elucidated in the text has found approval at the level of the Income Tax Appellate Tribunal (ITAT). See *M/s GE India Technology Centre Private Limited v The Deputy Director of Income Tax, Circle 11 (3), Bangalore* Income Tax Appeal (ITA) No 789/Bang/2010 & 487 & 925/Bang/2011 (ITAT, Bangalore).

<sup>83</sup> Circular No 06 /2013 - Circular on Conditions Relevant to Identify Development Centres Engaged in Contract R&D Services with Insignificant Risk (29 June 2013) F No 500/139/2012. The Circular states that economically significant functions would include conceptualisation and design of the product, and providing strategic direction and framework.

<sup>84</sup> Other indicators of when the risk may lie with the foreign enterprise include: the foreign enterprise has ownership of the outcome of the research, with no such legal or economic ownership vesting in the Indian entity; the foreign enterprise itself or through its associated enterprises provides capital or economically significant assets and also remuneration to the Indian entity; and the Indian entity does not assume any economically significant risks.

<sup>85</sup> The Indian entity is allowed to rebut this presumption to the satisfaction of the Revenue authorities.

substantial functions and assets located in China. Consequently, despite the advantages offered by the Chinese entities of MNEs, owing to these entities' low-risk classification, little profits are allocated to them.<sup>86</sup> To explain this concern further, the Chinese section in chapter 10 of the UN TPM delves briefly into some of these areas.

For instance, it stipulates that one of the comparative advantages offered by China is a low cost, well-educated labour force that can undertake R&D activities for overseas principals.<sup>87</sup> Such operations generally take the form of contract R&D, where the 'contribution of developing countries is often underestimated'.<sup>88</sup> China's State Administration of Taxation (SAT) claims that sometimes the foreign entity purported to be responsible for R&D has neither the requisite technical expertise nor the financial capacity.<sup>89</sup> In other instances, on the one hand, the Chinese entity enjoys tax incentives in China based on ownership of valuable new technology; on the other hand, it claims to be a contract R&D provider with no significant intangibles.<sup>90</sup> According to chapter 10, 'China believes that it is not sufficient by itself that the majority of risks, such as those in the case of unsuccessful research, have been shifted to the foreign related party'.<sup>91</sup> Instead, these are some of the cases where low cost-plus returns to the Chinese entity will not be considered adequate, and a different method for apportioning profits, such as the profit split method (PSM), would be more appropriate.<sup>92</sup> This is because, as under the PSM, a 'proper analysis of the value

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<sup>86</sup> UN TPM (n 4) para 10.3.5.1.

<sup>87</sup> *ibid.*

<sup>88</sup> *ibid* para 10.3.5.4.

<sup>89</sup> *ibid.*

<sup>90</sup> *ibid.*

<sup>91</sup> *ibid.*

<sup>92</sup> *ibid.* Under the PSM, first the profit arising from a transaction between associated enterprises is identified. It is then divided between those enterprises based on their contribution in generating the

provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm's length return for the R&D entity'.<sup>93</sup>

Another example relates to manufacturing. The Chinese section in chapter 10 of the UN TPM discusses electronic manufacturing services (EMS), 'where the entire, or nearly the whole of manufacturing and assembly activities of a foreign EMS multinational group have been outsourced to its Chinese affiliate'.<sup>94</sup> It explains that the typical set-up of such operations is that the bulk of the workforce and tangible assets of the EMS group are located in China, including high-level operational staff.<sup>95</sup> The group's headquarters are located outside China, with the group's revenues supported by significant manufacturing contracts with third party global consumer electronics companies.<sup>96</sup> In such circumstances, it is unacceptable to China that the profits of the Chinese manufacturer are stripped away on the grounds that it is a contract or a toll manufacturer with a low-risk profile.<sup>97</sup> According to China, such classification has insufficient regard for the fact that sizeable assets and substantial headcount of the EMS group are located in China, with only a few management personnel residing outside the country.<sup>98</sup> China is of the view that in such cases a contribution analysis will be useful to ensure that the apportionment of profits

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profit, which should reflect the functions performed, the assets used, and the risks assumed by the enterprises or their FAR profiles, such that the division approximates that between independent parties.

<sup>93</sup> *ibid.*

<sup>94</sup> *ibid* para 10.3.6.1.

<sup>95</sup> *ibid* para 10.3.6.2.

<sup>96</sup> *ibid.*

<sup>97</sup> *ibid.*

<sup>98</sup> *ibid* para 10.3.6.3.

between related enterprises is commensurate with each party's input to the value chain in the group.<sup>99</sup>

In line with the position contained in chapter 10 of the UN TPM, SAT's Circular 363 stipulates that entities claimed as ones with limited functions should not assume any market or decision-making risks.<sup>100</sup> Such entities must maintain an appropriate level of profit in line with their functional and risk profiles. If they make losses, it is mandatory to file relevant documentation for that year for the SAT's scrutiny.<sup>101</sup> This idea of alignment between the functional profiles of Chinese entities, their risk classification, and their profit upside or downside is also expressed in Article 39 of Circular 2.<sup>102</sup> This position is further clarified by Jiangsu State Tax Bureau's 'Administrative Plan on International Tax Compliance for 2014-15' that, as discussed in chapter IV, was the first official position on issues covered in the BEPS project coming from China.

The Plan states that the apportionment of profits to an entity must match its actual economic activities, which are identified through elements such as workforce, fixed assets, and sales.<sup>103</sup> Where there is a mismatch of functional profile and risk categorisation, tax authorities will encourage voluntary compliance through reminders and specific enquiries, and in severe cases, conduct special investigations.<sup>104</sup> This is

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<sup>99</sup> *ibid.*

<sup>100</sup> Guo Shui Han [2009] No 363 - Notice on Strengthening the Monitoring and Investigation of Cross-Border Related-Party Transactions 2009, para 1.

<sup>101</sup> *ibid* para 3.

<sup>102</sup> Circular 2 (n 58) Article 39.

<sup>103</sup> Jiangsu State Tax Bureau (JSTB), 'Administrative Plan on International Tax Compliance – 2014 - 2015' (JSTB 2014) 5 <[www.dbriefsap.com/bytes/6June2014\\_BEPS.pdf](http://www.dbriefsap.com/bytes/6June2014_BEPS.pdf)> accessed 30 October 2014.

<sup>104</sup> *ibid* 12.

described by the Plan as a step towards ‘defining and winning China’s fair share in international taxation’.<sup>105</sup> As an example of this approach, the Plan suggests that in contract R&D cases, regardless of Chinese entities’ ostensible risk classification, there will be intense scrutiny of routine cost-plus returns to R&D centers based on their functions and assets, and accordingly, overall value generation for the group.<sup>106</sup>

The above paragraphs reflect that India and China are likely to put an allocation of risk between related enterprises that undermines the contribution of the economic activities taking place in these countries in the profitability of an enterprise to strict examination. This is particularly so when compared to the OECD TPG, which are more accepting of the separation between the location of income producing factors such as workforce and fixed assets and the division of risk between associated enterprises. As discussed previously in this chapter, in light of the Musgraves’ construct of INE, the difference between the Indian and Chinese practice of the ALP and that contained in the OECD TPG could be viewed as an area for working towards a fairer division of taxing rights from the standpoint of these countries.

Vann has argued that emphasis on functional analysis and FAR profiles was intended to prevent rather than create transfer pricing opportunities, but the overwhelming focus on risk in value creation by an enterprise has had the opposite effect.<sup>107</sup> There are two main reasons for this. First, as risk can be contractually

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<sup>105</sup> *ibid* 23.

<sup>106</sup> *ibid* 15-16.

<sup>107</sup> Richard J Vann, ‘Taxing International Business Income: Hard Boiled Wonderland and the End of the World’ (2010) 2 *World Tax Journal* 291, 326.

assigned, an MNE can move it at will among group entities.<sup>108</sup> Kleinbard supports this position, and mentions the existing international transfer pricing rules and contractual assignment of risk possible under them as factors contributing to the phenomenon of ‘stateless income’.<sup>109</sup> Second, Vann discusses that risk has come to be identified more with aspects such as the functions of a limited number of significant people and ownership of assets.<sup>110</sup> These too can be separated from core functions and the creation or acquisition and the use of those assets, and placed anywhere in the world. In both these scenarios, with risk goes a substantial amount of profit.<sup>111</sup> In view of this, Vann suggests appropriate limits on the freedom of contract between associated enterprises vis-à-vis assignment of risks, such as making risks follow functions.<sup>112</sup> Vann wants this change to be accompanied with a more general shift in importance for transfer pricing purposes from significant people functions to total labour costs, and from the ownership of assets to their use.<sup>113</sup>

In distinction, Schön accepts only those limitations on allocation of risks between associated enterprises that, according to him, are seen between independent entities. These include compensation for assumption of risk, whether through proportional participation in profit potential or an additional fee, and the capability to bear the risk.<sup>114</sup> Likewise, Schön rejects the emphasis on the notion of control for ascertaining the appropriateness of assignment of risks between associated

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<sup>108</sup> *ibid* 326-327.

<sup>109</sup> Edward D Kleinbard, ‘Stateless Income’ (2011) 11 Florida Tax Rev 699, 706.

<sup>110</sup> Vann, ‘Taxing International Business Income: Hard Boiled Wonderland and the End of the World’ (n 107) 327-336.

<sup>111</sup> *ibid* 326.

<sup>112</sup> *ibid* 327.

<sup>113</sup> *ibid* 332, 336, 339-340.

<sup>114</sup> Wolfgang Schön, ‘International Taxation of Risk’ (2014) 68 Bulletin for Int’l Taxation 280, 288.

enterprises.<sup>115</sup> Schön acknowledges some cases where risk shifting within an MNE leads to profit shifting.<sup>116</sup> These include intra-group distribution of risk premiums, as any risk is ultimately borne by the shareholders of the parent company.<sup>117</sup> For him, other than in such cases, there should not be a departure from aspects central to the ALP-based approach to income allocation, such as ownership, funding, and contracts.<sup>118</sup> According to Schön, replacing these with a focus on ‘real activities’, or the existence of people performing the core functions and the assets used in the process in a particular jurisdiction, would be more of a formulary approach.<sup>119</sup> Other commentators have expressed similar disagreement with crossing the boundaries of the prevailing understanding of the ALP.<sup>120</sup>

Unrelated parties enjoy contractual freedom. The most basic expectation from a rational party operating independently in the market is, however, that it will seek returns reflecting at least the functions the party actually performs, the assets it uses, and the risks it actually controls and manages.<sup>121</sup> In this sense, an application of the ALP that gives due consideration to the relationship between these aspects, and to these attributes’ alignment with the profits allocated to associated enterprises, is

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<sup>115</sup> *ibid* 288-289.

<sup>116</sup> *ibid* 291-292.

<sup>117</sup> *ibid* 291.

<sup>118</sup> *ibid* 290.

<sup>119</sup> *ibid* 286.

<sup>120</sup> Carlo Garbarino and Mario D’Avossa, ‘The OECD Intangibles Project and the Concept of Intangibles Related Return’ (2015) 55 *European Taxation* 12, 15-17; Martijn de Lange, Paul Lankhorst, and Rutger Hafkenscheid, ‘(Non-) Recognition of Transactions between Associated Enterprises: On Behaving in a Commercially Rational Manner, Decision-Making Traps and BEPS’ (2015) 22 *Int’l Transfer Pricing Journal* 85, 93-94; David Ernack, ‘Integration, Fragmentation, and Global Value Chains – The Beginning of the End of the Arm’s Length Principle’ (2015) 44 *Tax Management Int’l Journal* 167, 168, 171. See also George Kofler, ‘The BEPS Action Plan and Transfer Pricing: The Arm’s Length Standard Under Pressure?’ [2013] *B T R* 646, 660-664.

<sup>121</sup> Patrick Breslin, ‘Coin Flips, Rational Decisions and Risk: Support for OECD Draft Guidance on Chapter I’ (2015) 23 *Tax Management Transfer Pricing Report* 1, 1-2, 6-7.

within the boundaries of the ALP. In such a scenario, refusing a move towards a practice of the ALP that furthers these ideas appears to give some kind of sacrosanct position to the prevailing usage of the ALP, even when there is awareness of its negative consequences.<sup>122</sup>

Thus, positions such as those of India and China discussed in this part should, in fact, be seen as an opportunity to assess how the ALP can be made to better reflect the actual operations underlying profit generation or value creation in modern day MNEs. They should also be viewed as a chance to think about the ALP and its implementation from the standpoint of countries with different levels of economic development and administrative capacities. As seen in chapter III, this opportunity was missed when the LONs, the OECD, and even the UN decided on these issues.<sup>123</sup>

**c. Application of the ALP under Article 7 of the OECD Model for attributing profits to PEs and the BICs – Another attempt to protect their tax base in an administratively simpler manner**

The existing Article 7 of the OECD Model, which was introduced in 2010, encompasses a two-step process for attributing profits to PEs. The first step is a functional and factual analysis to hypothesise PE as an entity separate from the rest of the enterprise, which undertakes functions, owns and/or uses assets, and assumes

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<sup>122</sup> Michael C Durst, 'The Two Option Compromise for Intangibles Pricing Guidelines' (4 June 2012) Tax Notes 1277, 1278-1279. See also Michael C Durst, "'Risk" and the OECD Discussion Drafts on Transfer Pricing' (15 October 2012) Tax Notes Int'l 285.

<sup>123</sup> Text to n 41-49 and 160-166 in chapter III.

risks.<sup>124</sup> The second step is to apply the OECD TPG by analogy to establish the prices of all transactions between the PE and other parts of the enterprise or ‘dealings’.<sup>125</sup> As it was believed that this method of attributing profits to PEs did not conflict with paragraph 2 of the pre-2010 Article 7, it was introduced in the Commentary to Article 7(2) of the 2008 version of the OECD Model.<sup>126</sup> This was most directly the result of the recommendations contained in the OECD’s 2008 report on attribution of profits to PEs.<sup>127</sup> Such functionally separate entity treatment of a PE, however, leaves no room for single-entity idea influenced features, such as the denial of deductions for mark-ups on dealings between the PE and others parts of the enterprise.<sup>128</sup>

The extent to which Article 7 of the pre-2008 OECD Model considered the PE and other parts of the enterprise as one unit has been a controversial issue.<sup>129</sup> At the heart of the debate was whether Article 7(1) supported the relevant business activity approach or the functionally separate entity view.<sup>130</sup> This was of particular interest in

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<sup>124</sup> OECD Model 2014 (n 3) Commentary to Article 7, para 21. As discussed in para 21, this involves attributing to the PE those risks and assets for which significant people functions relevant to the assumption of those risks and to the economic ownership of those assets are performed. See also Luis Nouel, ‘The New Article 7 of the OECD Model Tax Convention: The End of the Road’ (2011) 65 Bulletin for Int’l Taxation 5, 7.

<sup>125</sup> *ibid* para 22. See also Kasper Dziurdz, ‘Attribution of Functions and Profits to a Dependent Agent PE: Different Arm’s Length Principles under Articles 7(2) and 9?’ (2014) 6 World Tax Journal 135, 139-140.

<sup>126</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2008) Commentary to Article 7, para 17-18.

<sup>127</sup> OECD, ‘Report on the Attribution of Profits to Permanent Establishments’ (OECD 17 July 2008) <[www.oecd.org/tax/transfer-pricing/41031455.pdf](http://www.oecd.org/tax/transfer-pricing/41031455.pdf)> accessed 20 Dec 2014.

<sup>128</sup> Catherine Bobbett and John F Avery Jones, ‘The Proposed Redraft of Article 7 of the OECD Model’ (2010) 64 Bulletin for Int’l Taxation 20, 22.

<sup>129</sup> Philip Baker and Richard S Collier, ‘General Report’ in IFA (ed), *The Attribution of Profits to Permanent Establishments*, Cahiers de Droit Fiscal International Vol 91B (IFA 2006) 21, 25-53. See also Michael Kobetsky, ‘Article 7 of the OECD Model: Defining the Personality of Permanent Establishments’ (2006) 60 Bulletin for Int’l Taxation 411.

<sup>130</sup> *ibid* 30-31. See also Kobetsky, ‘Article 7 of the OECD Model: Defining the Personality of Permanent Establishments’ (n 129) 415-417. The relevant business activity approach involves allocating to the PE the profits arising from the business activities of the enterprise (earned from transactions between the enterprise and third parties or other associated enterprises), through the use of

light of Article 7(2) that, as seen in chapter III, attributed profits to a PE as if the PE was a distinct and a separate entity dealing wholly independently with the enterprise of which it was a part.<sup>131</sup> The question was further complicated by Article 7(3), which provided that only expenses incurred for the purposes of the PE, including executive and administrative expenses, whether in the country in which the PE was situated or elsewhere, were to be deducted in ascertaining the PE's profits. Particular confusion was caused by the part of the Commentary to the paragraph that prohibited deduction for royalties, interest (other than in the case of banking enterprises), and fees for services and management, paid by the PE to other parts of the enterprise and vice-versa, except to the extent of reimbursement of actual expenses.<sup>132</sup> This position, in fact, continued in the Commentary to Article 7(3) of the 2008 version of the OECD Model.<sup>133</sup>

Although this point was not articulated in the Commentary to the 2008 version of Article 7 of the OECD Model, the OECD's 2008 report on attribution of profits to PEs stated that a study of the evolution of the provision does not support the idea that Article 7(3) was meant to restrict the separate entity treatment of a PE envisaged under Article 7(2) of the pre-2010 OECD Model.<sup>134</sup> According to the report, the

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the ALP as envisaged under Article 7(2), or any other method as permitted under the then Article 7(4). In contrast, the functionally separate entity view treats the PE as a distinct entity for the purpose of all transactions including dealings. Thus, the PE's accounts, as opposed to the profits made by the enterprise as a whole, are the starting point for determining its profits.

<sup>131</sup> The Commentary to the Article made the issue more difficult by stating that a PE's accounts were the basis for determining its profits, but then suggesting that where appropriate, it was also possible to resort to other methods of allocating profits to the PE. See OECD, *Model Tax Convention on Income and on Capital* (OECD 2005) Commentary to Article 7, para 24. This point was, in fact, also mentioned in para 51 of the Commentary to Article 7 of the 2008 version of the OECD Model.

<sup>132</sup> OECD Model 2005 (n 131) Commentary to Article 7, para 17.4-17.7 and para 18. See also Kobetsky, 'Article 7 of the OECD Model: Defining the Personality of Permanent Establishments' (n 129) 422-425.

<sup>133</sup> OECD Model 2008 (n 126) Commentary to Article 7, para 27 and para 31-42.

<sup>134</sup> OECD, 'Report on the Attribution of Profits to PE 2008' (n 127) para 286.

provision was only aimed at ensuring that the deduction of expenses of a PE was not refused for inappropriate reasons, such as because the expenses were incurred outside the country in which the PE was located.<sup>135</sup> The report suggested that the inclusion of statements proscribing deduction of notional payments of royalties, interest (except in the case of banking enterprises), and fees for services and management in the Commentary to Article 7(3) since 1963, and Article 7(2) of the OECD Model being made subject to Article 7(3) in 1977, created the misleading impression of part-separate, part-single entity treatment of PEs under Article 7.<sup>136</sup> In order to eliminate such aspects, which conflicted with the functionally separate entity view of PEs, the OECD decided to introduce the new Article 7 in the 2010 update to the Model.

As discussed in chapter III, the LONs' engagement with attribution of profits to PEs lends itself more favourably to the report's position. The UN's work on Article 7 was, however, also influenced by the OECD's acknowledgment of the theoretical incompatibility of and the practical difficulties in recognising at least certain notional payments in determining a PE's profits in the Commentary to Article 7(3) of the OECD Model.<sup>137</sup> Hence, Article 7(3) of the UN Model states that only expenses actually paid to or by a PE will be taken into account in attributing profits to PEs. Additionally, the provision also stipulates that payments by way of royalties, interest (except in case of banking enterprises), fees for specific services and for management made to or by a PE to other parts of the enterprise otherwise than towards reimbursement of actual expenses, should not be considered for this purpose.

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<sup>135</sup> *ibid* para 285.

<sup>136</sup> *ibid* para 287.

<sup>137</sup> OECD, *Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* (OECD 1963) Commentary to Article 7, para 15-18; OECD, *Model Tax Convention on Income and on Capital* (OECD 1977) Commentary to Article 7, para 17-22.

Arguably, owing to this position in the text of Article 7(3), with Article 7(2) being subject to it, under Article 7 of the UN Model, there was always greater room for contending part-separate, part-single entity treatment of a PE or, in other words, for the limited application of the ALP for determining a PE's profits.<sup>138</sup> This is, however, indisputably in conflict with the new Article 7 of the OECD Model.

The BICs have reserved their right to use the pre-2010 version of Article 7 of the OECD Model. As mentioned previously in this section, like the UN Model, the Commentary to Article 7(3) of the pre-2010 OECD Model rejected deduction for notional payments in ascertaining a PE's profits. The author's empirical analysis of the provision for attribution of profits to PEs in the BICs' bilateral tax treaties shows that Brazil largely adopts this Article, but four of Brazil's bilateral tax treaties also use the detailed language of Article 7(3) of the UN Model for specifying the deductions allowed in determining a PE's profits.<sup>139</sup> About 45% of India's bilateral tax treaties follow Article 7(3) of the UN Model.<sup>140</sup> Similarly, approximately 47% of China's bilateral tax treaties include this provision.<sup>141</sup> The rest contain the pre-2010 Article 7 of the OECD Model.<sup>142</sup>

To check for any post-2010 change in the BICs' positions, the author focused separately on the treaties signed by these countries in and after 2010. The result, however, is not very different. Article 7 of Brazil's only bilateral tax treaty signed in

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<sup>138</sup> Richard J Vann, 'Do We Need 7(3)? History and Purpose of the Business Profits Deduction Rule in Tax Treaties' in John Tiley (ed), *Studies In The History Of Tax Law* (Hart Publishing 2011) vol 5, 393, 420.

<sup>139</sup> Annexure IV.

<sup>140</sup> Annexure V.

<sup>141</sup> Annexure VI.

<sup>142</sup> *ibid.*

this period continues the trend of following the pre-2010 Article 7 of the OECD Model.<sup>143</sup> Out of the 14 treaties concluded by India during this time, only 1 does not use the detailed language of Article 7(3) of the UN Model for stipulating the deductions permitted in attributing profits to PEs.<sup>144</sup> All of the bilateral tax treaties entered into by China in and after 2010 contain Article 7 of the pre-2010 version of the OECD Model.<sup>145</sup>

Viewing this continuing divergence from the separate entity treatment of a PE to the extent envisaged under the existing Article 7 of the OECD Model in light of the Musgraves' construct of INE, it could be said that the provision does not result in an acceptable gain in the national wealth of these countries or can lead to an unacceptable loss in their national wealth.<sup>146</sup> In other words, Article 7 of the OECD

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<sup>143</sup> Annexure IV.

<sup>144</sup> Annexure V.

<sup>145</sup> Annexure VI.

<sup>146</sup> The BICs' domestic laws also support this divergence. For instance, Indian law as well as Chinese law denies deduction of notional payments of rentals, royalties, interest (except in the case of banking enterprises), fees for technical services, and management fees paid by a PE to other parts of the enterprise. They also provide for recourse to other methods for attributing profits to PEs that are administratively easier than applying the OECD TPG or domestic transfer pricing provisions based on the same. See IT Act 1961 (n 57) ss 44DA and 44C; Income Tax Rules 1962 (n 59) Rule 10; Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law 2007 (n 58) Article 49 and Article 50; Guo Shui Fa [2010] No 19 – Administrative Measures for the Levy and Collection of Income Tax of Non-Resident Enterprises on Deemed Basis (2010), Article 4. Owing to the strong reliance on taxation at source and the greater ease in operating as a subsidiary in Brazil, Brazilian tax authorities rarely engage with the concept of PE and the rules for attribution of profit to PEs in Brazil's limited number of bilateral tax treaties. The domestic law in any case does not allow deduction for intra-entity payments of royalties, and fees for technical, administrative, scientific, and other services. The deduction for interest paid by a Brazilian resident to a related party outside Brazil is also limited. See Law 9430/96 (n 11) Article 18(9) and Article 22; Decree 3000 of 26 March 1999 (Income Tax Regulations), Article 353 and Article 354. See also Alexandre Siciliano Borges and Ana Carolina Pereira Monguilod, 'Brazil' in Rafaele Russo (ed), *The Attribution of Profits to a Permanent Establishment - The Taxation of Intra-Company Dealings* (IBFD 2005) 97; Rubens Branco, 'Brazil' in IFA (ed), *Source and Residence: A New Configuration of their Principles*, Cahiers de Droit Fiscal International Vol 90A (IFA 2005) 211; André de Souza Carvalho, 'Brazil' in IFA (ed), *Is There a Permanent Establishment?*, Cahiers de Droit Fiscal International Vol 94A (IFA 2009) 151, 156, 157, 163; Luís Eduardo Schoueri, 'Brazil' in Brauner and Pistone (n 34) 41, 52.

Model could be seen as giving rise to an unfair division of rights to tax active business income from the BICs' standpoint.

The rationale behind this result is made clear in India's and China's official positions on the existing Article 7 of the OECD Model. India does not agree with the 'approach underlying the new Article 7 of the OECD Model'.<sup>147</sup> As discussed by Kobetsky, an international enterprise and its PEs are part of a unitary business with a joint profit-making goal.<sup>148</sup> Hence, they are expected to act as integrated entities, with transactions between them being governed by common control rather than contracts representing competing interests.<sup>149</sup> Therefore, the use of the ALP for assessing intra-entity transactions is normatively flawed.<sup>150</sup> Vann has also made a similar argument in terms of focus on economic unity within an enterprise.<sup>151</sup> India's more fundamental theoretical opposition to Article 7 of the OECD Model could be considered reflective of such views, at least to the extent the separate entity fiction embodied in Article 7 of the OECD Model could undermine the country's tax base.

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<sup>147</sup> OECD Model 2014 (n 3) Non-OECD Economies' Positions on Article 7 of the OECD Model, para 1.1.

<sup>148</sup> Kobetsky, 'Article 7 of the OECD Model: Defining the Personality of Permanent Establishments' (n 129) 411, 425.

<sup>149</sup> *ibid*

<sup>150</sup> *ibid*. See also Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (CUP 2011) 391.

<sup>151</sup> Richard J Vann, 'Reflections on Business Profits and the Arm's Length Principle' in Brian J Arnold, Jacques Sasseville, and Eric M Zolt (eds), *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation (CTF) 2003) 133, 167. Vann, in fact, uses this rationale to urge for treating subsidiaries like PEs (as PEs were treated in the then Article 7 of the OECD Model) rather than stretching the separate entity fiction in the opposite direction, as done by the new Article 7 of the OECD Model.

Arguably, recognition of intra-entity transactions with an emphasis on the PE's independent functions could benefit the country in which the PE is located.<sup>152</sup> However, as Edgar and Holland point out, this has to be seen along with the aspects that are much more likely to influence the flow of profits from that country, such as the recognition of intra-entity transfers of intangibles.<sup>153</sup> Russo has also discussed the possibility of reduction in the host country's tax base owing to deductions for notional payments in cases where they were specifically denied in the Commentary to Article 7(3) of the 2008 version of the OECD Model.<sup>154</sup> Apart from this, there is a more general issue of MNEs manipulating prices of notional transactions between the PE and other parts of the enterprise to reduce the host country's tax base. Because of these reasons, Schön has argued that transactions between a PE and other parts of the enterprise should be recognised only if they substantiate relevant allocation of costs within the whole enterprise, and that dealings between them must not be allowed to distort the allocation of taxing rights between source and residence countries.<sup>155</sup>

As seen in chapter I, like India, both Brazil and China still have strong interests as host countries. Therefore, concerns regarding the possible adverse impact of the separate entity fiction under Article 7 of the OECD Model on the tax base of host nations discussed in the preceding paragraph exist for these countries as well. Additionally, as highlighted by Couzin and also Vincent, there is the issue of

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<sup>152</sup> Mary C Bennett and Carol Dunahoo, 'The Attribution of Profits to a Permanent Establishment: Issues and Recommendations' (2005) 33 *Intertax* 51, 53.

<sup>153</sup> Tim Edgar and David Holland, 'Source Taxation and the OECD Project on Attribution of Profits to Permanent Establishments' (7 February 2005) 37 *Tax Notes Int'l* 525.

<sup>154</sup> Raffaele Russo, 'Tax Treatment of "Dealings" Between Different Parts of the Same Enterprise Under Article 7 of the OECD Model: A Century of Uncertainty' (2004) 58 *Bulletin for Int'l Fiscal Documentation* 472, 479. This is to the extent such payments are not subject to withholding tax in the host country.

<sup>155</sup> Wolfgang Schön, 'Attribution of Profits to PEs and the OECD 2006 Report' (4 June 2007) 46 *Tax Notes Int'l* 1059, 1072.

complexity in applying the OECD TPG's guidance on the implementation of the ALP where there are no separate legal entities.<sup>156</sup> This will demand greater expertise and resources on the part of tax administrations. Substantial skill, time, and effort would also be needed to check tax-planning techniques using notional intra-entity payments for reducing tax liability in the host country. Tax administrations of developing countries are often strained in terms of these aspects. China's official position on the existing Article 7 of the OECD Model articulates this problem.

China 'understands and respects the separate and independent enterprise principle' as embodied in the provision.<sup>157</sup> It has, however, made it clear that the country's administrative capacity does not allow the use of this fiction for determining the profits attributable to a PE.<sup>158</sup> Therefore, China has also reserved its right to use administratively simpler methods for this purpose.<sup>159</sup> Considering Brazil's strong preference for an administratively simpler approach to transfer pricing discussed in section (a), the relevance of the Chinese position can be understood for Brazil. As a developing country, a similar stance would benefit India as well.

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<sup>156</sup> Robert Couzin, 'The OECD Project: Transfer Pricing Meets Permanent Establishment' (2005) 53 *Canadian Tax Journal* 401, 407-408; François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: The Case For Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)' (2005) 53 *Canadian Tax Journal* 409, 413-414. See also Annet Wanyana Oguttu, 'The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective' (2010) 64 *Bulletin for Int'l Taxation* 165, 169.

<sup>157</sup> OECD Model 2014 (n 3) Non-OECD Economies' Positions on Article 7 of the OECD Model, para 1.3.

<sup>158</sup> *ibid.*

<sup>159</sup> *ibid.*

Under Article 7 of both the OECD Model and the UN Model, the basic position is that the host country can tax only those profits that are attributable to a PE.<sup>160</sup> Therefore, the concept of PE and the rules for attribution of profits to PEs are of central importance in the division of rights to tax active business income between home and host countries. Over the years, the concept of PE in the Commentary to Article 5 of the OECD Model has been somewhat relaxed and expanded to accommodate changes in business methods facilitated by technological developments and an increasingly globalised economy.<sup>161</sup> This has a potentially widening impact on the scope of the host country's right to tax. In view of this trend, from the standpoint of host countries at least, it makes little sense that the rules for attribution of profits to PEs are then altered in a way that can negatively impact their tax base.<sup>162</sup>

Achieving uniformity in the interpretation of Article 7 was given as one reason for introducing the new provision in the OECD Model.<sup>163</sup> Arguably, the same end could have been achieved by making a choice in favour of an interpretation of Article 7 of the OECD Model that was less threatening to the interests of host countries. Another justification given for the change was the need for administrative simplicity.<sup>164</sup> That, as seen above, does not appear to be a good explanation from the perspective of the BICs and even other developing countries. Thus, overall, one is

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<sup>160</sup> Additionally, Article 7(1) of the UN Model provides for a limited force of attraction rule discussed in chapter III. See UN Model 2011 (n 3) Commentary to Article 7, para 6-7.

<sup>161</sup> The introduction of the discussion on server PE and deemed service PE in para 42.1-42.10 and para 42.11-42.48 of the Commentary to Article 5 are befitting examples in this regard.

<sup>162</sup> Vann, 'Reflections on Business Profits and the Arm's Length Principle' (n 151) 147, 165.

<sup>163</sup> OECD, 'Report on the Attribution of Profits to PE 2008' (n 127) para 8.

<sup>164</sup> OECD, 'Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading)' (2006) Part I, para 3 <[www.oecd.org/tax/transfer-pricing/37861293.pdf](http://www.oecd.org/tax/transfer-pricing/37861293.pdf)> accessed 20 December 2014.

compelled to question whether this change in the OECD Model was adequately considered from these countries' perspective.

## **II. Seeking recognition for distinct contributions in the profitability of MNEs and the prevailing practice of the ALP**

Starting from Franck's leading work in international law, chapter two outlined how the concept of fairness in the global sphere has a procedural and a substantive component.<sup>165</sup> Chapter II highlighted how the international taxation literature focuses on fairness in the outcome. It leveraged this emphasis to propose benchmarks for assessing and advancing substantive fairness in the international taxation framework. The parameter for the latter, which draws from the doctrine of economic allegiance, is whether a division of taxing rights between countries recognises a country's role or contribution in the profitability of the enterprise.<sup>166</sup> As shall be seen in the following paragraphs, India's and China's focus on accounting for location savings and other location-specific advantages (LSAs) in determining the profits apportioned to enterprises operating in these countries, is an effort in this direction.

According to the OECD TPG, allocation of location savings or cost savings in relocating operations from high-cost to low-cost countries depends on what independent parties in similar circumstances would have agreed upon.<sup>167</sup> This, in turn, would be based on their respective FAR profiles and, accordingly, their bargaining

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<sup>165</sup> Text to n 105-117 in chapter II.

<sup>166</sup> Text to n 138-149 in chapter II.

<sup>167</sup> *ibid* OECD TPG (n 4) para 9.149.

powers.<sup>168</sup> Discussing the issue in greater detail, the UN TPM explains that the possibility of deriving location savings may vary from country to country depending on factors like costs of labour, raw materials, transportation, rents, and governmental incentives, including tax exemptions.<sup>169</sup> The UN TPM points out that ‘dis-savings’ owing to aspects like the poor quality and unreliability of infrastructure, and inferior control of standards may offset these savings.<sup>170</sup> Thus, only net location savings are attractive for an MNE.<sup>171</sup> Unlike the OECD TPG, the UN TPM also engages substantially with other types of location-related benefits, such as skilled manpower and proximity to growing local or regional markets, that can give rise to incremental profits or location rent.<sup>172</sup> The UN TPM addresses these and location savings as LSAs that have become a ‘key transfer pricing issue for developing countries’.<sup>173</sup>

The UN TPM explains that the extent to which LSAs would lead to location savings and/or rent depends on the nature of an enterprise’s access to them.<sup>174</sup> For instance, location savings and/or rent might exist when the enterprise has exclusive access to LSAs. In a highly competitive market, most or all of the benefits of LSAs may, however, be passed to consumers in the form of lower prices.<sup>175</sup> Like the OECD TPG, the UN TPM suggests relying on suitable local comparables for allocating

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<sup>168</sup> *ibid.*

<sup>169</sup> UN TPM (n 4) para 5.3.2.39.

<sup>170</sup> *ibid.*

<sup>171</sup> *ibid* para 5.3.2.40.

<sup>172</sup> *ibid* para 5.3.2.41 and para 5.3.2.42.

<sup>173</sup> *ibid* para 1.10.15.

<sup>174</sup> *ibid* para 5.3.2.43.

<sup>175</sup> *ibid.*

location savings and rent between associated enterprises.<sup>176</sup> As stated before, the parties' respective bargaining powers are a key factor in the process.<sup>177</sup>

Along the lines of the UN approach, the Indian position in chapter 10 of the UN TPM focuses beyond cost-savings on the wider concept of LSAs.<sup>178</sup> The IR deviates from the OECD TPG and the UN TPM to the extent that it does not agree that local comparables can be used to achieve an arm's length allocation of location savings and rent.<sup>179</sup> The rationale is that local comparables will reflect the arm's length price between parties in the country offering the savings and/or the rent and not the difference in costs or additional profits accruing to enterprises because of relocating to that country.<sup>180</sup> Also, according to the IR, if an unrelated party has to compensate the party to the transaction in the jurisdiction offering LSAs by an amount equal to the cost of the savings and rent, there would be no incentive for the unrelated party to move business to that jurisdiction.<sup>181</sup> Therefore, arm's length compensation for location savings and rent should be such that both the parties would benefit from participating in the transaction.<sup>182</sup> Accordingly, the IR sees a method like the PSM, which can consider the contribution of both the enterprises to the profits generated from the transaction, as a suitable way of apportioning location savings and rent between associated enterprises.<sup>183</sup> However, the OECD TPG and the UN TPM view the PSM as an appropriate transfer pricing method only in the case of highly

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<sup>176</sup> *ibid* para 5.3.2.45.

<sup>177</sup> *ibid*.

<sup>178</sup> *ibid* para 10.4.7.1 and para 10.4.7.2.

<sup>179</sup> *ibid* para 10.4.7.4.

<sup>180</sup> *ibid*.

<sup>181</sup> *ibid* para 10.4.7.5.

<sup>182</sup> *ibid*.

<sup>183</sup> *ibid* para 10.4.7.3.

integrated operations or where both the parties contribute unique intangibles to the transaction.<sup>184</sup>

In the 2011 case of *Li & Fung International Group*, the Delhi Bench of the Income Tax Appellate Tribunal (ITAT) recognised the existence of location savings in a country like India, and held that the non-resident related party had benefitted from the Indian company's access to them.<sup>185</sup> The ITAT did not discuss the quantification and allocation of location savings. The Bench focused on the critical functions performed by the Indian company with tangible and intangible assets developed by it at its own cost, and significant risks assumed and managed by the Indian company in the process. According to the ITAT, these attributes had also enabled the Indian company to benefit from cost and other operational advantages in India.<sup>186</sup> The decision was, however, reversed by the High Court of Delhi on the ground of lack of sufficient evidence on the existence and the extent of location savings.<sup>187</sup>

Two subsequent ITAT decisions have taken a similarly less favourable view to the issue from the IR's perspective. In *Gap International*, and in the more recent *Watson Pharma* judgment, the competitive nature of the respective industries was seen as disabling the Indian company's exclusive access to location savings and

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<sup>184</sup> *ibid* para 6.3.17.1 and para 6.3.17.2; OECD TPG (n 4) para 2.109.

<sup>185</sup> *M/s Li & Fung Private Limited v Deputy Commissioner of Income Tax* ITA No 5156/Del/2010 (ITAT Delhi) para 8.

<sup>186</sup> *ibid*.

<sup>187</sup> *Li and Fung India Pvt Ltd v Commissioner of Income Tax* (2014) 264 CTR 441 (High Court of Delhi) para 49.

rent.<sup>188</sup> Interestingly, in *Watson Pharma*, the Mumbai Bench of the ITAT referred to the ‘Guidance on Transfer Pricing Aspects of Intangibles’ released as a part of the BEPS project in 2014. The Guidance states that location savings and other LSAs are not intangibles, and where functional analysis shows that location savings have not been passed to customers, reliance on local comparables is the most appropriate way of allocating them.<sup>189</sup> The ITAT held that, as the BEPS project was an OECD and G20 project, and India is a part of the G20, the country can be assumed to be in concurrence with this position.<sup>190</sup> This presumption, however, cannot be accepted in light of the IR’s approach in chapter 10 of the UN TPM, which in the absence of any governmental clarification or a binding decision of the Supreme Court of India (SC), the IR continues to pursue.

Like the consensus part of the UN TPM and the IR, China takes a broader view of LSAs.<sup>191</sup> The country is particularly interested in market premium, which is defined in chapter 10 of the UN TPM as the additional profit derived by an MNE by operating in a jurisdiction with ‘unique qualities impacting the sale and demand of the product or service’ like China.<sup>192</sup> The automotive industry is discussed as an example of one benefiting from location savings as well as market premium attributable to China’s booming population with growing wealth, and Chinese consumers’ general

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<sup>188</sup> *GAP International Sourcing (India) Private Limited v Assistant Commissioner of Income Tax* (2012) 149 TTJ 437 (ITAT Delhi) para 9.2; *M/s Watson Pharma Private Limited v Deputy Commissioner of Income Tax* (2015) 168 TTJ 281 (ITAT Mumbai) para 58.

<sup>189</sup> OECD, *Guidance on Transfer Pricing Aspects of Intangibles* (OECD 2014) para 1.83 and para 6.31. In the *GAP* case as well, the Delhi Bench of the ITAT had directed reliance on local comparables. See *GAP International Sourcing (India)* (n 188) para 9.2.

<sup>190</sup> *M/s Watson Pharma Private Limited* (n 188) para 61.

<sup>191</sup> UN TPM (n 4) para 10.3.3.1.

<sup>192</sup> *ibid* para 10.3.3.3.

preference for foreign brands and imported products, which creates a huge, inelastic demand for automobiles.<sup>193</sup>

The Chinese position in chapter 10 of the UN TPM is that the OECD TPG give limited guidance on LSAs that ‘arise more frequently in China and other developing economies rather than in established and developed economies (which comprise the bulk of the membership of the OECD)’.<sup>194</sup> China has adopted a four-step method to deal with the challenge of reconciling the ALP with the lack of suitable local comparables, which it believes is a key difficulty in dealing with LSAs. The first step is to identify if an LSA exists; the second is to determine whether the LSA generates savings and/or rent; the third step is to quantify and measure the savings and/or rent; and the last step is the allocation of those savings and/or rent.<sup>195</sup> For the final step, the SAT prefers to apply the PSM, which as stated before, diverges from the OECD TPG’s and the UN TPM’s position on when this transfer pricing method can be used.<sup>196</sup> The Chinese section in Chapter 10 of the UN TPM also suggests the use of the transactional net margin method (TNMM) with adjustments made to foreign comparables to allocate location savings and rent to Chinese enterprises.<sup>197</sup>

In line with the Chinese position in chapter 10 of the UN TPM, SAT’s Circular 84 released in 2010 emphasises that as an emerging economy, China offers MNEs

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<sup>193</sup> *ibid* para 10.3.3.6. Luxury goods sector is considered another example of one drawing substantial market premium.

<sup>194</sup> *ibid* para 10.3.3.1.

<sup>195</sup> *ibid* para 10.3.3.4.

<sup>196</sup> *ibid* para 10.3.5.11.

<sup>197</sup> *ibid* para 10.3.3.8 and para 10.3.3.9. The TNMM compares net profit margin relative to an appropriate base, such as costs, assets, sales etc. in a transaction between associated enterprises to the same profit margins earned by the enterprise being studied in a comparable uncontrolled transaction or by external comparables.

cheap land, labour, a large market with purchasing power of consumers, and other advantages that result in cost-savings and market premium.<sup>198</sup> The Circular requests developed countries to recognise and respect the contribution of these special economic factors in value created by the enterprise. In connection with this appeal, the Circular instructs local tax authorities to assist the SAT in realising additional profits arising in China due to these location-related benefits.<sup>199</sup> Circular 84 highlights that LSAs are being given increasing importance in bilateral Advance Pricing Agreement (BAPA) negotiations and transfer pricing audits. In fact, in 2009, RMB 0.5 billion was collected as additional tax revenue in BAPAs by applying the concept of location savings (and the subsequently discussed notion of marketing intangibles).<sup>200</sup>

The Jiangsu State Tax Bureau's previously mentioned Administrative Plan also reiterates that transfer pricing outcomes should be in line with value creation. Accordingly, China's 'unique and significant contributions' to the profitability of MNEs, particularly China's large domestic market and growing demand, must be duly reflected in the profits allocated to Chinese entities.<sup>201</sup> The Plan further directs adherence to the SAT's position on LSAs in chapter 10 of the UN TPM.<sup>202</sup>

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<sup>198</sup> Guo Shui Han [2010] No 84 – State Tax Administration Briefing on 2009 Anti-Avoidance Work 2010, 2.

<sup>199</sup> Through Guo Sui Han [2009] No 106 as well, the SAT has urged local tax authorities to carefully examine the information submitted by taxpayers for issues such as location savings.

<sup>200</sup> In 2010, in a seminar organised by the SAT, where participants included tax officials from different provinces, business representatives, academics etc., the SAT again emphasised that China should have priority right to tax the excess profits generated by market premium and cost savings. Need for more research in this area in order to safeguard China's revenue interests was also recognised. See SAT, 'International Comparative Study of Anti-Avoidance Measures – Summary of Seminar Topics' (SAT 2010) <[www.chinatax.gov.cn/n480462/n1845523/n1869581/9916519.html](http://www.chinatax.gov.cn/n480462/n1845523/n1869581/9916519.html)> accessed 10 May 2014.

<sup>201</sup> JSTB, 'Administrative Plan on International Tax Compliance – 2014 - 2015' (n 103) 2.

<sup>202</sup> *ibid* 2-3.

In view of the above it can be said that India and China treat LSAs as a distinct contribution that cannot be reflected suitably in the profits apportioned to enterprises operating in these countries based on local comparables or is difficult to account for through this mechanism. This approach towards LSAs, along with India's and China's projection of the PSM as a suitable alternative for this purpose, diverges from the OECD TPG and the UN TPM's position on the issue. Seen in light of the Musgraves' construct of INE, this deviation to attain a more acceptable gain in their national wealth than permitted under the OECD TPG's and the UN TPM's practice of the ALP could be considered an attempt towards a fairer apportionment of profits between associated enterprises from these countries' standpoint.

Allocating additional profits arising from LSAs is not a new issue.<sup>203</sup> As also reflected from the OECD TPG and the UN TPM, conventionally, the relative bargaining powers of associated enterprises have been considered central to this process.<sup>204</sup> This brings into play, among others, factors internal to MNEs, such as intangibles.<sup>205</sup> As the essence of LSAs is a unique contribution of a location in the profitability of an enterprise, the extent to which such aspects should be allowed to overshadow the same and take the benefit of LSAs away from the country that offered them in the first place is indeed questionable. For such reasons, Li criticises recourse

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<sup>203</sup> For a previous discussion of the issue in the US context see *Sundstrand Corporation and Subsidiaries v Commissioner of Internal Revenue* (1991) 96 TC 226 (United States Tax Court); *Compaq Computer Corporation and Subsidiaries v Commissioner of Internal Revenue* (1999) 78 TCM (CCH) 20 (United States Tax Court).

<sup>204</sup> Steven N Allen and others, 'Location Savings – A US Perspective' (2004) 11 Int'l Transfer Pricing Journal 158, 168-174; Merja Raunio, 'Supreme Administrative Court Ruling on Location Savings' (2013) 20 Int'l Transfer Pricing Journal 263, 264-265; Martijn A de Lange and Paul W H Lankhorst, 'The Impact of Location Advantages on the Transfer Pricing of Multinationals: On the Chinese Love For European Designer Handbags and Lower Production Costs in India' (2014) 21 Int'l Transfer Pricing Journal 223, 224.

<sup>205</sup> Steven N Allen and others (n 204) 168-174. See also Pankaj Jain and Vikram Chand, 'Location Savings: Indian and International Perspective' (2015) 43 Intertax 191, 196.

to ‘fuzzy notions’ of bargaining power to apportion location savings and rent between associated enterprises.<sup>206</sup>

Wilkie, in fact, questions if there even exists genuine bargaining power between associated enterprises, and therefore whether external comparables could ever be reliable for allocating location savings and rent.<sup>207</sup> He argues that LSAs are not intangibles in the legal sense, but they operate as if they were.<sup>208</sup> This is because the central idea underlying both the cases is of measuring distinct advantages and opportunities contributing to a firm’s profit and compensating fairly for them.<sup>209</sup> Thus, there is little logic in acknowledging that it is difficult to find suitable comparables for transactions involving intangibles, and accordingly allowing recourse to PSM, but insisting on reliance on local comparables where LSAs are concerned.<sup>210</sup>

Gonnet, Fris, and Coriano also contend that LSAs could be considered additional, location-specific intangibles that play an important role in a firm’s value creation.<sup>211</sup> They point out the unsuitability of local comparables for allocating location savings and rent between associated enterprises, and suggest the use of contribution analysis.<sup>212</sup> These commentators rightly state that determining the existence of LSAs, and whether and to what extent they result in location savings

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<sup>206</sup> Jinyan Li, ‘Global Profit Split: An Evolutionary Approach to International Income Allocation’ (2002) 50 *Canadian Tax Journal* 823, 835.

<sup>207</sup> J Scott Wilkie, ‘Intangibles and Location Benefits (Customer Base)’ (2014) 68 *Bulletin for Int’l Taxation* 352, 356.

<sup>208</sup> *ibid* 352.

<sup>209</sup> *ibid* 357 and 359.

<sup>210</sup> *ibid* 357.

<sup>211</sup> Sébastien Gonnet, Pim Fris, and Tommaso Coriano, ‘Location-Specific Advantages - Principles’ (2011) 06/11 *Transfer Pricing Int’l Journal* 1, 3.

<sup>212</sup> *ibid* 7.

and/or rent, demands a thorough analysis of competitive conditions and the company's market power.<sup>213</sup> As stated by Wilkie, LSAs are 'at the heart of the fundamental idea of determining the source of income', and thus, the division of taxing rights between countries.<sup>214</sup> Therefore, the complexity of this process should not be allowed to deter efforts towards methods of accounting for LSAs in transfer pricing analysis that are better aligned to the nature of LSAs, and accordingly, more suitably recognise the role of the country offering them in the profitability of an enterprise. Finding and accepting such methods will again require a change in thinking vis-à-vis the existing practice of the ALP. However, if it can lead to an application of the ALP that accommodates diverse value drivers of an MNE in an even-handed manner, and is more balanced from the standpoint of countries with different economic interests, then it is an exercise worth undertaking.

Both India's and China's focus on seeking recognition of such distinct contributions in the profits apportioned to enterprises operating in these countries is also reflected in their positions on marketing intangibles. Marketing intangibles generate promotional value for products and services, and thus aid in their commercial exploitation.<sup>215</sup> The Indian section in chapter 10 of the UN TPM highlights that transfer pricing of marketing intangibles is a particularly relevant issue in a country like India. This is because the country has 'unique market specific characteristics', such as market accessibility, a large customer base, and spending

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<sup>213</sup> *ibid* 4-6. See also Sébastien Gonnet, Makoto Ikeya, and Vladimir Starkov, 'Location Specific Advantages - Case Studies' (2011) 07/11 *Transfer Pricing Int'l Journal* 1.

<sup>214</sup> Wilkie (n 207) 352.

<sup>215</sup> UN TPM (n 4) 481. See also OECD, *Guidance on Transfer Pricing Aspects of Intangibles* 2014 (n 189) para 6.16.

power of customers.<sup>216</sup> According to the IR, because of these features, the Indian market has witnessed substantial marketing activities by Indian related parties of MNEs that result in the creation of local marketing intangibles.<sup>217</sup>

The IR believes that when an Indian company performs advertising, marketing, and promotion (AMP) functions, bears risks, and incurs AMP expenditure, beyond what a same or similar independent enterprise would perform or spend for its own benefit, the Indian company should be compensated for the return on the marketing intangibles.<sup>218</sup> Excess AMP expenditure along with a mark-up, or a share in the profits relating to the marketing intangibles have been discussed as suitable arm's length payments in such cases.<sup>219</sup> The existing decisions in the area are more favourable for the IR than in the case of location savings. Nevertheless, there appears to be a move towards a more holistic consideration of factors that play a role in brand building, and a more balanced assessment of AMP activities and expenditure in light of the Indian entity's overall functional profile.<sup>220</sup>

The Chinese position in chapter 10 of the UN TPM explains that while MNEs in developed countries often have superior intangibles, 'they need the fast growing markets in developing countries and the contribution of subsidiaries in these countries

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<sup>216</sup> UN TPM (n 4) para 10.4.8.12.

<sup>217</sup> *ibid.*

<sup>218</sup> *ibid* para 10.4.8.18.

<sup>219</sup> *ibid.*

<sup>220</sup> *Maruti Suzuki India Limited v Assistant Commissioner of Income Tax* (2010) 233 CTR 105 (High Court of Delhi); *M/s L.G. Electronics Private Limited v Assistant Commissioner of Income Tax* (2013) 22 ITR 1 (ITAT Delhi); *Sony Ericsson Mobile Communications India Private Limited v Commissioner of Income Tax* (2015) 276 CTR 97 (High Court of Delhi).

to develop these markets in order to monetise the value in such intangibles'.<sup>221</sup> The value of the intangibles received by the Chinese entity from the parent company in the initial stages of its operations may thus depend on the local efforts to promote and enhance them.<sup>222</sup> Accordingly, China's focus is on the AMP functions performed by the Chinese entity. PSM has been suggested as one of the methods for ensuring the appropriate apportionment of profits in cases where significant local marketing intangibles are identified.<sup>223</sup> In line with this position, the previously mentioned Circular 84 directs local tax authorities to help the SAT realise marketing intangibles related issues in China's favour.<sup>224</sup>

As seen in chapter IV, and also in the discussion on LSAs, the BICs are particularly interested in seeking recognition of the demand element's contribution to the profits allocated to enterprises operating in these countries. Their positions on marketing intangibles are a part of that emphasis. The use of these assets, and their eventual value, is linked integrally to the efforts and expenditure borne by the enterprise in the market State. These in turn derive their relevance from the potential demand of the goods or services in the State. Thus, appropriately accounting for such AMP activities and spending in the profits apportioned to the enterprise will be a step towards acknowledging the role of the demand factor in the profitability of MNEs.<sup>225</sup>

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<sup>221</sup> UN TPM (n 4) para 10.3.4.1.

<sup>222</sup> *ibid* para 10.3.4.2 and para 10.3.4.3. More generally as well, the Chinese position, as mentioned in chapter 10 of the UN TPM, is that where the Chinese entity has through use over the years, improved an intangible provided by a related party, even if that improvement has come through a trial and error, it raises the question of whether the Chinese entity should continue to pay the royalty initially decided, or whether it should be entitled to a return on intangibles developed by it.

<sup>223</sup> *ibid* para 10.3.5.11.

<sup>224</sup> Circular 84 (n 198) 4.

<sup>225</sup> Vann, 'Taxing International Business Income: Hard Boiled Wonderland and the End of the World' (n 107) 336-339.

### **III. International developments concerning the theory and the practice of the ALP and reflections for fairness in the international taxation rule-making process from the BICs' perspective**

Prior to the 2011 update to the UN Model, the Commentary to Article 9 of the Model recommended that as the OECD TPG represented internationally agreed principles on the application of Article 9 of the UN Model and the ALP embodied therein, all countries should follow the same for applying the ALP.<sup>226</sup> At the Seventh Session (2011) of the UN Tax Committee, the Committee experts from the BICs argued that this amounted to stating the role of the OECD TPG 'too broadly'.<sup>227</sup> This is because it appeared to endorse the suitability of the OECD TPG from the perspective of all countries.<sup>228</sup> These members sought that the Commentary should clarify that the OECD TPG are for 'guidance only'.<sup>229</sup>

Opposing this view, experts from OECD countries maintained that any departure from the then existing language of the Commentary to Article 9 of the UN Model would signal that the UN's interpretation of Article 9 was different from the OECD's.<sup>230</sup> They warned that this could result in potential disagreements between parties to existing and future bilateral tax treaties.<sup>231</sup> The compromise reached was to keep the language of the Commentary to Article 9 of the UN Model, *albeit* with the

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<sup>226</sup> UN DESA, *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2001) Commentary to Article 9, para 3.

<sup>227</sup> UN Tax Committee, 'Report on the Seventh Session' (2011) E/2011/45-E/C.18/2011/6, para 41.

<sup>228</sup> *ibid.*

<sup>229</sup> *ibid.*

<sup>230</sup> UN Tax Committee, 'Outcome of the 7th Session of the Committee of Experts on International Cooperation in Tax Matters (Geneva, 24-28 October 2011) – Executive Summary' (UN 2011) 2 <[www.un.org/esa/ffd/tax/seventhsession/ExecutiveSummary.pdf](http://www.un.org/esa/ffd/tax/seventhsession/ExecutiveSummary.pdf)> accessed 2 June 2014.

<sup>231</sup> *ibid.*

stipulation that the suggestion to follow the OECD TPG represented the view of the UN's Ad-Hoc Group of Experts, which has not been fully considered by the UN Tax Committee.<sup>232</sup>

In a 2012 letter to the UN, the Government of India's then representative in the meetings of the UN Tax Committee reacted to this change in strong terms. He stated that it was 'inconceivable' that the OECD TPG – a standard developed by 34 developed countries to suit their interests, could be considered 'internationally agreed principles' on the practice of the ALP.<sup>233</sup> According to him, when developing countries were not involved in shaping the initial drafting or the continuing developments in the OECD TPG, the UN Tax Committee could not take a decision on whether or not the OECD TPG should be followed by developing countries.

When the UN TPM, particularly chapter 10, is viewed in light of the preceding two paragraphs, it can be seen how the BICs' effective participation in the international taxation rule-making at the UN front has allowed these countries to clearly and comprehensively voice their discontent against the OECD TPG. It has also given them an opportunity to present alternative positions, even if the same were not achieved through the UN TPM itself. Going a step further, the BICs' participation in all stages of the rule-making process – from agenda-setting to decision-making, steered the UN Tax Committee to decide against following the new Article 7 of the OECD Model.

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<sup>232</sup> UN Report on the Seventh Session 2011 (n 227) para 44; UN Model 2011 (n 3) Commentary to Article 9, para 3.

<sup>233</sup> Sanjay Kumar Mishra, 'Letter from India's Permanent Mission to the UN, to the UN's Financing for Development Office' (25 March 2012) <[www.un.org/esa/ffd/tax/2012ICTM/LetterIndia.pdf](http://www.un.org/esa/ffd/tax/2012ICTM/LetterIndia.pdf)> accessed 2 June 2014.

The BICs, along with other developing countries, had argued that permitting PEs to deduct notional payments could change the balance between source and residence taxation reflected in the UN Model, which would be contrary to the interests of many developing countries.<sup>234</sup> Keeping in mind its wider membership and divergence of interests between developed and developing countries on international taxation issues, the UN Tax Committee accepted that what may be appropriate for the OECD Model might not be suitable for the UN Model.<sup>235</sup> Resultantly, the Commentary to Article 7 of the UN Model was updated in 2011 to state that the functionally separate entity treatment of PEs to the extent envisaged under Article 7 of the OECD Model cannot be accepted in Article 7 of the UN Model. The Commentary explains that this is because the provision is in ‘direct conflict’ with the wording of Article 7(3) of the Model, ‘which generally disallows deductions for amounts “paid” (other than toward reimbursement of actual expenses) by a permanent establishment to its head office’.<sup>236</sup>

Chapter IV mentioned that since 2004, China, and from 2007, India, have participated in the OECD’s tax work as observers (and 2012 onwards as participants). As far as transfer pricing is concerned, the Working Party 6 of the OECD’s Committee of Fiscal Affairs (CFA) has also made an effort to include Brazil in its programme.<sup>237</sup> This participation of the BICs could have influenced some

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<sup>234</sup> UN Tax Committee, ‘Report on the Fifth Session’ (2009) E/C.18/2009/6 (SUPP) para 31.

<sup>235</sup> *ibid* para 34-36.

<sup>236</sup> UN Model 2011 (n 3) Commentary to Article 7, para 1.

<sup>237</sup> Marlies de Ruiter, ‘Overview of the OECD’s Work on Transfer Pricing’ (Conference on Alternative Methods of Taxation of Multinationals, Helsinki, Finland, 13-14 June 2012) 2

developments in the OECD's engagement with transfer pricing in the recent years. The key ones include replacing the preference for traditional transaction methods with the freedom to choose the most appropriate of these and the transactional profit methods depending on the circumstances of the case (which has always been the position in the Indian and Chinese law);<sup>238</sup> additional guidance on comparability; and the discussion on business restructuring. The last among these also covers the details of the OECD TPG's previously elucidated position on location savings and allocation of risk between associated enterprises.<sup>239</sup> Further, in 2013, the OECD also warmed up to the idea of safe harbours,<sup>240</sup> *albeit* only for low-risk transactions.<sup>241</sup> Safe harbours have for long been used more widely in Brazil's transfer pricing framework.<sup>242</sup> These changes reflect a desire to make the OECD TPG's guidance on the practice of the ALP more accommodating of the diversity of challenges faced in the application of the ALP, and to introduce greater flexibility in the use of the OECD TPG. But has the OECD succeeded in achieving these objectives from the BICs' perspective?

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<[www.taxjustice.net/cms/upload/pdf/Marlies\\_de\\_Ruiter\\_1206\\_Helsinki\\_text.pdf](http://www.taxjustice.net/cms/upload/pdf/Marlies_de_Ruiter_1206_Helsinki_text.pdf)> accessed 2 June 2014.

<sup>238</sup> The OECD TPG, however, also state that the traditional transaction methods are the most direct means of establishing whether conditions in commercial and financial relations between associated enterprises are at arm's length. Therefore, they should be preferred where both traditional transaction methods and transactional profit methods can be applied in an equally reliable manner, taking into account the strengths and weaknesses of the methods, nature of the controlled transaction, availability of reliable information to apply the chosen method, and the degree of comparability between the controlled and uncontrolled transactions. See OECD TPG (n 4) para 2.2 and 2.3. The UN TPM does not make any such suggestion. See UN TPM (n 4) para 6.1.3.2 and para 6.1.2.1.

<sup>239</sup> OECD TPG (n 4) para 9.13-9.47 and para 9.148-9.160.

<sup>240</sup> Safe harbours are provisions that relieve a certain category of taxpayers from obligations imposed by a country's transfer pricing rules or lay down simpler obligations for the covered taxpayers. See UN TPM (n 4) 483-484; OECD TPG (n 4) para 4.94-4.95.

<sup>241</sup> OECD, 'Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines' (OECD 2013) para 4.125, para 4.127 and para 4.130-4.131 <[www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf](http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf)> accessed 20 January 2014. See also UN TPM (n 4) 483-484, para 3.8.2-3.8.4, and para 1.7.5-1.7.6.

<sup>242</sup> Valadão and Lopes (n 43) 63.

Section (a) of part I highlighted that Brazil has already shifted away from the comparables-based practice of the ALP to realise the country's objective of protecting its tax base from being undermined by manipulation of transfer prices between related parties in a manner that suits its technical and administrative capacity. The changes to the OECD TPG mentioned in the preceding paragraph do not involve anything along those lines. Therefore, from Brazil's perspective, these developments in the OECD TPG do not mean much other than that a part of its transfer pricing approach – the extensive use of safe harbours, has now found limited recognition at the OECD level. From India's and China's standpoint, in view of the discussion in section (b) of part I and in part II of this chapter, the answer would have to be 'no'. As concluded in section (c) of part I, and seen above as well, the OECD's position on attribution of profits to PEs also does not reflect the BICs' or other developing countries' interests.

Chapter IV pointed out that a plausible reason for such results is the lack of these countries' participation in the decision-making process at the OECD level. Considering the time point at which China and India were given observer status in the CFA, their influence in shaping the agenda of the OECD's work on attribution of profits to PEs was also limited. Thus, overall, even in the areas covered in this chapter, these countries have had limited ability to drive the OECD's consideration of the rules in light of the varying interests of countries at different levels of economic development. As highlighted in parts I and II, and even in this part, this is integral to further the BICs' concerns on the issues studied therein.

As mentioned in chapter IV, technically, the BEPS project offered the prospect of changing this position. Starting on a positive note for the issues covered in this

chapter, the 2015 final report of the BEPS project on Action Points 8-10 contains new guidance in respect of transactions involving commodities, which is to be added to the OECD TPG.<sup>243</sup> The guidance states that the comparable uncontrolled price (CUP) method would ‘generally be an appropriate transfer pricing method for establishing arm’s length prices of transfer of commodities between associated enterprises’.<sup>244</sup> However, the guidance diverges from the existing approach to the CUP method in that it allows reference to the quoted price of the commodity for this purpose.<sup>245</sup> This is essentially the price of the commodity in the relevant period in an international or domestic exchange market for commodities.<sup>246</sup> It also covers the price attained from a transparent price reporting or statistical body, or governmental price-setting agencies, where such indexes are used by unrelated parties to ascertain the prices of transactions in commodities between them.<sup>247</sup>

Latin American countries, including Brazil, have commonly applied this approach. Although these countries have used it outside of the CUP method, more as a separate transfer pricing method or the ‘sixth method’, its inclusion in the OECD TPG will nevertheless raise its international profile. This, in turn, will be a constructive step towards protecting the tax base of countries dependent on commodities, which largely tend to be developing countries, in an administratively

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<sup>243</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports* (OECD 2015) 53. The term ‘commodities’ encompasses ‘physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions’.

<sup>244</sup> *ibid* 53. Under the CUP method, the arm’s length price of a transaction between associated enterprises is established by reference to the price of the transaction in the case of external or internal comparables.

<sup>245</sup> *ibid*.

<sup>246</sup> *ibid*.

<sup>247</sup> *ibid*.

feasible manner.<sup>248</sup> This outcome of the BEPS project will thus advance the author's case for genuinely considering alternatives that can offer simple yet efficient transfer pricing solutions for developing countries.

The 2015 final report of the BEPS project on Action Points 8-10 also offers some progress on the issue discussed in section (b) of part I of this chapter. The report acknowledges that 'identifying risks goes hand in hand with identifying functions and assets'.<sup>249</sup> Contractual division remains the starting point for determining the allocation of risks between associated enterprises.<sup>250</sup> The notions of control over risk and the financial capacity to take on risk also stay central to ensuring that the assignment of risk between associated enterprises is consistent with their conduct.<sup>251</sup> The distinction, however, lies in the emphasis on capability and actual functional performance in both these areas.

Accordingly, control over risk is explained as the ability to decide to take on the risk, and whether and how to respond to the risk, and the real delivery of these tasks.<sup>252</sup> This requires decision-makers to possess competence and experience in the area of the particular risk, and an understanding of the impact of their decision on the business.<sup>253</sup> It further necessitates their access to relevant information to support the decision-making process.<sup>254</sup> The decision-makers can either gather the information

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<sup>248</sup> *ibid* 11.

<sup>249</sup> *ibid* 21.

<sup>250</sup> *ibid* 22.

<sup>251</sup> *ibid*.

<sup>252</sup> *ibid* 23.

<sup>253</sup> *ibid* 24.

<sup>254</sup> *ibid*.

themselves, or they can exercise the authority to specify and obtain the information.<sup>255</sup> In both the cases, they must have the capability to determine the objectives of collecting and analysing the information, and actually apply the same.<sup>256</sup> If a party is hired for accumulating and evaluating the information, then the decision-makers must have the capacity to and also be actually able to hire the provider, assess whether the right information is accumulated and adequately studied by it, and decide whether it is necessary to adapt or terminate the contract with the party.<sup>257</sup> Reflecting a similar emphasis on substance, financial capacity to assume the risk is defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions, and to bear the consequences of the risk materialising.<sup>258</sup> This takes into account the assets and options realistically available to the parties should the risk be realised.<sup>259</sup>

The above-elucidated position, which will be a part of the OECD TPG, does not necessarily mean that risk will be inseparable from the location of substantial workforce or tangible assets and the operations these give effect to. Nevertheless, this outcome is beneficial to countries such as India and China as it will give them more internationally accepted basis to scrutinise the allocation of risks between associated enterprises, especially where it would undermine the contribution of the economic operations in India and China to the profitability of an enterprise.

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<sup>255</sup> *ibid.*

<sup>256</sup> *ibid.*

<sup>257</sup> *ibid.*

<sup>258</sup> *ibid* 23.

<sup>259</sup> *ibid.*

This end is also served by the guidance on transfer pricing of transactions involving intangibles contained in the BEPS project's report on Action Points 8-10. This envisages a change in the OECD TPG to reflect that contractual relationships simply serve as reference points for identifying and analysing controlled transactions relating to intangibles.<sup>260</sup> Similarly, legal ownership of intangibles, by itself, would not confer any right ultimately to retain the returns derived by the MNE group from exploiting the intangible.<sup>261</sup> This, in turn, will depend on the functions the legal owner performs, the assets it uses, and the risks it assumes, and upon the contributions made by other group members through the functions performed, the assets used, and the risks assumed by them in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles.<sup>262</sup> Equally, providing funding for these purposes without performing any of the important functions in relation to the intangible, or exercising control over the financial risk, will generate no more than a risk-free return.<sup>263</sup>

Chapter III discussed that the initial goals of the LONs' work that led to the selection of the ALP for assessing correctness of prices of intra-entity transactions was ensuring that income generated through cross-border activities of enterprises was taxed once, and ideally, in the country that had the closest economic connection to the income. As also highlighted in section (b) of part I, over the years, the implementation of the ALP, however, became distanced from these objectives, such that transfer

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<sup>260</sup> *ibid* 76.

<sup>261</sup> *ibid*.

<sup>262</sup> *ibid*. The report states that in considering the arm's length compensation for functional contributions of various members of the MNE group, certain important functions will have special significance. The nature of these functions will depend on the facts and circumstances.

<sup>263</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports* (n 243) 65, 81.

pricing is now a common source of profits of MNEs ending up in low or no tax jurisdictions.<sup>264</sup> Considering the preceding paragraphs in light of this, the BEPS project only seeks to further the author's case for seizing the opportunity to work towards a practice of the ALP that better reflects the reality of profit generation in modern day MNEs, and allocates profits between associated enterprises accordingly. In the process, it also moves closer to achieving the objectives underlying the introduction of the ALP in the international taxation framework. From the viewpoint of countries such as India and China, which have shown concerns with respect to the prevailing application of the ALP and are capable of acting unilaterally to address them, missing the chance to move in this direction because of a rigid approach to the same would have meant greater possibility of further divergence from the globally accepted transfer pricing standards. This would not have been in the interest of businesses and, more importantly, potentially the longevity of the ALP itself.<sup>265</sup>

However, as also seen in chapter IV, the BEPS project has been more reserved with respect to issues that directly affect the existing division of taxing rights between countries. Allocation of location savings and rent is one such area. It was pointed out in part II that the BEPS project's interim Guidance on Intangibles did not treat LSAs

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<sup>264</sup> Reuven S Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (1995) 15 *Virginia Tax Rev* 89, 151-52; E E Lester, 'International Transfer Pricing Rules: Unconventional Wisdom' (1995) 2 *ILSA Journal of Int'l and Comparative L* 283, 297; E Chorvat, 'Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory' (2003) 54 *Alabama L Rev* 1251, 1253; Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing - Should the Separate Accounting Model Be Maintained for Modern Multinational Entities?' (2004) 7 *Journal of Australian Taxation* 196, 200-01; Michael Durst, 'Fixing Double Non-Taxation Under the Transfer Pricing Guidelines' (7 May 2012) *Tax Notes* 785, 787-789; Ilan Benshalom, 'Rethinking the Source of the Arm's Length Transfer Pricing Problem' (2013) 32 *Virginia Tax Rev* 425, 431.

<sup>265</sup> Richard Collier, Interview with Pascal Saint-Amans, Director, Centre for Tax Policy and Administration (CTPA), OECD (February 2014) 5 <[www.pwc.com/en\\_GX/gx/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf](http://www.pwc.com/en_GX/gx/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf)> accessed 10 December 2014. In this interview, Pascal Saint-Amans acknowledged that if the practice of the ALP is not fixed to align the location of profit with real activity, there is risk that some countries would move to unitary taxation, which would be a wrong move for businesses.

as intangibles.<sup>266</sup> The 2015 final report of the BEPS project on Action Points 8-10 maintains this position.<sup>267</sup> Accordingly, unlike the Indian and Chinese positions studied in part II of this chapter, the report does not discuss the possibility of using the PSM to adequately recognise the contribution of LSAs in the apportionment of profits between associated enterprises.<sup>268</sup> Such distinction between LSAs and intangibles appears to rest on whether something is capable of being owned or controlled for use in commercial activities.<sup>269</sup> The rationale for this additional requirement, and hence separate transfer pricing treatment is, however, difficult to understand when at their core, both are really important value drivers for MNEs.

There is some room for discussion on ‘unique and valuable contributions’ (apart from intangibles) by parties to a transaction that should allow recourse to transactional profit split methods, such as the PSM. The ideas proposed for interpreting this phrase include inputs that are sources of competitive advantage for the business and create difficulties in finding reliable comparables.<sup>270</sup> Seeing a justification for pursuing with their positions on transfer pricing treatment of LSAs in such a construction, countries like China and India can be expected to support it. The OECD is also carrying out work on ‘Transfer Pricing Comparability Data and Developing Countries’.<sup>271</sup> This

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<sup>266</sup> OECD, *Guidance on Transfer Pricing Aspects of Intangibles* 2014 (n 189) 13-14.

<sup>267</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports* (n 243) 73.

<sup>268</sup> *ibid* 44-45.

<sup>269</sup> *ibid* 67.

<sup>270</sup> *ibid* 60. See also OECD, ‘BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains’ (Public Discussion Draft, OECD 16 December 2014 – 6 February 2015) para 18 <[www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf](http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf)> accessed 30 December 2014.

<sup>271</sup> OECD, ‘Paper for Public Consultation on Transfer Pricing Comparability Data and Developing Countries’ (OECD 2014) <[www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf](http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf)> accessed 30 November 2014.

envisages improving developing countries' access to data sources for obtaining suitable comparables.<sup>272</sup> This might facilitate the Chinese position in chapter 10 of the UN TPM of using foreign comparables with adjustments resulting in allocation of additional profits owing to LSAs to local enterprises. The BEPS project did not engage substantially with the rules for attribution of profits to PEs.<sup>273</sup> Therefore, on that aspect as well, the BICs' positions are likely to persist, at least until the time the BICs' growing interests as home countries drive them towards adoption of Article 7 of the OECD Model.

The UN Tax Committee's Subcommittee on Transfer Pricing is working on updating the UN TPM. The proposed updates include: a chapter on the treatment of intangibles-related transactions, a chapter on intra-group services and management charges, a text or chapter on business restructuring, and an annexure on available technical assistance and capacity-building resources.<sup>274</sup> It may be that over time, the BICs and other developing countries try to further transfer pricing positions not dealt with or not addressed sufficiently through the BEPS project, via the UN TPM. This is especially so because their ability to influence advances in this area through the OECD after the BEPS project will depend on the nature of the BICs' participation in international taxation rule-making at the OECD, and the extent to which the issues of particular interest to the BICs are up for discussion at the OECD level.

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<sup>272</sup> *ibid* para 13 and para 14.

<sup>273</sup> OECD, *Preventing the Artificial Avoidance of PE Status, Action 7 – 2015 Final Report* (OECD 2015) para 19-20. The report makes it clear that any additional work on attribution of profits to PEs will only be taken up after the release of the second set of deliverables, with a view to completing it before the 2016 deadline for negotiation of the multilateral instrument envisaged under the project.

<sup>274</sup> UN Tax Committee, 'Report on the Tenth Session' (2015) E/2014/45-E/C.18/2014/6, para 33. See also UN Tax Committee's Subcommittee on Article 9 (Associated Enterprises), 'Report of the Coordinator' (2015) E/C.18/2015/CRP.1, 1.

## **Conclusion**

Parts I and II showed that the BICs agree with the theory of the ALP as contained in Article 9 of the OECD Model and the UN Model. These countries, however, diverge from the OECD TPG's, and to some extent also the UN TPM's, practice of the ALP for assessing correctness of transfer prices between associated enterprises. On the one hand, away from the comparables-based application of the ALP of the OECD TPG and the UN TPM, Brazil uses profit margins pre-fixed by law. On the other hand, India and China's implementation of the ALP is geared towards checking misalignment between risk classification of associated enterprises and their actual functional profiles. Both these deviations seek to preserve these countries' tax base, with the Brazilian approach to transfer pricing also highlighting the relevance of administrative simplicity in meeting this end.

Preventing their tax base from being undermined in an administratively less complex manner also emerged as the idea driving the BICs' departure from the OECD Model's separate entity treatment of PEs for the purpose of attributing profits to them. Additionally, India and China diverge from the OECD TPG's and the UN TPM's application of the ALP to ensure that these countries' distinct contribution in the value created by an MNE, particularly in the form of their growing markets, is recognised in the profits allocated to group enterprises operating in these countries.

The BEPS project has not led to a Brazil-like more general shift away from the comparables-based practice of the ALP. The recognition of the sixth method in the OECD TPG will nevertheless be progress in the direction of exploring

administratively simpler transfer pricing solutions that are of particular assistance to developing countries. The BEPS project also offers advances on the first of the above-mentioned concerns of India and China. Realising them will only be a step towards ensuring that the transfer pricing framework meets the objectives underlying the LONs' work that led to the selection of the ALP as the basis for apportionment of profits between related entities and, in turn, also the continued relevance of the ALP itself. The project, however, does not deal specifically with attribution of profits to PEs. Further, it has displayed a reluctance to engage with issues likely to affect the prevailing division of taxing rights between countries.

In comparison, the BICs' effective participation in rule-making at the UN level has allowed the BICs to raise all transfer pricing issues of significance to them to international prominence and deliberation, and also to protect the UN Model's position on attribution of profits to PEs. Along with the nature of the BICs' participation in the OECD's tax work in the future, the OECD's willingness to engage with such issues will be important in setting the ground for a fairer international taxation rule-making process from the BICs' standpoint at the OECD.

## Chapter VI

### Examining Options for a Fairer International Taxation Rule-Making Process

This chapter examines alternatives for a fairer international taxation rule-making process from the perspective of the BICs and developing countries more generally.<sup>1</sup> The focus is on the key practical developments in this area in the recent years. As stated in chapter II, there has been limited academic engagement with fairness in the development of the rules for allocation of taxing rights between countries. Works dealing with institutional reform in the international taxation framework are, however, of much help. Therefore, they have been discussed at relevant points in this chapter.

Accordingly, part I of the chapter assesses the prospect of the OECD emerging as a world tax body that offers the BICs and other developing countries a fairer international taxation rule-making process. This takes into account the new model of international taxation rule-making at the OECD level used in the BEPS project. Part II of the chapter evaluates the more radical option of an international, intergovernmental body for pursuing this end. In light of the different challenges involved in realising both these alternatives, part III analyses how the UN Tax Committee can be reformed to provide a good shorter-term solution.

Chapter II established participation and effectiveness of participation as indicators of fairness in the rule-making process.<sup>2</sup> The latter essentially means equal involvement in all stages of the rule-making process – from agenda-setting and

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<sup>1</sup> As stated in chapter I, for the purpose of this study, ‘developing countries’ is an umbrella term for all countries that are not classified as high-income OECD as well as high-income non-OECD economies.

<sup>2</sup> Text to n 118-128 in chapter II.

discussions to decision-making. All three options mentioned in the preceding paragraph are examined based on these parameters.

### **I. The prospect of the OECD emerging as a world tax body that offers the BICs and other developing countries a fairer international taxation rule-making process**

Avery Jones has argued that the OECD is ‘becoming the world body overseeing tax treaties’.<sup>3</sup> Taking this position further, Cockfield has discussed the rise of the OECD as an informal ‘World Tax Organisation’.<sup>4</sup> He considers enhancing the membership of the OECD as a key step in this direction.<sup>5</sup> In comparison, Avery Jones believes that all that is needed is accommodation of more source taxation.<sup>6</sup> As shall be seen in the following paragraphs, there have been limited developments in both these directions at the OECD.

Let us first consider Cockfield’s point about increasing the membership of the OECD. Since 2000, OECD membership has been given only to Chile, Estonia, Israel, Slovak Republic, and Slovenia.<sup>7</sup> The World Bank classifies all of these as high-income countries.<sup>8</sup> Post 2013, the OECD has launched accession talks with Colombia,

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<sup>3</sup> John F Avery Jones, ‘David R Tillinghast Lecture - Are Tax Treaties Necessary’ (1999) 53 Tax L Rev 1, 2.

<sup>4</sup> Arthur J Cockfield, ‘The Rise of the OECD as Informal ‘World Tax Organisation’ through National Responses to E-commerce Challenges’ (2006) 8 Yale Journal of L & Technology 136.

<sup>5</sup> *ibid* 184-185.

<sup>6</sup> Avery Jones (n 3) 2.

<sup>7</sup> OECD, ‘Members and Partners’ (*OECD*) <[www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm](http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm)> accessed 30 July 2015.

<sup>8</sup> See the country profiles of these countries at World Bank, ‘Data: Countries and Economies’ (*World Bank*) <<http://data.worldbank.org/country>> accessed 30 July 2015.

Latvia, Costa Rica, and Lithuania.<sup>9</sup> Out of these, only Colombia and Costa Rica are developing countries.<sup>10</sup> This offers limited room to expect a significant increase in the OECD membership in the coming years. Importantly, there is even less ground to believe that this opportunity will be widely available to developing countries.

This does not mean, however, that the OECD has not made or is not making efforts to involve non-members, including developing countries, in its tax work. In 2002, the OECD, the IMF, and the World Bank together set up the International Tax Dialogue (ITD).<sup>11</sup> In 2010, the OECD created the Task Force on Tax and Development.<sup>12</sup> In July 2015, the OECD and the United Nations Development Programme (UNDP) announced the Tax Inspectors Without Borders programme.<sup>13</sup> These initiatives address other important issues such as: domestic resource mobilisation via better management of tax incentives and greater expertise of tax administrations, especially vis-à-vis transfer pricing; more transparency in reporting of relevant financial data by MNEs; and effective exchange of information.<sup>14</sup> The issue, however, is that none of these endeavours deal with the core subject of division of taxing rights between countries.

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<sup>9</sup> OECD, 'Members and Partners' (n 7).

<sup>10</sup> See the country profiles of Colombia and Costa Rica at World Bank, 'Data: Countries and Economies' (n 8).

<sup>11</sup> OECD, 'International Tax Dialogue' (OECD) <[www.oecd.org/ctp/tax-global/international-tax-dialogue.htm](http://www.oecd.org/ctp/tax-global/international-tax-dialogue.htm)> accessed 20 December 2012. The Inter-American Development Bank, the European Commission (EC), and the Inter-American Centre of Tax Administrations joined the initiative later. Interestingly, the UN is not a member of this initiative.

<sup>12</sup> OECD, 'Tax and Development Programme' (OECD) <[www.oecd.org/ctp/tax-global/taxanddevelopment.htm](http://www.oecd.org/ctp/tax-global/taxanddevelopment.htm)> accessed 20 December 2012.

<sup>13</sup> OECD, 'Tax Inspectors Without Borders' (OECD, 2015) <[www.oecd.org/tax/taxinspectors.htm](http://www.oecd.org/tax/taxinspectors.htm)> accessed 6 August 2015.

<sup>14</sup> OECD, 'International Tax Dialogue' (n 11); OECD, 'Tax and Development Programme' (n 12); OECD, 'Tax Inspectors Without Borders' (n 13).

In 1991, the OECD established an Advisory Group for Cooperation with Non-Member Economies with regards to taxation. The Group too started with a focus on sharing technical expertise.<sup>15</sup> However, over the years, especially with the adoption of the OECD's Global Relations Programme, it has also started giving attention to greater consultation with non-members in generation and implementation of OECD standards and guidelines.<sup>16</sup> The meetings of the OECD's Global Forums on Tax Treaties and Transfer Pricing are a part of this endeavour. These meetings, which have been attended widely by representatives from non-OECD countries, allow officials from these countries to become aware of the Committee of Fiscal Affairs' (CFA) on-going work in these areas and give their input on the issues covered.<sup>17</sup> This, however, is not the same as participation in agenda-setting, discussions, and decision-making vis-à-vis the development of the rules for allocation of taxing rights between countries.<sup>18</sup> As argued by Christians, this in turn leaves other countries, particularly least developed countries, as predominantly norm-takers. According to her, their economic, social, and legal context is easily overlooked in the development of the rules that have a critical impact on countries' ability to raise revenue in a global economy.<sup>19</sup> As seen in chapters IV and V, even in the case of invitees or participants

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<sup>15</sup> OECD, *Directory of Bodies of the OECD* (OECD 2012) 257.

<sup>16</sup> As stated in chapter IV, since 1997, certain non-OECD countries like the BICs have been able to register official positions on the OECD Model and its Commentary. This is also a part of the endeavour to get greater input of non-member countries in the OECD's tax work. It is in addition to the enhanced engagement programme vis-à-vis some of these countries, such as the BICs, mentioned in chapter IV.

<sup>17</sup> OECD, 'Developed and Developing Countries Gather at the OECD to Tackle BEPS' (*OECD*, 26 September 2014) <[www.oecd.org/tax/treaties/developed-and-developing-countries-gather-at-the-oecd-to-tackle-beps.htm](http://www.oecd.org/tax/treaties/developed-and-developing-countries-gather-at-the-oecd-to-tackle-beps.htm)> accessed 6 August 2015; OECD, 'Global Forum on Transfer Pricing' (*OECD*) <[www.oecd.org/tax/transfer-pricing/global-forum-transfer-pricing.htm](http://www.oecd.org/tax/transfer-pricing/global-forum-transfer-pricing.htm)> accessed 6 August 2015.

<sup>18</sup> Peter Essers, 'International Tax Justice between Machiavelli and Habermans' (2014) 68 *Bulletin for Int'l Taxation* 54, 57. Essers makes the point that consultation is not the same as participation. The former does not entail the same rights as the latter, such as influence in final decision-making.

<sup>19</sup> Allison Christians, 'Global Trends and Constraints on Tax Policy in the Least Developed Countries' (2010) 42 *UBC L Rev* 239, 274.

in the CFA and/or its subsidiary bodies, such as the BICs, not all of these parameters for effective participation in the rule-making process are met.

Unsurprisingly, since the BICs' engagement in the OECD's tax work, there has been no significant move towards greater source taxation in the OECD Model. As discussed in chapter IV, the deemed service PE alternative, which replaces the fixed place of business requirement in the concept of PE with a threshold comprising of a time limit and the same or connected project restriction, was introduced in the Commentary to Article 5 of the OECD Model.<sup>20</sup> If anything, there have been important changes in the OECD Model that the BICs do not agree with owing to concerns regarding adverse impact on their tax base as host countries. One example is the introduction of the new Article 7. As elucidated in chapter V, the BICs have lodged reservations against this provision. They were also active in ensuring that the 2011 update to the UN Model did not adopt this position.<sup>21</sup>

If the work on the BEPS project's deliverables is to be taken as a model for rule-making in international taxation at the OECD in the future, the same was led by 44 countries – 34 OECD members and only 10 non-members from the G20 and OECD accession countries, including the BICs. These 10 countries participated as associates in the project, which gave them equal status as OECD countries. In the first year of the BEPS project, the views of other developing countries were collected mainly through regional consultations and thematic forums.<sup>22</sup> These were conveyed to

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<sup>20</sup> Text to n 15-16 and n 34 in chapter IV.

<sup>21</sup> Text to n 232-234 in chapter V.

<sup>22</sup> The regional consultation events covered Asia-Pacific, Latin American and Caribbean, and Francophone countries. The thematic events were Annual Meetings of the OECD's Global Forum on Tax Treaties, the OECD's Global Forum on Transfer Pricing, and the OECD's Task Force on Tax and

the CFA and its subsidiary bodies to be considered in the development of the BEPS project's output. They also shaped a two-part report drafted by the OECD on request from the G20 Development Working Group (DWG). The report deals with the main sources of BEPS for developing countries, their relation to the BEPS Action Plan, and how the G20 DWG could assist these countries in dealing with BEPS challenges.<sup>23</sup>

It could be argued that in the strict timeline of the BEPS project, such indirect involvement offered an efficient and cost-effective way of getting developing countries' input in the rule-making process. As stated before, however, this did not amount to these countries' effective participation in the project. Attempting to improve this position, in September 2014, under the 'structured dialogue process', 14 developing countries were invited to attend the meetings of the CFA and its subsidiary bodies.<sup>24</sup> Additionally, two regional organisations – the African Tax Administration Forum (ATAF) and the Inter-American Centre for Tax Administration (CIAT) were also asked to participate in these meetings as observers.<sup>25</sup>

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Development. See OECD, 'Special Meeting of the OECD Task Force on Tax and Development on BEPS and Developing Countries and Summary of the BEPS Consultations' (OECD 2014) 1-2 <[www.oecd.org/tax/tax-global/co-chairs-statement-task-force-tax-development-march-2014.pdf](http://www.oecd.org/tax/tax-global/co-chairs-statement-task-force-tax-development-march-2014.pdf)> accessed 6 August 2015. See also OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (OECD 2014) 7 <[www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf](http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf)> accessed 10 December 2014.

<sup>23</sup> OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (n 22) 1, 6, 7; OECD, 'Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (OECD 2014) 6-7 <[www.oecd.org/tax/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf](http://www.oecd.org/tax/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf)> accessed 6 August 2015. The IMF worked closely with the OECD in drafting these reports.

<sup>24</sup> OECD, 'BEPS Project and Developing Countries: From Consultation to Participation' (OECD 2014) 2 <[www.oecd.org/ctp/strategy-deepening-developing-country-engagement.pdf](http://www.oecd.org/ctp/strategy-deepening-developing-country-engagement.pdf)> accessed 6 August 2015. These countries are: Albania, Azerbaijan, Bangladesh, Croatia, Georgia, Jamaica, Kenya, Morocco, Nigeria, Peru, Philippines, Senegal, Tunisia, and Vietnam.

<sup>25</sup> At that time, the IMF, the World Bank, and the UN had already been participating in these meetings as observers.

As ‘invitees’, these countries’ presence in the meetings of the CFA and its working groups could be limited or excluded if the Chair of the OECD Council or the chair of the CFA so decided.<sup>26</sup> Their representatives could intervene in the discussions at the chair’s discretion, but were not able to take part in the decision-making process.<sup>27</sup> This position also applied to the ATAF and CIAT. Also, as these 14 developing countries and organisations became invitees only after the first set of deliverables of the BEPS project was released, it can be said that they did not have any direct involvement in shaping the project’s agenda. Owing to these reasons, their participation in the BEPS project also fell short of meeting the parameters of effective participation.

In light of this, the extent to which these countries and organisations formed a successful channel to advance the interests of developing countries more generally is also questionable. Doubts are, in fact, raised on the efficacy of all the mediums of contributing to the project from the standpoint of other developing countries when the strict timeline of the BEPS project and the volume of information generated by it are considered.<sup>28</sup> One is only made more sceptical by the fact that, whereas the associates and the invitees received technical support at the OECD level, such assistance was unavailable to other developing countries.<sup>29</sup>

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<sup>26</sup> OECD, ‘Resolution of the Council on Partnerships in OECD Bodies’ (9 October 2012) C(2012)100/FINAL, 6.

<sup>27</sup> *ibid.*

<sup>28</sup> Action Aid, ‘BEPS Process: Failing to Deliver for Developing Countries’ (Action Aid 2014) 4-5 <[www.francophonie.org/IMG/pdf/beps\\_16th\\_sept\\_2014\\_actionaid.pdf](http://www.francophonie.org/IMG/pdf/beps_16th_sept_2014_actionaid.pdf)> accessed 6 August 2014. One such medium was sending a direct response to the OECD when the various discussion drafts were opened for consultation. Research by Action Aid discusses how, due to their limited resources and technical capacity, developing countries were unable to make as effective use of this option as the other stakeholders, such as businesses.

<sup>29</sup> *ibid* 3.

The above-discussed aspects increased the likelihood of some of the key outcomes expected by developing countries from an international taxation reform project of this scale not being realised. The possibility of this happening, in fact, became clear in the first year of the project. The OECD report on BEPS in low-income countries recognised the importance of revenue mobilisation in developing countries and, as highlighted in chapter I, the significance of corporation tax for these countries.<sup>30</sup> It further acknowledged developing countries' inability to ensure that the treaty terms they negotiate are beneficial to them.<sup>31</sup> All these aspects are linked to the international framework for division of taxing rights between countries. Unsurprisingly, the regional consultations undertaken in the first year of the BEPS project revealed that the balance between source and residence taxation in the OECD Model and the UN Model is an important concern for developing countries.<sup>32</sup> In line with the BEPS project's Action Plan of 2013, the OECD report on BEPS in low-income countries, however, did not deal with this issue.<sup>33</sup>

At the Ninth Session (2013) of the UN Tax Committee, it was highlighted that a number of issues of great importance to developing countries were not a part of the BEPS Action Plan, and that there are also matters on which developing countries

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<sup>30</sup> OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (n 22) 10-11.

<sup>31</sup> OECD, 'Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (n 23) 15.

<sup>32</sup> OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (n 22) 9.

<sup>33</sup> The emphasis is on devising practical tool kits to help developing countries implement internationally recognised options in the areas that the consultations with them revealed as being of high priority to these countries. These are Action Points 4, 6, 7, 10, 11 and 13. Consultations undertaken in the first year of the BEPS project also highlighted taxation of indirect transfer of assets located in the country as an issue of importance for developing countries. The report directs the OECD, along with the IMF, to examine whether further analysis on this is needed. See OECD, 'Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' (n 23) 16.

might take a view different from that of the OECD countries.<sup>34</sup> Accordingly, it was decided that through a subcommittee on BEPS issues for developing countries, the UN Tax Committee will engage with the work of the OECD and G20, but it will also pursue its own agenda on BEPS.<sup>35</sup> Interestingly, the BICs' interaction with this subcommittee shows that even the BICs are critical of the scope of the BEPS project's agenda and certain items, such as the allocation of taxing rights between countries, being entirely off the negotiating table.<sup>36</sup>

The Indian response to a questionnaire issued by the UN Tax Committee's subcommittee on BEPS states that, 'India is of the strong belief that the BEPS issues must be addressed in a manner that results in breaking down all such structures or practices that promote or protect base erosion and profit shifting'.<sup>37</sup> 'For example, if the problem is a leaking bucket then steps must be taken to swiftly plug that leak or replace the bucket instead of debating how to calibrate the speed of inflow of water into the leaking bucket.'<sup>38</sup> These statements indicate the expectation of more fundamental reforms to the existing international taxation rules.<sup>39</sup> This was also the

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<sup>34</sup> UN Tax Committee, 'Report on the Ninth Session' (2014) E/2013/45-E/C.18/2013/6, para 91.

<sup>35</sup> *ibid* para 92.

<sup>36</sup> Horner has discussed that countries' participation in the rule-making process cannot be viewed as effective if a 'gag rule' applies to some of the issues that are of greatest concern or interest to them. See Frances M Horner, 'Do We Need an International Tax Organisation?' (8 October 2001) 24 *Tax Notes Int'l* 179, 185.

<sup>37</sup> Government of India, 'Countries' Experiences Regarding Base Erosion and Profit Shifting Issues' (UN 2014) 7 <[www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsIndia.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsIndia.pdf)> accessed 6 August 2015.

<sup>38</sup> *ibid*.

<sup>39</sup> India, in fact, has long held this expectation. A reflection of this is a 2001 report of an Indian governmental committee on electronic commerce and taxation. The report states that the concept of PE negatively affects the tax base of countries like India. The report explains that one of the reasons for this is because the concept pre-supposes that any massive sales in a country are not possible in the absence of a PE. According to the report, 'contrary to the developed countries' view', there is no possible 'liberal interpretation' of this concept that can adequately address source countries' concerns. The report suggests 'complete abandonment of the existing concept of PE', and urges the OECD and

promise of the BEPS report of 2013.<sup>40</sup> However, the Action Plan of the BEPS project that followed the report made it clear that the project was not to touch on the assignment of taxing rights between countries per se.<sup>41</sup> The BEPS project's reluctance to deal with issues directly impacting the prevailing international division of taxing rights was also evident in chapters IV and V.

Enhancing source taxation, in turn, appears to be an integral part of the Indian reply to the questionnaire issued by the UN Tax Committee's subcommittee on BEPS. The response highlights India's huge market potential, and urges greater consideration of challenges such countries face due to the growth of the digital economy.<sup>42</sup> China's and Brazil's replies to the questionnaire also reflect a desire for the UN to take up this matter.<sup>43</sup> The official response of China's State Administration of Taxation (SAT) to the first set of deliverables released under the BEPS project in September 2014, in fact, expressed disappointment on the lack of consensus on this issue.<sup>44</sup> Taking a stronger view on the broader point, the Indian reply states that, 'in many of the

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the UN to make a 'serious attempt' to find an alternative to it. See Central Board of Direct Taxes (CBDT), *Report of the High Powered Committee on E-commerce and Taxation* (Ministry of Finance of India 2001) 20-21, 67.

<sup>40</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 7-9, 51. This document clearly stated the need for a holistic, 'out of the box' approach for addressing BEPS, which would entail dealing with different aspects of the issue, including the balance between source and residence taxation.

<sup>41</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 11. The BEPS Action Plan made it clear that 'while addressing BEPS might restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing standards on the allocation of taxing rights on cross-border income'.

<sup>42</sup> Government of India, 'Countries' Experiences Regarding Base Erosion and Profit Shifting Issues' (n 37) 2, 7.

<sup>43</sup> Government of China, 'Response to United Nations Questionnaire: Base Erosion and Profit Shifting Issues for Developing Countries' (UN 2014) 2-3 <[www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf)> accessed 6 August 2015; Government of Brazil, 'Comments from Brazil' (UN 2014) 2-3 <[www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsBrazil.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsBrazil.pdf)> accessed 6 August 2015.

<sup>44</sup> State Administration of Taxation (SAT), 'Publication of G20 BEPS Project 2014 Deliverables' (SAT 2014) <[www.chinatax.gov.cn/n2735/n2834/n2835/c779912/content.html](http://www.chinatax.gov.cn/n2735/n2834/n2835/c779912/content.html)> accessed 10 October 2014.

discussions and decisions at the OECD, India gathers the impression that the real issues are being swept under the carpet and the superficial ones are sought to be addressed. This approach is not going to significantly impact BEPS'.<sup>45</sup>

These views of the BICs could change with their growing interests as home countries. They do, nevertheless, support the conclusion that if the OECD has to act as a world tax body, it will not only have to be open towards greater participation of non-members in the rule-making process. It will also have to ensure that their involvement is effective in the sense that all the participants have an equal opportunity to shape all the stages of the development of the rules for division of taxing rights between countries, from agenda-setting to decision-making.

The on-going work on a legally binding multilateral instrument for implementing some of the outcomes of the BEPS project addresses the first of these aspects.<sup>46</sup> However, in line with the project's overall approach with regards to engagement with the international assignment of taxing rights, the interactions between the participating countries will not extend to this issue.<sup>47</sup> If, as in this case, the OECD remained open to the participation of all countries and, additionally, endeavoured to make the process effective, it could have been on the path to becoming a world tax body. This would have required extending the ambit of the

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<sup>45</sup> Government of India, 'Countries' Experiences Regarding Base Erosion and Profit Shifting Issues' (n 37) 8.

<sup>46</sup> It is open to any country to join the exercise. In fact, over 90 countries are already involved in producing this document. See OECD, 'Multilateral Instrument for BEPS Tax Treaty Measures: The Ad Hoc Group' (OECD) <[www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm](http://www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm)> accessed 5 December 2015.

<sup>47</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* (OECD 2014) 26.

instrument or the OECD's tax work more generally to matters of particular interest to a range of countries, such as the allocation of taxing rights between countries.

None of this, however, appears to be realisable in the near future. The 2015 final report of the BEPS project on Developing a Multilateral Instrument to Modify Bilateral Tax Treaties makes it clear that participation of non-members in the generation of the document 'does not create, and cannot be interpreted to create, a precedent in the context of OECD procedures for the participation of non-members in OECD activities'.<sup>48</sup> In view of the conventional disinclination of the OECD to take up changes to the prevailing division of taxing rights between countries, if and when the OECD will be more willing to deal with such issues is also uncertain. Therefore, in the short or even the medium-term, it is difficult to foresee the OECD as a 'world' tax body.

## **II. Establishing an intergovernmental body for dealing with international taxation issues**

In 2000, the UN Secretary General appointed a panel chaired by former Mexican President Ernesto Zedillo to 'recommend strategies for mobilisation of resources required to accelerate equitable and sustainable growth in developing countries as well as economies in transition, and to fulfil poverty and development commitments enshrined in the UN Millennium Declaration'.<sup>49</sup> One of the suggestions of the panel

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<sup>48</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report* (OECD 2015) 11.

<sup>49</sup> UN, 'Letter from the Secretary General to the President of the General Assembly' (25 June 2001) UN General Assembly (GA) A/55/1000 (Zedillo Panel Report), 1.

was to create an international tax organisation (ITO).<sup>50</sup> This proposal was driven by the need to address challenges to taxation posed by a globalised world, including the complexity in distribution of the right to tax income of MNEs between countries.<sup>51</sup>

The panel's report was to be considered in preparation for the International Conference on Financing for Development organised in Monterrey, Mexico in 2002. However, the outcome of the conference – the Monterrey Consensus – was limited to highlighting ‘the need to strengthen international tax cooperation through enhanced dialogue among national tax authorities and greater coordination of the work of concerned multilateral bodies and relevant regional organisations, giving special attention to the needs of developing countries and economies in transition’.<sup>52</sup>

The 2008 Doha Declaration on Financing for Development was more concrete. It requested the Economic and Social Council (ECOSOC) of the UN to examine strengthening of institutional arrangements in the area of international taxation, including the UN Tax Committee.<sup>53</sup> The 2011 report of the UN Secretary General finally followed up on this issue. The report discussed conversion of the UN Tax Committee into an intergovernmental commission on international cooperation in tax matters that was to serve as a subsidiary body of the ECOSOC.<sup>54</sup> This resonates with the Zedillo panel's idea of an ITO, with the difference being that the 2011 report of the UN Secretary General sensibly chooses to have such a structure under the aegis of

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<sup>50</sup> *ibid* 27-28.

<sup>51</sup> *ibid* 65.

<sup>52</sup> UN, *Monterrey Consensus on Financing for Development* (UN 2002) para 64.

<sup>53</sup> UN, *Doha Declaration on Financing for Development* (UN 2009) para 16.

<sup>54</sup> UN, ‘Strengthening of Institutional Arrangements to Promote International Cooperation in Tax Matters, Including the Committee of Experts on International Cooperation in Tax Matters’ (18 March 2011) E/2011/76, para 63-77.

an existing international organisation. This would save the time and effort in agreeing to an entirely new set-up and processes for intergovernmental interaction and waiting for them to gain legitimacy.

Among the leading global bodies dealing with tax issues, the IMF and the World Bank have traditionally focused on delivering technical assistance in tax policy and administration.<sup>55</sup> The OECD has been the leader in the work on the international rules for assignment of taxing rights and also has the advantage of greater expertise and resources.<sup>56</sup> As seen in part I, however, the OECD does not offer developing countries more generally direct involvement in the development of these rules, and has made limited progress on the issue of source taxation that is relevant to these countries. The rule-making process followed in the BEPS project, and the clarification regarding the process adopted for drafting the multilateral instrument for implementing some of the project's proposals along with the OECD's conventional reluctance to deal with issues impacting the division of taxing rights between countries, do not give great hope for change in the near future. Apart from these persisting drawbacks is the problem of the OECD's origin and reputation as a 'rich countries' club'.<sup>57</sup> In comparison, the UN, with its universal membership and the UN Tax Committee's particular mandate to give 'special attention' to developing

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<sup>55</sup> Victor van Kommer, 'Norms and Policy Setting, Identification of Gaps and Exploration of Opportunities for Creating Greater Synergies in respect of Technical Assistance in Tax Matters' (A paper prepared by the IBFD for the UN Tax Committee, UN 2012) 12-14 <[www.un.org/esa/ffd/wp-content/uploads/2014/10/ICTM2012\\_ibfd\\_BackgroundPaper.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ICTM2012_ibfd_BackgroundPaper.pdf)> accessed 10 August 2015.

<sup>56</sup> Dries Lesage and Thijs Van de Graaf, 'Thriving in Complexity? The OECD System's Role in Energy and Taxation' (2013) 19 *Global Governance* 83, 90. See also Dries Lesage, 'Taxation and the 2008 UN Follow-Up Conference on Financing for Development: Policy Recommendations' (2008) 61 *Studia Diplomatica* 133.

<sup>57</sup> Robert O'Brien and Marc Williams, *Global Political Economy* (Palgrave Macmillan 2004) 125. For a discussion on the OECD's gradual move away from this perception see Nicola Bonucci, 'The OECD at Fifty: Some Observations on the Evolving Nature of an International Organization' (2011) 43 *George Washington Int'l L Rev* 239, 253-254.

countries and economies in transition, appears more suitable for hosting an intergovernmental forum for matters concerning international taxation.<sup>58</sup>

Also, having an intergovernmental commission as a subsidiary body of the ECOSOC gives an opportunity to better integrate international taxation in the UN's Financing for Development Programme.<sup>59</sup> Being a part of a broader development agenda could lead to contentious issues in this area, such as the allocation of taxing rights between countries being viewed in a more open and holistic manner. Even if this change in outlook is not achieved, tactically, putting these issues with other factors influencing global development would offer more room for better bargains and compromises.<sup>60</sup> These aspects also make the UN a better home for an international body addressing international taxation issues. This is more so when compared to specialised forums that do not yet cover taxation, like the WTO.<sup>61</sup> This is apart from the inexperience of such organisations vis-à-vis tax matters discussed by Brauner as well as Jung and the existing flaws in their processes.<sup>62</sup>

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<sup>58</sup> For the mandate of the UN Tax Committee see UN Economic and Social Council (ECOSOC) Resolution 2004/69 (11 November 2004) E/2004/69, 2. For a comparison with the mandate of the OECD's Committee on Fiscal Affairs (CFA) see OECD, *Directory of the OECD Bodies* (n 15) 254-255.

<sup>59</sup> Dries Lesage, David McNair, and Mattias Vermeiren, 'From Monterrey to Doha: Taxation and Financing for Development' (2010) 28 *Development Policy Rev* 155, 157.

<sup>60</sup> For a general discussion on how the institutional settings for international negotiations can generate cooperative bargaining strategies see Heather Elko McKibben, 'The Effects of Structures and Powers on State Bargaining Strategies' (2013) 57 *American Journal of Political Science* 411.

<sup>61</sup> Thuronyi discusses that whether it is an existing or a new agency that is chosen, an inter-country negotiation process should lead to the choice of forum for hosting a global body for dealing with international taxation matters. In the former category he considers the WTO to be an option. See Victor Thuronyi, 'International Tax Cooperation and a Multilateral Treaty' (2001) 26 *Brooklyn Journal Int'l L* 1641, 1676. Slemrod and Avi-Yonah have also mentioned the WTO as a potential platform for negotiating a multilateral agreement for dealing with international taxation issues. See Joel Slemrod and Reuven S Avi-Yonah, '(How) Should Trade Agreements Deal with Income Tax Issues' (2002) 55 *Tax L Rev* 533, 554.

<sup>62</sup> Yariv Brauner, 'International Trade and Tax Agreements May Be Coordinated, But Not Reconciled' (2005) 25 *Virginia Tax Rev* 251, 258-259; Youngjin Jung, 'How Far Should the WTO Reach Into Income Tax Policies?' (2005) 16 *Journal of Int'l Taxation* 36, 64. Whisenhunt has highlighted the lack

Although after the 2011 report of the UN Secretary General it was not clear whether the intergovernmental commission was meant to have universal membership, the author, like other academic writers who have discussed the idea of an international or world tax body, supports this position.<sup>63</sup> As mentioned in the 2011 report, participating individuals would most likely be persons holding key positions in their national tax authorities or Ministries of Finance.<sup>64</sup> Drawing from Tanzi's work, the Zedillo panel suggested several functions for such a body. These include: compiling relevant statistics and tax information for as many countries as possible; sharing best practices and maintaining surveillance of tax developments in the same way that the IMF does for macroeconomic policies; and developing arbitration procedures for inter-country disputes in international taxation.<sup>65</sup> However, for the author, the most important task mentioned in both the Zedillo panel's recommendations and Tanzi's proposal is developing basic norms in international taxation.<sup>66</sup> If in doing so the intergovernmental commission can offer all countries an equal opportunity to be involved in all stages of rule-making, from agenda setting to discussions and decision-making, then it will meet the parameters for fairness in process established in chapter II.

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of transparency as one such flaw. See Whitney Whisenhunt, 'To Zedillo or Not To Zedillo: Why the World Needs an ITO' (2002) 16 *Temple Int'l & Comparative L Journal* 541, 554, 558.

<sup>63</sup> According to Thuronyi, because each country has a sovereign right to tax, each country should have a representative in a world tax body. See Thuronyi (n 61) 1676. See also Adrian J Sawyer, *Developing a World Tax Organisation: The Way Forward* (Fiscal Publications 2009) 189-190.

<sup>64</sup> UN, 'Strengthening of Institutional Arrangements to Promote International Cooperation in Tax Matters, Including the Committee of Experts on International Cooperation in Tax Matters' (n 54) para 63.

<sup>65</sup> Zedillo Panel Report (n 49) 28. See also Vito Tanzi, 'Is there a Need for a World Tax Organization?' in Assaf Razin and Efraim Sadka (eds), *The Economics of Globalization – Policy Perspectives from Public Economics* (CUP 1999) 173, 184-185.

<sup>66</sup> In addition to the functions of the body discussed by Tanzi, the Zedillo Panel also mentioned: taking a 'lead role in restraining tax competition designed to attract multinationals with excessive and unwise incentives'; and 'sponsoring a mechanism for multilateral sharing of tax information'.

As stated in chapter II, fairer international taxation rule-making does not guarantee an equitable division of taxing rights. In a set-up comprising of model documents and bilateral tax treaties, the chances of a fair outcome are undoubtedly influenced by relative political and economic powers of the treaty partners. For developing countries, fairness in process can nevertheless increase the chances of attaining it by allowing them to leverage sheer force of numbers and reach a better starting point for bilateral tax treaty negotiations. In view of this it is understandable why G77 and China have approached the prospect of an intergovernmental body for addressing international taxation matters with enthusiasm,<sup>67</sup> and smaller developing countries see ‘equal participation and voice’ in international taxation rule-making as key in getting their ‘fair share of revenue’ from cross-border activities of MNEs.<sup>68</sup>

The BICs also support the proposal because of its potential to raise the legitimacy and authority of the UN’s tax work.<sup>69</sup> The latter attribute will also be influenced by potentially greater expertise that will be available for this purpose. This is because the UN’s existing set-up for dealing with international taxation issues

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<sup>67</sup> G77 and China, ‘Improved Monitoring and Regulation of Financial Markets and Institutions’ (Position Paper of the Group of 77 and China Presented at the Meeting of the Ad Hoc Open Ended Working Group of the General Assembly to Follow Up on the Issues Contained in the Outcome of the Conference on World Financial and Economic Crisis and its Impact on Development, 2010) para 27 <[www.g77.org/statement/getstatement.php?id=100503](http://www.g77.org/statement/getstatement.php?id=100503)> accessed 10 August 2015; G77 and China, ‘Statement on Behalf of the Group of 77 and China’ (Statement delivered by the Chair of the Group of 77 and China at the Special Meeting of the ECOSOC on International Cooperation in Tax Matters, 2015) <[www.un.org/esa/ffd/wp-content/uploads/2015/04/2015esm-SouthAfrica.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015esm-SouthAfrica.pdf)> accessed 10 August 2015.

<sup>68</sup> Francophone Low-Income Countries (LIC) Ministers’ Network, ‘LICs Demand Their Fair Share of Global Tax Revenue’ (Press Note from a Conference of Finance Ministers of Francophone LICs, 2012) 1 <[www.francophonie.org/IMG/pdf/minmeet\\_washington\\_oct2014\\_press\\_note\\_en.pdf](http://www.francophonie.org/IMG/pdf/minmeet_washington_oct2014_press_note_en.pdf)> accessed 10 August 2015.

<sup>69</sup> For the BICs’ positions on this issue see the submissions made by these countries to the Note Verbale circulated by the UN Tax Committee asking for countries’ views on ‘Strengthening Institutional Arrangements to Promote International Cooperation in Tax Matters, including the Committee of Experts on International Cooperation in Tax Matters’ in 2010 at <[www.un.org/esa/ffd/tax-committee/tc-ta-tax-cooperation.html](http://www.un.org/esa/ffd/tax-committee/tc-ta-tax-cooperation.html)> accessed 10 August 2015.

assumes that individual Committee members are experts on all aspects of the area.<sup>70</sup> In comparison, in their delegation to the intergovernmental commission, member States could include individuals with knowledge and skills specific to the different working groups of the commission.<sup>71</sup> Additionally, international discussions involving country representatives rather than experts acting in their personal capacity would mean greater national accountability for the stands taken at the global level and, potentially, more scrutiny of their alignment with the domestic positions on taxation of MNEs. Civil society groups that consider the creation of a global body for dealing with international taxation concerns as necessary for a more equal and balanced international taxation framework will have a vital role to play in achieving these ends.<sup>72</sup>

The exact working methods of an intergovernmental body on international taxation matters will be determined by the participating States. There are, however, two issues that even the idea of such a structure will encounter. The first is how the body would take decisions. The second is the nature of its output. Considering the first issue, one possibility is taking action based on the majority view. One country one vote, which Thuronyi views as consistent with each country's sovereignty, is at

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<sup>70</sup> UN, 'Strengthening of Institutional Arrangements to Promote International Cooperation in Tax Matters, Including the Committee of Experts on International Cooperation in Tax Matters' (n 54) para 69.

<sup>71</sup> *ibid.*

<sup>72</sup> As a reflection of civil society groups' interest in this issue see Claire Godfrey, 'Business Among Friends – Why Corporate Tax Dodgers are Yet Not Losing Sleep Over Global Tax Reform' (Briefing Paper 185, Oxfam 2014) 15-16 <[www.oxfam.org/sites/www.oxfam.org/files/bp185-business-among-friends-corporate-tax-reform-120514-en\\_0.pdf](http://www.oxfam.org/sites/www.oxfam.org/files/bp185-business-among-friends-corporate-tax-reform-120514-en_0.pdf)> accessed 10 August 2015; Tove Maria Ryding, 'Q&A on Financing for Development (FfD) and the Intergovernmental Tax Body' (Eurodad 2015) <<http://eurodad.org/files/pdf/557ae4411d063.pdf>> accessed 10 August 2015.

the heart of this course.<sup>73</sup> The advantage of the approach will be faster and possibly bolder decision-making.<sup>74</sup> From developing countries' perspective this could also mean strength in numbers. Developed countries may, however, see this as a threat. The OECD countries may also find the idea problematic because of being accustomed to the alternative of decision by consensus.<sup>75</sup> Consensus based decision-making between countries with different levels of development and concomitantly diverse economic interests could, however, pose the risk of no action.<sup>76</sup> Difficulty in reaching consensus is, in fact, one reason why OECD countries, such as the US, the UK, Japan, Canada and Australia, among others, oppose the proposals contained in the 2011 report of the UN Secretary General.<sup>77</sup>

As discussed by Ring, 'no ideal voting structure exists'.<sup>78</sup> Yet there are functional bodies with universal or near universal membership dealing with contentious issues.<sup>79</sup> If an international taxation rule-making process that offers effective participation to all countries is the goal, then the focus should be on studying available examples and working on their drawbacks. For instance, if the consensus

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<sup>73</sup> Thuronyi (n 61) 1676. As another option, Thuronyi has mentioned applying different voting rules for different steps, such as initial enactment, revision, and enforcement of documents produced by the global body for dealing with international taxation issues.

<sup>74</sup> Diane M Ring, 'Prospects for a Multilateral Tax Treaty' (2004) 26 *Brooklyn Journal of Int'l L* 1699, 1705.

<sup>75</sup> OECD, 'Resolution of the Council on Decision-Making by the Council and its Standing Committees' (2014) C(2014)120/REV2, 2.

<sup>76</sup> Diane M Ring, 'Prospects for a Multilateral Tax Treaty' (n 74) 1705.

<sup>77</sup> See the submissions made by OECD countries to the Note Verbale circulated by the UN Tax Committee asking for countries' views on 'Strengthening Institutional Arrangements to Promote International Cooperation in Tax Matters, including the Committee of Experts on International Cooperation in Tax Matters' in 2010 cited at (n 69).

<sup>78</sup> Diane M Ring, 'Prospects for a Multilateral Tax Treaty' (n 74) 1705.

<sup>79</sup> *ibid.* One example is the Conference of Parties, which is the supreme decision-making body vis-à-vis the Framework Convention on Climate Change, where all 195 countries parties to the Convention are represented. See UN, 'Framework Convention on Climate Change - Conference of Parties' (UN) <<http://unfccc.int/bodies/body/6383.php>> accessed 19 August 2015.

option is chosen, overlap of interests between countries could be leveraged in the decision-making process.<sup>80</sup> As stated before, placing taxation under the broader umbrella of tax and development could also lead to more willingness, or at least, more room for striking compromises. Cautious drafting could also aid in reaching sufficient international consensus or acceptance by a ‘critical mass’ of jurisdictions required for advances.<sup>81</sup> Arguably, any organisation that seeks to project itself as a global standard-setting body will have to rely on one or more of such measures. The OECD also did the same while acknowledging the deemed service PE alternative.<sup>82</sup>

Admittedly, seeking to settle international taxation matters at the intergovernmental level based on consensus would mean slow progress in the more sensitive areas, such as the balance of taxing rights between countries. As argued in chapter II, however, from a longer-term perspective, outcomes resulting from countries’ effective participation in the rule-making process are more likely to be followed.<sup>83</sup> Considering the evolution and development of the existing framework for allocation of taxing rights between countries studied in chapter III, and the BICs’

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<sup>80</sup> For instance, among the countries against the creation of an intergovernmental commission, Australia, Canada, and the UK share interests with the BICs and other developing countries in terms of having greater FDI inflows than outflows. Similarly, considering the focus of chapter IV – services – among these countries, like Brazil and China and developing countries more generally, Australia, Canada, and Japan are net importers. Like the US and the UK, India, in fact, now has a positive balance in trade in services. The US and the UK also feature above Brazil and India in terms of market potential, which is expected to rise strongly for the African economies as well.

<sup>81</sup> Achieving progress in this way is mentioned in OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 13, 21.

<sup>82</sup> As highlighted in chapter IV, along with the BICs, there were some OECD countries that also sought acceptance of the deemed service PE alternative in the OECD Model. Other OECD countries, particularly the US, however, opposed this move. As a compromise, the deemed service PE formulation was introduced in the Commentary to Article 5 of the OECD Model. Even in the Commentary, a careful reference to ‘minority’ interests and the need to ‘circumscribe the circumstances’ in which a country can tax active business income generated by a non-resident service provider in the absence of its PE as envisaged in Article 5 of the OECD Model in the country, was employed to reach a broadly agreeable result.

<sup>83</sup> Text to n 109-113 in chapter II.

divergence from the same examined in chapters IV and V, working towards such more robust and durable, *albeit* gradual results, would be more advisable than repeating the errors of the past.

This brings us to the second preliminary issue facing the creation of an intergovernmental commission for dealing with tax matters. This is the nature of the output of such a body. If it is a model document or guidelines, proximity to the prevailing set-up for rule-making in international taxation is likely to make the output, and concomitantly, the forum that gives rise to it, more acceptable to countries from a sovereignty point of view.<sup>84</sup> As stated before, this course will, however, leave much to inter-country treaty negotiations, which are vulnerable to power play.<sup>85</sup> In comparison, a legally binding multilateral tax treaty might raise sovereignty concerns, but from developing countries' perspective, this could ensure that the lack of expertise and resources for bilateral tax treaty negotiations does not prevent them from benefiting from the international taxation framework.<sup>86</sup>

Between these two options is a long gap that can be bridged through incremental approaches.<sup>87</sup> For instance, Thuronyi suggests starting with a single

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<sup>84</sup> Diane M Ring, 'Prospects for a Multilateral Tax Treaty' (n 74) 1708. Ring has discussed sovereignty as a primary challenge in giving effect to a multilateral tax treaty. According to Slemrod as well, 'ceding tax policy-making authority to an international agreement would compromise national sovereignty too greatly'. See Joel Slemrod, 'Tax Principles in an International Economy' in Michael J Boskin and Charles E McLure Jr (eds), *World Tax Reform: Case Studies of Developed and Developing Countries* (ICS Press 1990) 11, 21. See also Diane M Ring, 'What's at Stake in the Sovereignty Debate: International Tax and Nation State' (2008) 49 *Virginia Journal of Int'l L* 155; Diane M Ring, 'Democracy, Sovereignty and Tax Competition: The Role of Sovereignty in Shaping Tax Cooperation' (2009) 9 *Florida Tax Rev* 555.

<sup>85</sup> Tsilly Dagan, 'Just Harmonization' (2010) 42 *UBC L Rev* 331, 344.

<sup>86</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 16. See also Thuronyi (n 61) 1656.

<sup>87</sup> Dale Pinto, 'A Proposal to Create a World Tax Organisation' (2003) 9 *New Zealand Journal of Taxation L and Policy* 145, 160.

model document for entering into new treaties and renegotiating older ones.<sup>88</sup> Over time, that text will be opened up for signing as a multilateral tax treaty.<sup>89</sup> That treaty can then be changed gradually for greater advances through a global institutional framework.<sup>90</sup> According to Thuronyi, the initial instrument can be based on the OECD Model.<sup>91</sup> Owing to the comparatively greater balance between the interests of developed and developing countries, the author, however, believes that the UN Model would be a better starting point. The author is also of the view that in stage one of this proposal, building the capacity of developing countries vis-à-vis treaty negotiations will be key in ensuring that they are on track for eventually signing up to and benefiting from the multilateral treaty.

Another incremental course suggested by Ring, Reinhold, Pinto and Sawyer, and also Oliver, is to start from issue-based cooperation.<sup>92</sup> This, in fact, is reflected in the international trend towards multilateralism.<sup>93</sup> The OECD's Convention on Mutual Administrative Assistance in Tax Matters is seeing growing uptake.<sup>94</sup> The success of the Convention could be attributed to the lesser diversity in the tax administrations of

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<sup>88</sup> Thuronyi (n 61) 1667.

<sup>89</sup> *ibid*

<sup>90</sup> *ibid* 1668.

<sup>91</sup> *ibid* 1667.

<sup>92</sup> Diane M Ring, 'Prospects for a Multilateral Tax Treaty' (n 74) 1707; Richard L Reinhold, 'Some Things that Multilateral Tax Treaties Might Usefully Do' (2004) 57 Tax L Rev 661, 662. See also David B Oliver, 'Tax Treaties and the Market State' (2003) 56 Tax L Rev 587, 606; Adrian J Sawyer, 'Is an International Tax Organisation an Appropriate Forum for Administering Binding Rulings and APAs?' (2004) 2 e-Journal of Taxation Research 8; Adrian J Sawyer, 'Developing an International (World) Tax Organisation for Administering Binding Rulings and APAs - The Way Forward' (2006) 21 Australian Tax Forum 287, 313-316; Dale Pinto and Adrian J Sawyer, 'Towards Sustaining the Future of Taxation: Is a World Tax Organisation Necessary and Feasible in Today's Globalised World?' (2009) 24 Australian Tax Forum 179, 197-200.

<sup>93</sup> The idea of a multilateral instrument for dealing with double taxation has been around since the time of the LONs. See LONs, *LONs' Fiscal Committee: Report to the Council on the First Session of the Committee* (C516.M.175.1929.II. LONs 1929) 6. It is, however, only over the years, through issue-based developments discussed in the text that greater openness towards such an agreement can be seen.

<sup>94</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 14.

countries, and freedom from the confines of the prevailing bilateral tax treaty network.<sup>95</sup> The work on the previously mentioned legally binding multilateral instrument sought to further some of the outcomes of the BEPS project is, however, advancing even in the absence of these factors. It could be said that greater overlap in countries' interests vis-à-vis addressing BEPS has made this development possible, and that this will not be the case with regards to contentious issues in international taxation, such as the division of taxing rights between countries.<sup>96</sup> However, this too was inconceivable in the last decade. Arguably, if the basics of this set-up continue to come under pressure from developments in technology and business methods that have fuelled the BEPS project, the need for more coordinated changes will only increase.<sup>97</sup>

The swiftest manner of achieving them would be to extend an existing multilateral instrument to the areas not covered by it.<sup>98</sup> It will also be the option through which most certainty and predictability in international tax relations could be reached.<sup>99</sup> These attributes were discussed in chapter II as indicators of a fair international taxation framework from the standpoint of businesses.<sup>100</sup> Like the BEPS project's proposed multilateral document, this extension could offer flexible adaptation. This could be achieved by requiring countries' commitment to a core set

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<sup>95</sup> Richard J Vann, 'A Model Tax Treaty for the Asia-Pacific Region' (2010) Sydney Law School Legal Studies Research Paper No 10/ 22, 28-30.

<sup>96</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 26.

<sup>97</sup> With the BEPS project's proposed multilateral instrument, similar arguments made in the past now appear to have come true. See Charles E McLure Jr, 'Taxation of E-Commerce: Economic Objectives, Technical Constraints, and Tax Laws' (1997) 52 Tax L Rev 269, 277; Arthur J Cockfield, 'Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation' (2001) 85 Minnesota L Rev 1171, 1264.

<sup>98</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 13.

<sup>99</sup> *ibid* 16-17.

<sup>100</sup> Text to n 150-154 in chapter II.

of provisions, but then giving them the choice to opt-out of some or select alternatives to them and also to opt-in for additional obligations.<sup>101</sup> Moderating the level of countries' commitment through the use of different types of wording and duties would also be helpful in attaining comprehensive change without creating the fear of impinging on a country's freedom to shape its international tax policy.<sup>102</sup>

Beyond the above-discussed preliminary issues, a practical concern in realising an intergovernmental body for dealing with international taxation matters will be the financial resources required for setting it up and running it. In its Resolution 2006/48, the ECOSOC requested the UN Secretary General to establish a trust fund to receive voluntary contributions from member States and other institutions interested in the UN Tax Committee's activities.<sup>103</sup> In its Resolution 2008/16 the ECOSOC urged member States as well as relevant organisations to contribute generously to the fund.<sup>104</sup> The trust fund, however, remains empty.<sup>105</sup> The question of resources thus continues to be another ground for the previously mentioned OECD countries' opposition to such a forum.<sup>106</sup>

The prospect of governmental level effective participation in the rule-making process, and linked to this, the potentially greater influence of the outcome, could

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<sup>101</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* 2014 (n 47) 48-54.

<sup>102</sup> *ibid* 55-56.

<sup>103</sup> UN, ECOSOC Resolution 2006/48 (28 July 2006) E/2006/48, 2.

<sup>104</sup> UN, ECOSOC Resolution 2008/16 (24 July 2008) E/2008/16, 2.

<sup>105</sup> UN, 'Further Strengthening the Work of the Committee of Experts on International Cooperation in Tax Matters' (11 March 2015) E/2015/51, para 13.

<sup>106</sup> See the submissions made by OECD countries to the Note Verbale circulated by the UN Tax Committee asking for countries' views on 'Strengthening Institutional Arrangements to Promote International Cooperation in Tax Matters, including the Committee of Experts on International Cooperation in Tax Matters' in 2010 cited at (n 69).

change the position of bigger developing countries, such as the BICs. This also applies to the OECD countries like Mexico and Chile that support the idea of an intergovernmental body for dealing with international taxation issues at the UN.<sup>107</sup> Along with monetary support from any other willing countries, these countries' contribution could get the body started. Once it is established, to generate an equal sense of ownership of the body and its output, it would be better if a mandatory participation fee is set for all countries. To enable developing countries to pay their share, a realistic minimum will have to be discussed by the member States, with the remainder being supplied by the ECOSOC. Another option, as suggested by Thuronyi, is to take dues from members relative to their tax collections.<sup>108</sup> In this way, the more developed countries that have higher tax to GDP ratios are likely to have a greater contribution.<sup>109</sup> It will then have to be ensured that this does not translate into a disproportionate influence on the body's work.

Another ground on which OECD countries, such as the US, the UK, Australia, Japan, and Canada, along with the EU, oppose the formation of an intergovernmental commission for international taxation matters at the UN is that it will lead to duplication of tax work of other organisations like the OECD.<sup>110</sup> According to them, these bodies also give sufficient consideration to the interests of developing

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<sup>107</sup> *ibid*, replies of Mexico and Chile.

<sup>108</sup> Thuronyi (n 61) 1679.

<sup>109</sup> For a comparison of tax to GDP ratios of countries across the world see World Bank, 'Tax Revenue (% of GDP)' (*World Bank*) <<http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS>> accessed 10 August 2015.

<sup>110</sup> See the submissions made by OECD countries and the EU to the Note Verbale circulated by the UN Tax Committee asking for countries' views on 'Strengthening Institutional Arrangements to Promote International Cooperation in Tax Matters, including the Committee of Experts on International Cooperation in Tax Matters' in 2010 cited at (n 69).

countries.<sup>111</sup> However, as seen in part I, the existing international taxation framework lacks a forum that is both facilitative of developing countries' effective participation in the rule-making process and open to engaging directly with contentious issues in the area, such as the distribution of taxing rights between countries. To this extent, rather than duplication, there is a gap in this set-up that an intergovernmental body for addressing international taxation matters proposed by the Zedillo panel in 2000, and discussed further in the UN Secretary General's 2011 report, will fill. As explained in this part, preliminary technical and pragmatic challenges in realising the idea are also surmountable. It should, however, be remembered that this will not be a short and easy process.

G77 and China, along with civil society groups from across the world, continue to use opportunities like the Third Financing for Development conference in Addis Ababa in July 2015 to give momentum to the proposal.<sup>112</sup> In the meanwhile, however, they must not fail to make the most of the existing opportunities for fairer international taxation rule-making from the perspective of developing countries more generally. As the only other forum dealing with international taxation issues, the UN Tax Committee is the obvious option for pursuing this objective in the shorter-term.

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<sup>111</sup> *ibid.*

<sup>112</sup> G77 and China, 'General Statement on behalf of the Group of 77 and China' (Statement delivered by the Chair of the Group of 77 and China at the Third International Conference on Financing for Development, 14 July 2015) <[www.g77.org/statement/getstatement.php?id=150714](http://www.g77.org/statement/getstatement.php?id=150714)> accessed 10 August 2015; Civil Society Organisations' (CSO) Financing for Development (FfD) Group, 'Declaration from the Addis Ababa Civil Society Forum on Financing for Development' (CSO Forum 12 July 2015) <<https://csoforffd.files.wordpress.com/2015/07/addis-ababa-cso-ffd-forum-declaration-12-july-2015.pdf>> accessed 10 August 2015.

### III. Enhancing the efficiency and legitimacy of the UN Tax Committee

A 2012 report of the UN Secretary General pointed out the absence of ‘enough voice and participation of developing countries’ in the existing norm-setting arrangements in the area of international taxation, including the UN Tax Committee.<sup>113</sup> Part I of this chapter helped understand how this criticism applies to the OECD. In comparison, through chapters IV and V, the author discussed the UN Tax Committee as the international forum offering the BICs and even other developing countries effective involvement in shaping the rules for division of taxing rights between countries. The UN’s work on the provision for taxation of FTS for the UN Model, Article 7 of the Model, and the UN TPM analysed in these chapters also highlighted the Committee’s increasing openness towards engaging with the BICs and other developing countries’ concerns vis-à-vis these rules.<sup>114</sup> Thus, the UN Tax Committee being subject to this complaint may seem surprising. Two main reasons, however, justify this critique. The first is the small size of the UN Tax Committee. This paves the way for limited contribution of developing countries in the Committee’s work, which in turn affects its legitimacy. The second is the lack of resources that makes it difficult to mitigate the impact of the first issue and also reduces the efficiency of the Committee.

Taking up the first issue, the UN Tax Committee has only 25 members. Their selection is aimed at achieving adequately diverse representation in terms of

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<sup>113</sup> UN, ‘Role and Work of the Committee of Experts on International Cooperation in Tax Matters’ (29 February 2012) E/2012/8, para 17.

<sup>114</sup> This is also reflected in the UN’s decision to pursue its own work on BEPS and the retention of Article 14 of the UN Model discussed in the text to n 34-35 of this chapter and n 72-73 of chapter IV respectively.

geography and tax systems.<sup>115</sup> Thus, there is an inherent limitation on the number of experts from developing countries that can serve on the Committee. This flaw could be mitigated to a certain extent by increasing the involvement of individuals from developing countries in the UN Tax Committee's ad hoc subcommittees and working groups as external experts or observers.<sup>116</sup> An attempt could also be made to have more governmental observers from developing countries at the Committee's meetings. Observers do not participate in the final decision-making process or initial agenda-setting. Therefore, such a participation in the rule-making process cannot be considered entirely effective.<sup>117</sup> Nevertheless, it is an opportunity to introduce more developing countries to the UN's tax work. This could lead to more nominations from these countries for Committee membership, or to a greater number of individuals from these countries serving on the ad hoc subcommittees.

The second problem of the shortage of resources faced by the UN's tax work, however, limits the pursuit of the options mentioned in the preceding paragraph.<sup>118</sup> It is recommended that the ad hoc subcommittees and working groups use electronic means of interaction, but it is accepted that their efficient operation may require face-to-face meetings.<sup>119</sup> This is particularly desirable where more technically complex or more politically divisive issues are involved. Members of the subcommittees and working groups work pro bono, and thus are required to finance their attendance at

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<sup>115</sup> UN, ECOSOC Resolution 2004/69 (n 58) 1-2.

<sup>116</sup> UN, ECOSOC Resolution 2006/48 (n 103) 1.

<sup>117</sup> Diane Ring, 'Who is Making International Tax Policy: International Organizations as Power Players in a High Stakes World' (2009) 33 *Fordham Int'l L Journal* 649, 673-674.

<sup>118</sup> UN, 'Role and Work of the Committee of Experts on International Cooperation in Tax Matters' (n 113) para 16.

<sup>119</sup> UN, 'Further Strengthening the Work of the Committee of Experts on International Cooperation in Tax Matters' (n 105) para 10. See also UN, 'Role and Work of the Committee of Experts on International Cooperation in Tax Matters' (n 113) para 47.

these meetings.<sup>120</sup> The 2012 report of the UN Secretary General points out that lack of funding for this purpose often results in little or no participation of members from developing countries in the meetings of the subcommittees and working groups as experts or even as observers.

According to the report, this results in a ‘representational imbalance between developed and developing countries’, and also leads to a ‘disproportionate number of participants from the business sector’ on certain subcommittees and working groups.<sup>121</sup> Consequently, the outcome of the meetings of the subcommittees and working groups is less likely to reflect ‘true consensus’ between countries.<sup>122</sup> As experts and observers at the meetings of the UN Tax Committee must also arrange for their participation, the report sees the same issues as ‘systemic risks’ to the integrity and legitimacy of the UN Tax Committee’s work.<sup>123</sup>

Even if there are enough monetary resources to enable more individuals from developing countries to participate at the Committee and subcommittee levels, the issue of effectiveness of that participation will remain unless the participants can be offered technical support to appropriately assess the impact of the issues being covered for their countries and make meaningful contributions to the discussions. As stated in chapter II, the absence of such assistance can raise questions about the fairness of the rule-making process from the standpoint of the involved countries.<sup>124</sup>

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<sup>120</sup> UN, ‘Role and Work of the Committee of Experts on International Cooperation in Tax Matters’ (n 113) para 50.

<sup>121</sup> *ibid.*

<sup>122</sup> *ibid* para 49.

<sup>123</sup> *ibid* para 50.

<sup>124</sup> Text to n 129 and n 133-135 in chapter II.

The Committee's dependence on pro bono ad hoc subcommittees supported by a Secretariat of only three personnel is also an indirect restriction on the expanse of the Committee's agenda.<sup>125</sup> The fact that the subcommittees have had only 10 face-to-face consultations between 2003 and July 2011 further reflects the constraint on how much the Committee has been able to take up and deliver on.<sup>126</sup> Contrast this with the OECD. The Centre for Tax Policy and Administration (CTPA), which provides technical support to the CFA and its subsidiary bodies, has a staff of over 100 people. Funding available from member countries and the fees paid by participants and associates also contribute towards the CFA's greater and more timely output on international taxation issues, and hence leadership in international taxation rule-making.<sup>127</sup> Accordingly, it is not surprising that, although mainly through changes to

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<sup>125</sup> The Secretariat comprises of one senior economic affairs officer who serves as the Committee's Acting Secretary, one economic affairs officer, and one general service staff member. In the past, Norway, and now Germany (since 2012), have funded temporary assistance in the form of an associate expert. All Committee members who responded to a questionnaire circulated by the UN Tax Committee in 2012 felt that, given the scope of their work, the Secretariat support was 'grossly inadequate', with too much responsibility being left with the subcommittees to keep a track of progress of their work, and prepare documents for Committee meetings. These members were also of the view that the Committee would benefit from more analysis and drafting help in preparing background papers for Committee meetings. See UN, 'Role and Work of the Committee of Experts on International Cooperation in Tax Matters' (n 113) para 51. See also UN, 'Further Strengthening the Work of the Committee of Experts on International Cooperation in Tax Matters' (n 105) para 17.

<sup>126</sup> All the Committee members who replied to the questionnaire mentioned in the preceding footnote agreed that 'real progress' in fulfilling the Committee's mandate is 'often contingent on face-to face meetings where issues can be fully discussed and consensus reached'. As subcommittee members fund their presence at the meetings, a 'fraction of the required meetings takes place', which has 'negatively affected the pace of progress in the Committee's work'. Some of the members also felt that 'regardless of the work of the subcommittees, a meeting once a year for five working days does not provide sufficient time to make significant progress in implementing the Committee's broad mandate'. See UN, 'Role and Work of the Committee of Experts on International Cooperation in Tax Matters' (n 113) para 47 and para 53. See also UN, 'Strengthening of Institutional Arrangements to Promote International Cooperation in Tax Matters, Including the Committee of Experts on International Cooperation in Tax Matters' (n 54) para 14.

<sup>127</sup> For details of participants' and associates' fee commitments see OECD, 'Resolution of the Council on Partnership in OECD Bodies' (n 26) 8-9.

the Commentary, the OECD Model has been revised multiple times.<sup>128</sup> The UN Model, however, has been updated only twice since 1980.<sup>129</sup>

If this situation persists, from the BICs' perspective it means that even if experts from these countries enjoy effective participation in the UN Tax Committee, the role that they can play in shaping the global standards in international taxation through the UN is limited. It is acknowledged that since 2008, the UN Tax Committee has shown more willingness and momentum in dealing with matters important to these and other developing countries.<sup>130</sup> However, as seen in chapters IV and V, and also in light of the preceding paragraph, much credit for this has to be given to the commitment of the Committee members and the individuals on the subcommittees, particularly from the BICs and other involved developing countries. It is critical to realise that this factor is only some compensation for the lack of resources and the limitations on the scope and timeliness of the Committee's work due to that reason. Importantly, from the perspective of future planning, it is a variable relying on individual personalities.

Furthermore, the sustainability of a model for advancing fairness in the international taxation rule-making process that depends on bigger, more influential developing countries to promote the interests of developing countries more generally is questionable.<sup>131</sup> Taking the example of the BICs, as seen in chapter I, these

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<sup>128</sup> The OECD Model and/or its Commentary were changed in 1977, 1992, 1996, 1998, 2000, 2003, 2005, 2008, 2010, and 2014.

<sup>129</sup> The UN Model was updated in 2001 and 2011.

<sup>130</sup> The 2011 update to the UN Model, the introduction of the UN's Transfer Pricing Manual (TPM) in 2012, and the on going work on the provision for taxation of FTS for the UN Model are evidence of this.

<sup>131</sup> This criticism also applies to the BEPS project model of rule-making discussed in part I of this chapter. See also Allison Christians, 'Taxation in a Time of Crisis: Policy Leadership From the OECD to the G20' (2010) 5 *Northwestern Journal of Law and Social Policy* 19, 39-40.

countries remain substantial importers of capital.<sup>132</sup> To this extent the BICs' interests vis-à-vis the international division of taxing rights are still aligned with those of other developing countries. The BICs' position as home economies is, however, also growing.<sup>133</sup> This raises doubts on how long representatives from countries like the BICs can be expected to be the genuine voice of developing countries on issues relating to allocation of taxing rights between countries and the degree to which a division of taxing rights fair from the BICs' perspective can be considered equitable from the standpoint of developing countries more generally. This also because the BICs' bilateral tax treaties with other developing countries do not reflect much inclination to promote the cause of source taxation regardless of their own economic interests.

This statement is supported by the author's empirical analysis of the BICs' bilateral tax treaties.<sup>134</sup> For instance, considering the issue of taxation of active business income of non-resident service providers studied in chapter IV, about 37% and 54% of India's bilateral tax treaties with OECD economies and non-OECD high-

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<sup>132</sup> See graphs 4, 5, and 6 in chapter I.

<sup>133</sup> *ibid.*

<sup>134</sup> The author reached the results discussed in the text following this footnote by dividing the BICs' bilateral tax treaties into four categories: treaties with 1) OECD economies; 2) high income non-OECD economies; 3) other developing economies; and 4) African economies. This classification is based predominantly on the economic situation of the BICs' treaty partners, which in turn can influence the BICs' economic interests in relation to them, and hence the BICs' bilateral tax treaties with them. The starting point for studying the economic situation of the BICs' treaty partners was the World Bank's grouping of countries based on the level of their economic development. The difference, however, lies in developing countries. Depending on their income levels, the World Bank divides them into further categories. The author, however, considered these countries in just two groups: African economies and other developing countries. This was done to serve the limited objective of obtaining an understanding of the BICs' treaty positions with respect to developing countries more generally along with covering their special interest in investment destinations in Africa mentioned in chapter I. The direction and quantum of flow of trade and investment between the BICs and other countries was used to substantiate the classification based on the World Bank's data.

income economies respectively have a deemed service PE provision.<sup>135</sup> There is a drop to approximately 33% when India's bilateral tax treaties with other developing economies are considered.<sup>136</sup> Similarly, there is a fall to almost 29% in the case of treaties with African economies.<sup>137</sup> Further, whereas the time thresholds for deeming the existence of a service PE in more than 50% of the treaties in other groups are lesser than 183 days in a 12 month period, all of India's bilateral tax treaties with African economies follow this UN standard.<sup>138</sup>

The deemed service PE provision in all of India's bilateral tax treaties with African economies also contains the 'same or connected project' limitation.<sup>139</sup> Similarly, all except one of the treaties with other developing countries include this threshold requirement that, as seen in chapter IV, India has criticised strongly at the UN.<sup>140</sup> In comparison, about 67% and 83% of India's bilateral tax treaties with OECD and high-income non-OECD economies respectively, require services to be rendered for the same or connected project for deeming the existence of an enterprise's service PE in the country.<sup>141</sup> An examination of the provisions for taxation of FTS in India's bilateral tax treaties shows similar results. Approximately 97% and 82% of these treaties with OECD countries and non-OECD high-income economies have this

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<sup>135</sup> Annexure II.

<sup>136</sup> *ibid.*

<sup>137</sup> *ibid.*

<sup>138</sup> *ibid.*

<sup>139</sup> *ibid.*

<sup>140</sup> Text to n 33-39 in chapter IV.

<sup>141</sup> Annexure II.

provision.<sup>142</sup> There is, however, a fall to 73% and 64% when India's bilateral tax treaties with other developing economies and African countries are seen.<sup>143</sup>

China's bilateral tax treaties show a similar change to a lesser scope of host State taxation of active business income of non-resident service providers in cases where China is more likely to be the home country as compared to the ones in which there is more chance of China being the host country. For instance, approximately 88% and 77% of China's bilateral tax treaties with OECD economies and high-income non-OECD developing countries respectively, contain a deemed service PE provision.<sup>144</sup> About 69% of its treaties with other developing economies and 64% of them with African countries, however, subject taxation of active business income of non-resident service providers to the fixed place of business PE threshold.<sup>145</sup> Also, whereas the deemed service PE provision in only about 17% of China's bilateral tax treaties with OECD countries uses time thresholds greater than 183 days,<sup>146</sup> 30% of the treaties with other developing economies do so.<sup>147</sup> About 46% of China's bilateral tax treaties with African economies apply a higher time limit for deeming the existence of an enterprise's service PE in a country.<sup>148</sup>

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<sup>142</sup> *ibid.*

<sup>143</sup> Another aspect of India's bilateral tax treaties that shows a similar trend is the force of attraction rule. Approximately 41% of these treaties with OECD economies contain it. In comparison, only about 18% and 14% of India's bilateral tax treaties with other developing countries and African economies have the limited force of attraction rule. See Annexure V.

<sup>144</sup> Annexure III.

<sup>145</sup> *ibid.*

<sup>146</sup> These are China's bilateral tax treaties with: the Czech Republic – 9 months in any 12 month period; Hungary and Slovenia – 12 months; Israel – 12 months in any 24 month period; and Turkey – 12 months.

<sup>147</sup> These are China's bilateral tax treaties with: Cuba and Jamaica – 12 months in any 24 month period; Mongolia, Belarus, and Ukraine – 18 months; Kazakhstan, Armenia, and Kyrgyzstan – 12 months; and Albania – 9 months in any 12 month period.

<sup>148</sup> Annexure III.

The above-discussed pattern is not seen in Brazil's bilateral tax treaties.<sup>149</sup> However, Brazil has only 8 treaties with other developing countries, 4 of which are with Latin American States, and only one with an African nation – South Africa. This does not give a sufficiently large and diverse sample size to draw a strong conclusion vis-à-vis Brazil on this aspect. Nevertheless, even if only India and China are considered, the potential for dichotomy in the treaty positions bigger developing countries seek for themselves as host nations and those that they are prepared to offer as home States can be seen. This, along with the above-mentioned increasing potential for difference in economic interests, means that the existing reliance on these countries to compensate for other developing countries' inadequate or ineffective participation in the UN Tax Committee's work should not make one lose sight of much needed reforms to the UN Tax Committee.

Foremost among these will be increasing the resources of the Committee. This will help enhance technical assistance from the Secretariat and the frequency of the meetings of the Committee and the subcommittees. This, in turn, will improve the scope and pace of the Committee's output. It will also enable experts and government representatives from a greater number of developing countries to participate in the international taxation rule-making process through this front, which will provide more legitimacy to the UN's tax work. The Third Financing for Development Conference

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<sup>149</sup> For instance, all of Brazil's bilateral tax treaties have the 'other income' provision. As seen in chapter IV, this was used up till 2014 to bring taxation of payments for a wide range of services (technical services and technical assistance not involving transfer of technology) under Brazil's tax net, regardless of whether the non-resident service provider had a PE in Brazil. Similarly, about 77% of Brazil's bilateral tax treaties with OECD economies include 'fees for technical services and technical assistance' in the definition of royalties. As stated in chapter IV, from 2014, these have been taxable in Brazil like royalties, irrespective of whether they involve transfer of technology. All of Brazil's bilateral tax treaties with other developing countries and its only treaty with an African nation – South Africa – take this position.

in Addis Ababa in July 2015 was a step in this direction. It was agreed to raise the resources of the UN Tax Committee to allow it to hold two meetings in a year lasting four days each. More intergovernmental consideration of tax issues through a special meeting of the UN Tax Committee with the ECOSOC on international cooperation in tax matters was also discussed.<sup>150</sup>

The UN's efforts in supporting the UN Tax Committee, however, must not end here. Equally, the BICs and other developing countries must also think about contributing towards the Committee's resources. This is especially considering that the UN Tax Committee has been the only forum that has consistently enabled them to further their positions on international taxation issues. In view of the discussion in parts I and II of this chapter, at least in the short-term, this may be the only way of increasing developing countries' equal participation in all stages of the rule-making process – from agenda-setting and discussions to decision-making. Therefore, civil society organisations must also devote greater attention to the Committee's work and help raise its profile as well as uptake.<sup>151</sup>

## **Conclusion**

This chapter examined three proposals for a fairer international taxation rule-making process from the perspective of the BICs and also other developing countries based on the parameters established for this purpose in chapter II. The first of these was the

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<sup>150</sup> UNGA Resolution 69/313 (27 July 2015) A/RES/69/313, para 29.

<sup>151</sup> Research done by the IBFD suggests significant room for greater use of provisions of the UN Model in bilateral tax treaties between UN-UN countries (essentially non-OECD countries) as well as between UN-OECD countries. See Wim Wijnen and Jan de Goede, 'The UN Model in Practice (1997-2013)' (2014) 68 *Bulletin for Int'l Taxation* 118, 146.

emergence of the OECD as a world tax body. Part I highlighted that the OECD's membership is mainly comprised of developed countries and there is not much to suggest that it will increase substantially in the coming years. Nevertheless, since the mid-2000s, the BICs have participated to varying degrees in the meetings of the CFA and its subsidiary bodies. The absence of a direct input in agenda-setting and/or final decision-making has, however, meant a largely indirect influence over the OECD's engagement with the rules for division of taxing rights between countries.

Over the years, other developing countries have also benefited from the OECD's efforts to inform them of and also help them apply the international tax standards. The OECD has even been more open to these countries' input in their development. This, however, does not equate to a country's effective participation in that process, which would entail their equal involvement in all its stages – from agenda-setting and discussions to final decision-making. From the standpoint of the BICs and other developing countries, this position vis-à-vis fairness in the international taxation rule-making process at the OECD level has impacted its outcome. There has been no significant increase in source taxation in the OECD Model. Instead, there have been developments, such as the introduction of the new Article 7, which are questionable from the perspective of these countries.

The BICs participated in the BEPS project on an equal footing with OECD members and other associates. The involvement of developing countries more generally has, however, either been completely indirect or ineffective because of their inability to shape the project's agenda and have direct control over its outcome. Thus, an area of particular concern to these countries - the allocation of taxing rights

between countries, was not considered in the project. In comparison, the process of drafting of the legally binding multilateral instrument sought to implement some of the results of the BEPS project is equally open to all countries. The persistence of this position would have set the stage for the OECD's emergence as a world tax body. The OECD has, however, made it clear that this is not to be taken as a precedent for its tax work. In any case, a global tax body is expected to cater to the interests of countries across the world. This, in turn, means that certain issues like the division of taxing rights between countries cannot always be kept off the negotiating table. Conventionally, the OECD has been reluctant to deal with this matter. Thus, overall, in the short or even medium term, it is difficult to see the OECD functioning as a world tax body.

An intergovernmental forum offering effective participation to all countries and open to dealing with all international taxation matters would address the drawbacks in the rule-making process at the OECD. Part II highlighted that historical and pragmatic reasons make the UN a suitable host for such a body. The idea of the platform would, however, face some preliminary technical challenges, such as determining how the body will take decisions, and the nature of its output. As discussed in part II, these are not insurmountable. Relevant academic literature and also examples from existing international structures offer potential solutions. The practical question of resources to achieve and maintain such a body can also be addressed. Realising all these measures will, however, not be quick and easy. As shown by the Third Financing for Development conference in 2015, politically as well, this remains a difficult move. Thus, while efforts in the direction of this long-term goal continue, those in favour of it, which includes the G77 and China as well as civil society organisations across the

world, must not lose sight of other ways of achieving a fairer international taxation rule-making process in the short-term.

Being the other leading forum for setting the standards in international taxation, the UN Tax Committee is the obvious option to explore in this regard. The Committee is the only body where members from developing countries have always participated as equals with those from other countries. The Committee has also been increasingly open towards addressing issues going to the fundamentals of the existing international rules for assignment of taxing rights that are of particular concern to the BICs and other developing countries. Achieving fairer international taxation rule-making from the standpoint of these countries at the level of the UN Tax Committee, however, needs dealing with the Committee's problem of shortage of resources.

This affects the number of matters that the Committee can take up and deliver on. Importantly, it limits the wider participation of developing countries in the UN's tax work, which although will not guarantee a more equitable division of taxing rights from developing countries' perspective, but can increase the chances of it by allowing developing countries to use the sheer force of numbers and reach a better starting point for bilateral tax treaty negotiations. Bigger developing countries like the BICs cannot be considered adequate substitutes for developing countries effective participation in the rule-making process. This is due to the growing difference of economic interests between the BICs and other developing countries. This is also because there is little to suggest that the BICs would support international tax policy positions favourable to the broad group of developing countries regardless of their economic interests.

These issues are at the heart of the authority and legitimacy of the Committee's work. The Third Financing for Development conference's commitment to increase the Committee's finances is a step in the direction of addressing them. The Committee will also benefit from the efforts of the BICs and other developing countries as well as non-governmental organisations to raise the profile and uptake of the Committee's work.

## Chapter VII

### Examining Options for a Fairer Division of Rights to Tax Active Business Income

This chapter examines options for a fairer division of rights to tax active business income from the perspective of the BICs. Like in chapter VI, an attempt will also be made to highlight the implications of the preferred alternatives for developing countries more generally. It was discussed in chapter II that academic literature in international taxation has concentrated largely on the rules for allocation of taxing rights between countries.<sup>1</sup> Therefore, there are more proposals to be examined for advancing fairness in the rules than in the rule-making process. However, as set out in chapter I, the author has decided to focus only on those that, owing to their recognition in international policy documents, could be attainable in the short and medium term.

Section (a) of part I of this chapter evaluates possible reforms to the existing nexus for host State taxation of active business income, including those discussed in the BEPS project. Section (b) of part I discusses the changes that will be required to the prevailing rules for attribution of profits to PEs to support the preferable option. Section (b) of part I also considers improvements to the existing practice of the ALP for apportionment of profits between associated enterprises. Part II of the chapter reviews global formulary apportionment as a medium-term alternative to further a fairer division of rights to tax active business income from the standpoint of the BICs and other developing countries.

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<sup>1</sup> Text to n 102-103 in chapter II.

Chapter II established that an assignment of rights to tax active business income that recognises a country's contribution in the generation of the income could be considered fair from the country's perspective.<sup>2</sup> As emphasised in chapter II, rather than quantitative exactitude, the focus is on feasible ways of accounting for a country's broad role in creation of that income.<sup>3</sup> Certainty, stability, and elimination of double taxation were highlighted as some of the parameters of a fair international taxation framework from the standpoint of businesses.<sup>4</sup> All these parameters will be applied to examine the alternatives covered in parts I and II.

### **I. Short-term proposals for advancing fairness in the international division of rights to tax active business income**

The case studies taken up in chapters IV and V present two broad findings. The first is the BICs' interest in protecting and enhancing their tax base as a host country. The second is their effort to seek recognition of their distinct input, particularly their consumer base, in the international division of rights to tax active business income. These results are connected by the BICs' motivation to ensure that their contribution in the profitability of an enterprise is reflected in the allocation of taxing rights between countries.

The following two sections examine options for furthering these findings at the level of each of the two key aspects of the existing framework for assignment of rights to tax active business income between countries: ascertaining when a country

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<sup>2</sup> Text to n 138-142 in chapter II.

<sup>3</sup> Text to n 143-145 in chapter II.

<sup>4</sup> Text to n 154 in chapter II.

can tax an MNE's active business income, and how much of that income the country can tax.

**a. Rethinking a country's right to tax active business income of a non-resident enterprise**

As discussed in chapter III, the prevailing international rules for allocation of taxing rights allow a country to tax the profits generated by a non-resident enterprise operating in the country only if the enterprise has a PE in the country. Chapter IV highlighted that the concept of PE envisages a high degree of physical presence of a non-resident enterprise in the country. Changing methods of production of goods and performance of services raise doubts about the suitability of the existing notion of PE for facilitating adequate recognition of the contribution of the supply State, or the country where the goods and services are produced, in the profitability of the enterprise.<sup>5</sup> With changes in technology and business practices, the likelihood of the existence of a PE in the demand State or the country whose consumers pay for the goods and services of the enterprise is even less.<sup>6</sup>

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<sup>5</sup> Jinyan Li, 'Protecting the Tax Base in the Digital Economy' in Alexander Trepelkov, Harry Tonino, and Dominika Halka (eds), *UN Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (UN 2015) 407, 440. Li highlights the case of construction PEs as one instance of this. Li discusses that even though construction projects demand physical presence of a non-resident enterprise in a country, technological developments have substantially reduced the time required to complete them. In view of this, she argues for a significant downward adjustment in the time threshold for deeming the existence of a construction PE in a country.

<sup>6</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 25, 36-37. See also Richard L Doernberg and others, *Electronic Commerce and Multijurisdictional Taxation* (Kluwer Law International 2001) 6-8, 591-592; Arthur J Cockfield, 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles' (2002) 56 *Bulletin for Int'l Fiscal Documentation* 606, 608-612; Tatiana Falcão and Bob Michel, 'Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study' (2014) 42 *Intertax* 317, 324.

Action Point 7 of the BEPS project deals with preventing artificial avoidance of PE status. The work on Action Point 7 will result in changes to the preparatory and auxiliary activity exception and the concept of agency PE in Article 5 of the OECD Model. As discussed in chapter IV, these modifications are aimed at helping market States recover tax base lost due to unsuitability of the former when the exempt activity is a core activity of the business and the circumvention of the latter.<sup>7</sup> Another alteration to Article 5 of the OECD Model under Action Point 7 that will also help preserve a host country's tax base will be restricting companies' ability to split contracts in the country to escape meeting the time threshold for deeming the existence of a construction PE or a service PE.<sup>8</sup> However, the overall objective of Action Point 7 was not to lower the degree of physical presence contained in the existing concept of PE, let alone finding alternatives that account for the role of a consumer base in the generation of profits by an MNE.

The aim of Action Point 7 was to address base erosion and profit shifting. Several proposals in academic literature in international taxation have tried to deal with these issues. For instance, Doernberg has suggested imposing a single low-rate withholding tax on payments that reduce the tax base of a country regardless of their

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<sup>7</sup> Text to n 159-165 in chapter IV. The European Commission's (EC) Expert Group on Taxation of the Digital Economy has expressed support for these measures as short-term reform options. See Commission Expert Group, 'Report on Taxation of the Digital Economy' (EC 2014) 6-8, 47-49 <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/gen\\_info/good\\_governance\\_matters/digital/report\\_digital\\_economy.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf)> accessed 30 July 2015.

<sup>8</sup> OECD, *Preventing the Artificial Avoidance of PE Status, Action 7 – 2015 Final Report* (OECD 2015) para 16-18. See also OECD, 'BEPS Action 7: Preventing the Artificial Avoidance of PE Status' (Public Discussion Draft, OECD 31 October 2014 - 9 January 2015) para 32-34 <[www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf](http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf)> accessed 10 January 2015; OECD, 'BEPS Action 7: Preventing the Artificial Avoidance of PE Status' (Revised Discussion Draft, OECD 15 May 2015 - 12 June 2015) para 42-47 <[www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf](http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf)> accessed 10 August 2015.

characterisation.<sup>9</sup> Dividends are, however, one of the two exceptions.<sup>10</sup> This is because they are not deductible in computing the tax liability of an enterprise in a country.<sup>11</sup> As non-business consumers also normally do not subtract the cost of consumption, payments made by them are the second exception, which will be taxable in the host country only if the non-resident enterprise has a PE in the country.<sup>12</sup> To avoid raising the overall level of taxation for enterprises, the host State's tax is creditable in the home State.<sup>13</sup> Doernberg recommends that non-resident enterprises should also have the right to file tax returns on net-basis in the host country and receive a refund for withholding tax paid when it is due.<sup>14</sup>

Doernberg's suggestion goes beyond the BEPS project's work on Action Point 7 in recognising that with growing digitisation, it is increasingly possible for an enterprise to profit from an economy without having the degree of physical presence envisaged in the concept of PE. Doernberg's idea, however, falls short of comprehensive recognition of the demand element in creation of an MNE's profits.<sup>15</sup> This aspect is addressed in Hinnekens's proposal to introduce a 'virtual PE' by removing the fixed place of business requirement in Article 5 of the OECD Model.<sup>16</sup> In the alternative, Hinnekens recommends a special article to allocate the right to tax

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<sup>9</sup> Richard L Doernberg, 'Electronic Commerce and International Tax Sharing' (30 March 1998) 16 Tax Notes Int'l 1013, 1015-1016.

<sup>10</sup> *ibid* 1016.

<sup>11</sup> *ibid*.

<sup>12</sup> *ibid*.

<sup>13</sup> *ibid*.

<sup>14</sup> *ibid*.

<sup>15</sup> For more discussion of this issue with Doernberg's idea see Arthur J Cockfield, 'Balancing National Interests in the Taxation of Electronic Commerce Business Profits' (1999) 74 Tulane L Rev 133, 202-203.

<sup>16</sup> Luc Hinnekens, 'Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century' (1998) 26 Intertax 192, 195.

profits from business conducted over the Internet to the host country in the absence of the enterprise's PE in the country, in much the same manner as Article 17 of the OECD Model.<sup>17</sup>

Avi-Yonah and Halabi have formulated a similar, *albeit* clearer option. Under this, a remote seller will be deemed to have a PE in a country if the enterprise's gross annual receipts from sales in the country in the preceding year exceed 1,000,000 USD.<sup>18</sup> Pinto's suggestion shows similar sophistication in design as compared to Hinnekens's idea. It subjects income from all international transactions involving goods or services that are provided electronically, or purchased via electronic means, except passive dividend or interest income, to a uniform rate withholding tax.<sup>19</sup> The tax will be refundable if the gross sales of a business in the host country for the relevant period remain below a *de minimis* threshold.<sup>20</sup> Sellers whose operations exceed the threshold could elect to file a return in the host country and be taxed on net basis.<sup>21</sup>

Two options in the 2014 report of the BEPS project on Action Point 1 discussed in chapter IV also sought to provide greater recognition to the demand element in the division of taxing rights between countries.<sup>22</sup> The first was a new nexus based on

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<sup>17</sup> *ibid.*

<sup>18</sup> This is regardless of whether or not the seller satisfies any other condition in Article 5 of the OECD Model. See Reuven S Avi-Yonah and Oz Halabi, 'A Model Treaty for the Age of BEPS' (2014) University of Michigan Law and Economics Working Paper No 103, 15-18 <[http://repository.law.umich.edu/law\\_econ\\_current/103/](http://repository.law.umich.edu/law_econ_current/103/)> accessed 30 July 2015.

<sup>19</sup> Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold' (2006) 60 *Bulletin for Int'l Taxation* 266, 277-278.

<sup>20</sup> *ibid* 278.

<sup>21</sup> *ibid.*

<sup>22</sup> Text to n 169-172 in chapter IV.

digital presence for enterprises engaged in fully dematerialised digital activities.<sup>23</sup> The second was imposing a final withholding tax on payments made by residents of a country for digital goods and services offered by a foreign provider.<sup>24</sup> Hongler and Pistone refined the first of these alternatives to involve four key elements: a conception of digital services; a user threshold; a time limit; and a *de minimis* revenue level.<sup>25</sup> A variation of the first option proposed earlier by the Task Force on the Digital Economy in France called for a definition of PE specific to this context, based on data obtained through regular and systematic monitoring of Internet users in the country.<sup>26</sup>

The issue with the above-discussed proposals, however, is that they try to ring-fence particular types of activities or businesses for the purpose of taxation. This approach is inappropriate in view of the pervasiveness of developments in technology and resulting changes to business methods – a fact that has now been recognised in the BEPS project as well.<sup>27</sup> The provision for taxation of fees for technical services (FTS) that will be introduced in the UN Model can be criticised for the similar reason. As discussed in chapter IV, the draft Article for taxing FTS marks a move away from ascertaining a country's right to tax a non-resident enterprise's active business income based on the enterprise's physical presence in the country and links it to the consumer

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<sup>23</sup> OECD, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014) 143-145.

<sup>24</sup> *ibid* 146.

<sup>25</sup> Peter Hongler and Pasquale Pistone, 'Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy' (2015) IBFD Working Paper 20, 2-3, 24-26 <<http://bit.ly/1mGhpax>> accessed 15 September 2015.

<sup>26</sup> Pierre Collin and Nicolas Colin, 'Task Force on the Taxation of the Digital Economy' (Report to the Minister for Economy and Finance, Minister for Industrial Recovery, Minister Delegate for the Budget and Minister Delegate for Small and Medium-Sized Enterprises, Innovation and the Digital Economy, 2013) 4-5, 116-121 <[www.hldataprotection.com/files/2013/06/Taxation\\_Digital\\_Economy.pdf](http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf)> accessed 21 December 2014.

<sup>27</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (OECD 2015) para 115.

base offered by the country.<sup>28</sup> These benefits are, however, limited to a separate category of economic activity that will be taken out of the purview of the concept of PE and treated distinctly for the purpose of host State taxation.<sup>29</sup>

This is also a downside of another suggestion made at the UN, which is to have a separate article in the UN Model for taxation of fees for cyber-based technical services, and include payments for the use of or the right to use an industrial, commercial, or scientific online database in the UN Model's definition of royalties.<sup>30</sup> All such approaches open the door for conflicts on what is covered within the special treatment.<sup>31</sup> The problem will be more acute in these two cases because of the already complex scheme of both the OECD Model and the UN Model vis-à-vis taxation of services.<sup>32</sup>

Avi-Yonah's idea of a refundable withholding tax does not suffer from such drawbacks and it also deals with the deficiencies of the work on Action Point 7 of the BEPS project in a more comprehensive manner. The proposal involves the use of a withholding tax at a rate equal to the corporate tax on the sales of goods and services.<sup>33</sup> This is to be refunded completely if gross sales in a country fall below a

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<sup>28</sup> Text to n 130-145 in chapter IV.

<sup>29</sup> Text to n 135-139 in chapter IV.

<sup>30</sup> Yansheng Zhu, 'Proposed Changes to the UN Model Convention Dealing with the Cyber-Based Services' (2014) E/C.18/2014/CRP.9, 9-14.

<sup>31</sup> For criticism of categorisation of income into different categories in tax treaties see John F Avery Jones, 'David R Tillinghast Lecture - Are Tax Treaties Necessary' (1999) 53 *Tax L Rev* 1, 17. See also OECD, *Addressing the Tax Challenges of the Digital Economy* 2014 (n 23) 133.

<sup>32</sup> Brian J Arnold, 'The Taxation of Income from Services Under Tax Treaties: Cleaning Up the Mess' (2011) 65 *Bulletin for Int'l Taxation* 59.

<sup>33</sup> Reuven S Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard L Rev* 1573, 1672.

quantitative threshold.<sup>34</sup> The demand country is, in any case, meant to give back the difference between the gross tax and the net tax, according to the return filed by the taxpayer.<sup>35</sup> The net tax is then creditable in the country of residence of the taxpayer.<sup>36</sup> Avi-Yonah is clear, however, that the demand country can tax in this manner only in the limited scenario of the income being left untaxed in the supply country because it is a production haven, or because the income does not belong to any jurisdiction.<sup>37</sup>

In comparison is the ‘significant presence’ test, which was introduced in chapter IV as one of the more radical reforms to the nexus for host State taxation discussed in the 2014 report of the BEPS project on Action Point 1.<sup>38</sup> The test does not resort to the random manner of reform inherent in creating PE fictions or selecting categories of activities or income that should not be subject to the PE rule and threshold. It also does not treat the demand State’s right to tax as secondary. Instead, the proposal boldly suggests focusing on both demand and supply side factors, which show a ‘purposeful and sustained interaction with the economy of a country’ to develop a replacement of the concept of PE.<sup>39</sup>

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<sup>34</sup> *ibid.*

<sup>35</sup> *ibid* 1673.

<sup>36</sup> *ibid.*

<sup>37</sup> *ibid.*

<sup>38</sup> Text to n 171-172 in chapter IV.

<sup>39</sup> OECD, *Addressing the Tax Challenges of the Digital Economy* 2014 (n 23) 146. See also BEPS Monitoring Group, ‘Addressing the Tax Challenges of the Digital Economy’ in OECD, ‘Comments Received on Public Discussion Draft, BEPS Action 1: Addressing the Tax Challenges of the Digital Economy’ (OECD 2014) 34, 41 <[www.oecd.org/ctp/comments-action-1-tax-challenges-digital-economy.pdf](http://www.oecd.org/ctp/comments-action-1-tax-challenges-digital-economy.pdf)> accessed 1 July 2015. The 2015 report of the BEPS project on Action Point 1 discusses the test as the ‘significant economic presence’ test. From this point onwards, it is this terminology that shall be used to refer to the test.

The demand side factors relevant for establishing significant economic presence of an enterprise in a country discussed in the 2015 report of the BEPS project on Action Point 1 include: the presence of a local domain name;<sup>40</sup> a local website or other digital platforms to present the goods and services with a view to attract customers in a country;<sup>41</sup> local payment options;<sup>42</sup> monthly active users on a digital platform that are habitually resident in a country in a tax year;<sup>43</sup> number of contracts concluded online with persons habitually resident in a country in a tax year;<sup>44</sup> and the volume of content collected through a digital platform from users and customers habitually resident in a country in a tax year, including personal data and user generated content.<sup>45</sup> The 2014 report of the BEPS project on Action Point 1 had also suggested selling goods and services sourced from suppliers in a country or offering delivery from such suppliers as demand side factors relevant for establishing a non-resident enterprise's significant economic presence in the country.<sup>46</sup>

For the supply side factors, the 2014 report of the BEPS project on Action Point 1 was vague in mentioning 'some degree of physical presence in a country directly or

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<sup>40</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 279. According to the report, a non-resident enterprise targeting customers or users in a country will generally obtain this digital equivalent of a local address in the country.

<sup>41</sup> *ibid.*

<sup>42</sup> *ibid.* The report states that a non-resident enterprise that 'maintains a purposeful and sustained interaction with the economy of a country will frequently ensure that local customers have a seamless purchasing experience'. Such options are an important part of that. The report highlights that this factor will be even more relevant in countries that have stringent banking regulations, currency controls, or low penetration of international credit cards.

<sup>43</sup> *ibid* para 280. These are defined as registered users who logged in and visited a company's digital platform in the 30 day period ending on the date of measurement. According to the report, such a factor presents the advantage of measuring the customer/user base in a country both in terms of size and level of engagement.

<sup>44</sup> *ibid.*

<sup>45</sup> *ibid.*

<sup>46</sup> OECD, *Addressing the Tax Challenges of the Digital Economy* 2014 (n 23) 146.

via a dependent agent for a certain time period such as 6 months' in the country.<sup>47</sup> The 2015 report does not add anything to this. The existing concept of PE with improvements to it as a result of the BEPS project could continue to be relevant in this regard, with the advantage being that it will no longer be the sole determinant of a country's right to tax active business income of a non-resident enterprising operating in the country, but only one factor in establishing the same. Additionally, proposals such as Wilde's quantitative 'labour factor test', which focuses on an MNE's workforce in a country subject to a *de minimis* threshold, could be considered.<sup>48</sup>

For greater certainty, which was set out in chapter II as an indicator of a fair outcome from the standpoint of businesses,<sup>49</sup> a quantitative element similar to that suggested by Avi-Yonah and Halabi, Cockfield, and Hongler and Pistone could accompany the qualitative factors.<sup>50</sup> The 2015 report of the BEPS project on Action Point 1 states that revenue generated on a sustained basis from a country is one of the 'clearest potential indicators of the existence of a significant economic presence'.<sup>51</sup> Therefore, one of the factors of the significant economic presence test should be revenue based, which would also cover the gross revenue generated by remote transactions concluded by non-resident enterprises with customers in a country.<sup>52</sup>

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<sup>47</sup> *ibid.*

<sup>48</sup> Maarten de Wilde, "'Sharing the Pie": Taxing Multinationals in a Global Market' (PhD thesis, Erasmus University 2015) 333.

<sup>49</sup> Text to n 151 and 154 in chapter II.

<sup>50</sup> Avi-Yonah and Halabi (n 18) 15-18; Arthur J Cockfield, 'Balancing National Interests in the Taxation of Electronic Commerce Business Profits' (n 15) 198-203; Hongler and Pistone (n 25) 24. See also Arthur J Cockfield, 'Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test' (2003) 38 *Canadian Business L Journal* 400-24; Maarten de Wilde, "'Sharing the Pie": Taxing Multinationals in a Global Market' (2015) 43 *Intertax* 438, 444-445.

<sup>51</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 278.

<sup>52</sup> *ibid.*

According to the report, to minimise the risk of manipulation, the same ‘should be framed in absolute terms and in local currency’.<sup>53</sup> Set at an appropriate level, this parameter will add to the administrative feasibility of the approach and limit compliance costs for taxpayers.<sup>54</sup>

It is vital to realise that the above discussion of the factors relevant for a nexus for taxation based on a non-resident enterprise’s economic presence in a country is not exhaustive. Further work will be required to devise a combination of these or other such aspects representing both supply and demand side of income creation, which can mark the level of an enterprise’s participation in the economy of a country that is administratively sufficient to allow the country to tax the profits generated by the enterprise.<sup>55</sup> To ensure balance from the standpoint of countries at different levels of development and longevity of the final result, it is important that these factors are arrived at by effective participation of all countries. This reinforces the importance of working towards a fairer international taxation rule-making process.

As this nexus for host State taxation of active business income will replace the concept of PE, the expectation is that the existing approach to alleviation of double taxation, with the home country giving credit for host country taxes, or exempting the income produced in the country from taxation in the home country, will apply. Elimination of double taxation was discussed in chapter II as another indicator of a

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<sup>53</sup> *ibid.*

<sup>54</sup> *ibid* para 277.

<sup>55</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Commentary to Article 7, para 11; UN Department of Economic and Social Affairs (DESA), *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011) Commentary to Article 7, para 1. As reflected in the Commentary to Article 7 of the OECD Model and the UN Model, this was the rationale behind the development of the concept of PE.

fair international taxation framework from the standpoint of businesses.<sup>56</sup> To realise this end, it will also be crucial that countries apply the significant presence test in a uniform manner. A binding multilateral instrument discussed in chapter VI could make this possible.<sup>57</sup>

Since work on such an instrument is on going, this would have been an opportune time to advance an option such as the significant economic presence test. As highlighted in chapter IV, however, for now the BEPS project has limited itself to checking some ways of circumventing the PE threshold that lead to BEPS.<sup>58</sup> One must be wary of such tweaks to the international rules for allocation of taxing rights between countries. In a world where cross-border business long moved beyond brick-and-mortar structures, changes that fundamentally remain rooted in ideas such as physical presence are likely to outlive their utility in a short span of time.<sup>59</sup> The server PE is one such example.<sup>60</sup>

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<sup>56</sup> Text to n 153-154 in chapter II.

<sup>57</sup> Text to n 46 in chapter VI.

<sup>58</sup> Text to n 173-174 in chapter IV.

<sup>59</sup> This, in turn, could mean that an important aim behind the BEPS project – of checking uncoordinated responses of countries to international taxation issues, could again assume the same or similar global significance as it has in the past few years. See OECD, *Addressing Base Erosion and Profit Shifting* 2013 (n 6) 50-51.

<sup>60</sup> OECD Model 2014 (n 55) Commentary to Article 5, para 42.1-42.10. In 2004, a Technical Advisory Group of the OECD concluded that there was ‘no evidence that communication efficiencies of the Internet have caused any significant decrease’ in tax revenues of capital-importing countries. Accordingly, no ‘dramatic departure’ from the then existing international rules for assignment of taxing rights between countries was needed. In line with this approach, in 2005, the idea of server PEs was introduced in the Commentary to Article 5 of the OECD Model. This took the basic principles of the concept of PE, such as physical presence, and modified them for application in the digital context. See OECD, ‘Are the Current Treaty Rules for Taxing Business Profits Appropriate for E - commerce? – Final Report’ (OECD 2004) para 350 <[www.oecd.org/ctp/treaties/35869032.pdf](http://www.oecd.org/ctp/treaties/35869032.pdf)> accessed 2 November 2014. In less than a decade, the BEPS report of 2013 acknowledged that nowadays ‘it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the Internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits...’ See OECD, *Addressing Base Erosion and Profit Shifting* 2013 (n 6) 35-36.

Notably, the 2015 report of the BEPS project on Action Point 1 recognises this concern.<sup>61</sup> Accordingly, it states that the impact of developments in technology and new business models on international taxation policy, and the success of the measures suggested in the BEPS project and national level approaches to deal with such changes, will continue to be monitored.<sup>62</sup> Based on this study, it will be decided whether further work needs to be carried out on reform options like the significant economic presence test.<sup>63</sup> Even at this initial stage of development, this test for nexus for host State taxation appears more comprehensive than any of the other alternatives examined in this section. This is in terms of both emphasis on economic as opposed to physical presence of an enterprise in a country for the purpose of taxation, as well as the recognition of demand and supply side of a country's contribution in the profitability of an enterprise. In this way, it is better for addressing the previously mentioned findings from chapters IV and V and advancing the idea of fairness in the division of rights to tax active business income established in chapter II.

In view of these merits, the author believes that the significant economic presence test must at least be given serious consideration at the international level. This is also because, as stated in chapter I, developing countries remain largely host countries.<sup>64</sup> A test for nexus based on a combination of supply and demand side factors will benefit them by offering greater source taxation than available under the

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<sup>61</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 358.

<sup>62</sup> *ibid* para 359.

<sup>63</sup> *ibid* para 360.

<sup>64</sup> United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2015: Reforming International Investment Governance* (UN 2015) ix, x, 2-12.

existing international rules for allocation of taxing rights between countries.<sup>65</sup> An important practical issue in fully realising these benefits, however, will be the method for determining how much of the profits of a non-resident enterprise taxable in a country on this basis could be taxed by the country. The following section explores some proposals for answering this question.

#### **b. Reviewing the rules for ascertaining how much of an enterprise's active business income a country can tax**

Baez and Brauner point out the difficulty in attributing profits to a nexus for host State taxation that does not rely on physical presence of the enterprise in the country.<sup>66</sup> In such a scenario, steps central to Article 7 of the OECD Model, such as assessing the functions performed, the assets used, and the risks assumed by related entities and applying the OECD Transfer Pricing Guidelines (TPG) by analogy to the transactions between them, may not be a viable course.<sup>67</sup> The 2015 report of the BEPS project on Action Point 1 discusses withholding tax as an option. According to the report, this could be imposed as a standalone final gross-based tax on payments made for online purchases of goods and services from non-resident providers, or as a more general proxy for taxation on net basis under the significant economic presence test

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<sup>65</sup> Daurer has mentioned how the existing division of taxing rights between countries 'is depriving LDCs, which primarily are in the position of the source state and which want to levy taxes at source, from badly needed revenue'. See Veronika Daurer, 'Tax Treaties and Developing Countries' (2014) 42 *Intertax* 695, 696.

<sup>66</sup> Andres Baez Moreno and Yariv Brauner, 'Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy' (White Paper, IBFD 2015) 6 <<http://bit.ly/1O5JTcT>> accessed 3 September 2015.

<sup>67</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 285. See also Leonard Waagenaar, 'The Effect of OECD Base Erosion and Profit Shifting Action Plan on Developing Countries' (2015) 69 *Bulletin for Int'l Taxation* 84, 90-92; Hongler and Pistone (n 25) 32-33. Hongler and Pistone have discussed this as a particular issue in the digital context.

for nexus.<sup>68</sup> Given the potentially distortionary impact of gross-based taxation on cross-border activities, the report favours the latter option.<sup>69</sup>

The author agrees with this choice. It will, however, require a clear and simple delineation of the type of transactions to which the tax will apply, without creating incentives for any particular business structure.<sup>70</sup> Importantly, it will need agreeing to a suitable low-rate withholding tax. The 2015 report of the BEPS project on Action Point 1 discusses fixing this based on typical profit margins of domestic taxpayers operating in the same class of industry or type of business.<sup>71</sup> Additionally, the option of filing on net basis suggested by Doernberg, Pinto, and Avi-Yonah could be considered.<sup>72</sup> As discussed in the report, the system enabling this should also allow taxpayers to claim a refund if they are at a loss on net-basis at the end of the tax year.<sup>73</sup> As an interesting future possibility, Baker has stated that better exchange of information between countries may permit withholding taxes to be charged on net income booked outside the country.<sup>74</sup>

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<sup>68</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 292.

<sup>69</sup> *ibid* para 298-301.

<sup>70</sup> *ibid* para 293.

<sup>71</sup> *ibid* para 298.

<sup>72</sup> Doernberg (n 9) 1016; Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (n 33) 1672; Pinto (n 19) 278.

<sup>73</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 301.

<sup>74</sup> Philip Baker, 'Alternative Approaches in the World Without the Government of India Principle' (OUCBT Taxing Multinationals Conference, Oxford, 18 March 2013) <[www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Events/conferences/2013/taxing\\_multinationals/philip-baker.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/2013/taxing_multinationals/philip-baker.pdf)> accessed 10 August 2015.

Admittedly, it is more difficult to impose a withholding obligation on individuals as opposed to businesses.<sup>75</sup> For this reason, the 2015 report of the BEPS project on Action Point 1 discusses levying a withholding requirement on financial institutions involved in processing payments between non-resident enterprises and payers in the country, which will be regulated by the domestic law.<sup>76</sup> According to the report, the task of such an intermediary will be facilitated by mandatory registration for non-resident enterprises, at the time of which remote sellers would designate a dedicated bank to account for all payments received from local customers.<sup>77</sup>

If such or other efficient withholding mechanisms for a low-rate withholding tax under the significant economic presence nexus for host State taxation could be developed, the tax will serve the added function of a tool for enforcement and tax collection.<sup>78</sup> This will be an advantage for the BICs and other developing countries whose tax administrations are often short on resources and expertise. As compared to the existing approach to attribution of profits to PEs, especially under the OECD Model, the advantage of administrative ease will in fact also remain, *albeit* to a lesser

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<sup>75</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 296. See also Arthur J Cockfield, ‘Balancing National Interests in the Taxation of Electronic Commerce Business Profits’ (n 15) 202-203; Daniel W Blum, ‘Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined’ (2015) 69 *Bulletin for Int’l Taxation* 314, 324.

<sup>76</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 297; OECD, *Addressing the Tax Challenges of the Digital Economy 2014* (n 23) 146.

<sup>77</sup> This is because the intermediaries will then be required to withhold the tax only for payments made to these specific bank accounts. The report acknowledges that challenges in ensuring compliance will still remain in the case of intermediaries situated in third countries with no relation to the jurisdiction of the customer.

<sup>78</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 292; OECD, *Addressing the Tax Challenges of the Digital Economy 2014* (n 23) 146.

degree, in the case of other plausible alternatives, such as deemed profit methods or fractional apportionment.<sup>79</sup>

The 2015 report of the BEPS project on Action Point 1 discusses the use of deemed profit methods for determining how much of a non-resident enterprise's profits will be taxable in a country owing to the enterprise's significant economic presence in the country. It suggests applying a ratio of presumed expenses to the revenue derived by the enterprise from transactions with customers in the country as an option.<sup>80</sup> According to the report, establishing an appropriate ratio will depend on a number of factors, including the industry concerned, the degree of integration of a particular enterprise, and the type of product or service provided.<sup>81</sup> The report also mentions that if fractional apportionment is chosen for assigning profits to an enterprise with a significant economic presence in a country, either a pre-determined formula could be employed, or allocation factors could be applied on a case-by-case basis.<sup>82</sup> Both the alternatives will require establishing the tax base to be divided, the factors to be used for that purpose, and the weight to be attached to them.<sup>83</sup>

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<sup>79</sup> Interestingly, the domestic laws of the BICs, such as India and China use these options. For instance, Rule 10 of the Income Tax (IT) Rules of India permits tax authorities to use indirect methods of attributing profits to PEs. Butani has highlighted that since Rule 10 pre-dates the introduction of the transfer pricing provisions in the Indian IT Act by over three decades, tax authorities often find recourse to it administratively easier. See Mukesh Butani, 'Transfer Pricing Disputes in India' in Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012) 584, 626-627. In the case of China, Circular 19 of the State Administration of Taxation (SAT) provides that if an enterprise's accounting books and data are incomplete, or if the enterprise has insufficient documents in the case of an audit, or even otherwise, tax authorities can determine its taxable income using simpler methods or the deemed profit methods contained in the Circular. See Guo Shui Fa [2010] No 19 – Notice of the State Administration of Taxation on Administrative Measures for the Levy and Collection of Income Tax of Non-Resident Enterprises on Deemed Basis 2010, Article 4.

<sup>80</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 290.

<sup>81</sup> *ibid.*

<sup>82</sup> *ibid* para 287.

<sup>83</sup> *ibid.*

The 2015 report of the BEPS project on Action Point 1 does not favour the options discussed in the preceding paragraph. A common reason is the extent to which they depart from the prevailing international standards.<sup>84</sup> This argument is less convincing to the extent other methods of determining a PE's profits, which deliver results in line with the ALP, have been permitted under the two Models.<sup>85</sup> Importantly, if the goal is to come up with a workable and sound approach to determining how much of a non-resident enterprise's profits are attributable to the enterprise's significant economic presence in a country, this concern should not hinder holistic consideration of any approach that shows potential in this regard.<sup>86</sup>

An open perspective should, in fact, also be adopted towards applications of the arm's length principle (ALP) for apportionment of profits between associated enterprises that are better suited to recognise the contribution of each enterprise to the profitability of an MNE. As compared to the other transfer pricing methods, because of the way in which the profit split method (PSM) works, it has greater potential to pursue such a use of the ALP. Under the PSM, one approach to splitting profits between associated enterprises is contribution analysis. This involves distributing profits arising from the transactions under examination as per the relative value of the functions performed by the enterprises, taking into account the assets used and the risks assumed.<sup>87</sup> Residual profit split, which is the other way of applying the PSM,

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<sup>84</sup> *ibid* para 288, 291.

<sup>85</sup> UN Model 2011 (n 55) Commentary to Article 7, para 19.

<sup>86</sup> For an insight into the other possible options see OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (n 27) para 286, para 302-308.

<sup>87</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010) para 2.119-1.120; UN, *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2013) para 6.13.4.2. See also Sébastien Gonnet and Pim Fris, 'Contribution Analysis under the Profit Split Method' (Intellectual Property Supplement, *International Tax Review* 2007) 8 <[www.nera.com/content/dam/nera/publications/archive1/PUB\\_ContributionAnalyses\\_ITR\\_Dec2007.p](http://www.nera.com/content/dam/nera/publications/archive1/PUB_ContributionAnalyses_ITR_Dec2007.p)

seeks to achieve this end in two steps. First, routine profits are allocated to associated enterprises through the use of comparables-based transfer pricing methods.<sup>88</sup> Second, the remainder that is attributable to unique and valuable contributions of associated enterprises is divided between them.<sup>89</sup>

As compared to other transfer pricing methods, the greater inward focus on the actual role of an enterprise in the profits generated from a transaction or a set of transactions, which is clear in both these alternatives, reflects the method's suitability to further the idea of substantive fairness in the international framework for allocation of rights to tax active business income proposed in chapter II. In this way, the PSM can also address a country's concerns regarding its tax base being compromised because of the role of the functions performed in the country being undermined by other aspects relevant for transfer pricing purposes. Chapter V highlighted that as a part of addressing this issue, the BEPS project has revisited the OECD TPG's guidance on assignment of risks and intangibles-related returns between associated enterprises.<sup>90</sup> It has, however, explored the potential of the PSM in such cases and, more importantly, as a mechanism to facilitate recognition of a country's contribution in the profits made by an enterprise operating in the country, to a limited degree.<sup>91</sup>

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df> accessed 3 September 2014; Norbert Hezig, Manuel Teschke, and Christian Joisten, 'Between Extremes: Merging the Advantages of Separate Accounting and Unitary Taxation' (2010) 38 *Intertax* 334, 345-348.

<sup>88</sup> OECD TPG (n 87) para 2.121; UN TPM (n 87) para 6.3.14.4.

<sup>89</sup> *ibid*; *ibid*.

<sup>90</sup> Text to n 247-257 in chapter V.

<sup>91</sup> This result can be rationalised in view of the fact that the focus of the BEPS project is to align transfer pricing outcomes with value creation, which is equated with undertaking functions or carrying out the economic activity that generates profits for an enterprise. As discussed in chapter II, the idea of accounting for a country's contribution in the profitability of an enterprise is, however, wider and extends to the totality of economic advantages offered by a country to an enterprise.

The 2014 discussion draft of the BEPS project on the ‘Use of Profit Splits in the Context of Global Value Chains’ mentioned fragmentation of functions in an enterprise as a potential addition to the two scenarios mentioned in the OECD TPG and the UN Transfer Pricing Manual (TPM) as suitable for the use of the PSM.<sup>92</sup> The 2015 final report of the BEPS project on Action Points 8-10, however, does not engage with this issue. In fact, apart from transactions involving intangibles, the report presents only cases of significant group synergies, and unique and valuable contributions, as areas for exploring the advantages of the PSM.<sup>93</sup>

Chapter V presented scenarios concerning marketing intangibles and location rents as others deserving of attention in this regard.<sup>94</sup> Marketing intangibles are aligned with the category of contributions considered unique and valuable in the OECD TPG and the UN TPM.<sup>95</sup> Thus, the case for the use of the PSM for appropriate apportionment of profits between associated enterprises in transactions involving marketing intangibles is stronger. As stated in chapter V, accepting greater recourse to the PSM when location-specific advantages (LSAs) exist requires recognising their unique and valuable role in the profitability of an enterprise.<sup>96</sup> It also demands acknowledging the difficulty in accounting for location rents in transfer pricing

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<sup>92</sup> OECD, ‘BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains’ (Public Discussion Draft, OECD 16 December 2014 – 6 February 2015) para 26-27 <[www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf](http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf)> accessed 30 December 2014. As stated in chapter V, the two scenarios recognised by the OECD TPG and the UN TPM as suitable for the use of the PSM are highly integrated business operations and transactions involving unique and valuable contributions like intangibles.

<sup>93</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (OECD 2015) 60-61.

<sup>94</sup> Text to n 202-212 and 223 in chapter V.

<sup>95</sup> OECD TPG (n 87) para 2.137; UN TPM (n 87) para 6.3.17.2.

<sup>96</sup> Text to n 202-212 in chapter V.

analysis in the absence of suitable local comparables. The 2015 final report of the BEPS project on Action Points 8-10, however, remains reluctant on both these counts.

The report, in fact, appears directed at discouraging more general resort to the PSM.<sup>97</sup> According to the report, in cases where the PSM is unlikely to result in an arm's length outcome, 'an appropriate method using inexact comparables is likely to be more reliable' than an inappropriate use of the PSM.<sup>98</sup> In view of the fact that in both cases the result reached will not reflect the actual arm's length price of the transaction, this position is difficult to understand. In such a scenario, if apart from the above-mentioned features, one option can offer more objectivity, certainty, and importantly, potentially a level playing field for tax administrations of countries at different levels of development, then that should be preferred.

At the heart of all the merits of the PSM, however, is the methodology for determining how the profits are to be split. The 2015 final report of the BEPS project on Action Points 8-10 makes it clear that further work will be done on this issue.<sup>99</sup> Owing to the lesser quantification of respective contributions of associated enterprises involved, tax administrations often show greater preference for the residual profit split method.<sup>100</sup> A cruder approach to splitting residual profits would be the use of a pre-determined formula.<sup>101</sup> Considering the relative immobility of consumers, Avi-Yonah

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<sup>97</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (n 93) 58.

<sup>98</sup> *ibid* 60.

<sup>99</sup> *ibid* 59, 61.

<sup>100</sup> Toshio Miyatake, 'General Report' in IFA (ed), *Transfer Pricing and Intangibles*, Cahiers de Droit Fiscal International Vol 92A (IFA 2007) 17, 33.

<sup>101</sup> Reuven S Avi-Yonah and Ilan Benshalom, 'Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized

has expressed preference for a formula based on sales.<sup>102</sup> However, the author believes that a three-factor formula based on assets, a labour element, and sales will be more balanced in terms of reflecting both supply and demand sides of profit creation.<sup>103</sup> The advantage of any such approach is potentially greater administrative feasibility. As stated before, this is especially important for the BICs and also other developing countries. In view of this, this proposal deserves consideration in the discussions on the use of the PSM, which will also benefit from a study of more sophisticated valuation techniques.

Greater access to information relating to associated enterprises that will result from developments such as country-by-country reporting covered under Action Point 13 of the BEPS project and enhanced inter-country exchange of the same, will be key in finding applications of the PSM that deliver its benefits.<sup>104</sup> From the perspective of businesses, one way of increasing certainty, particularly where aspects like location rents and marketing intangibles are concerned, will be bilateral or multilateral advance pricing agreements (APAs).<sup>105</sup> Apart from covering the preliminary issue of

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Formulary Alternative' (2011) 3 World Tax Journal 371, 380-381. See also Stanley I Langbein, 'A Modified Fractional Apportionment Proposal for Transfer Pricing' (10 February 1992) 54 Tax Notes 719.

<sup>102</sup> Reuven S Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation' (2010) 2 World Tax Journal 3, 16-17; Reuven S Avi-Yonah, 'Splitting the Unsplittable: Toward a Formulary Approach to Allocating Residuals Under Profit Split' (2013) University of Michigan Public Law and Legal Theory Research Paper Series, Working Paper No 378, 3-4 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2369944](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2369944)> accessed 10 August 2015.

<sup>103</sup> The labour element mentioned here is discussed in more detail in section (b) of this part.

<sup>104</sup> OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (OECD 2014). 61 jurisdictions have signed up to a multilateral competent authority agreement implementing the standard on automatic exchange. India is one of them; OECD, 'Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting' (OECD 2015) <[www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf](http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf)> accessed 10 August 2015.

<sup>105</sup> Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets' (2005) 40 Tax Notes Int'l 895, 906; Johannes Becker, Ronald B Davies, and Gitte Jakobs, 'The Economics of Advance Pricing Agreements' (2014) OUCBT Working Paper 14/26, 20

ascertaining the existence of location rents and marketing intangibles, the APAs could detail the method used for allocating them between associated enterprises. Enhanced *ex ante* interaction between tax administrations over concrete issues, as is possible in the APA process, can also help address any room for double taxation.<sup>106</sup> As stated before, certainty in the tax policy of a country and alleviation of double taxation are parts of a fair outcome from the standpoint of businesses.

For developing countries more generally, international assistance in capacity building will also be vital in realising the full potential of the PSM or any other more sophisticated transfer pricing methods.<sup>107</sup> It will be equally important, however, to continue research on simpler transfer pricing options. The sixth method discussed in chapter V, which will now be a part of the OECD TPG, is one such alternative.<sup>108</sup> The OECD's discussion draft on 'Transfer Pricing Comparability Data and Developing Countries' mentioned in chapter V also gives some suggestions for dealing with the shortage of suitable local comparables in developing countries. An important one among these is facilitating access to good quality data for transfer pricing purposes, including foreign comparables and assistance in making requisite comparability adjustments.<sup>109</sup> Another is making it possible to evaluate a transaction by testing the

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<[www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/series-14/WP1426.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/series-14/WP1426.pdf)> accessed 3 September 2015. Greater certainty would also be achieved by an open discussion on determining the existence of location rents and marketing intangibles and methods of accounting for them in transfer pricing analysis at the international level in fairer rule-making settings.

<sup>106</sup> Diane M Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross-Border Taxation' (2000) 21 Michigan Journal of Int'l L 143, 175-183. For criticisms of advance pricing agreements (APAs) see Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better' (1997) 28 L & Policy in Int'l Business 1133, 1158.

<sup>107</sup> OECD, 'Transfer Pricing Comparability Data and Developing Countries' (Paper for Public Consultation, OECD 2014) para 25 <[www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf](http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf)> accessed 30 November 2014.

<sup>108</sup> Text to n 241-246 in chapter V.

<sup>109</sup> OECD, 'Transfer Pricing Comparability Data and Developing Countries' (n 107) para 13-21.

return earned by the foreign counterparty.<sup>110</sup> As mentioned in the discussion draft, this can mitigate the risk that the domestic party will only be allocated routine profits without considering whether it should share in any residual return that may arise in the transaction.<sup>111</sup> Any such options that can facilitate the recognition of a country's contribution in the income generated by cross-border activities of MNEs, and along with other reforms to the transfer pricing rules prevent its tax base from being undermined, will be welcome results.

## **II. Global formulary apportionment – A medium-term alternative for a fairer division of taxing rights among countries?**

As stated in chapter II, in their seminal work on INE in 1972, the Musgraves found the 'implementation of bonafide separate accounting exceedingly difficult'.<sup>112</sup> Peggy Musgrave's later works present global formulary apportionment as a promising option for reform. The alternative envisages non-recognition of intra-group transactions and allocation of the group's profits among countries based on a formula.<sup>113</sup> It would be a notable change away from the existing transfer pricing rules. Yet, global formulary apportionment has attracted attention across the world.

For instance, an 'ambitious' agenda item for the International Tax Organisation (ITO) proposed by the Zedillo panel in 2001 was to 'develop and secure agreement on

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<sup>110</sup> *ibid* para 22.

<sup>111</sup> *ibid*.

<sup>112</sup> Richard A Musgrave and Peggy B Musgrave, 'Inter-Nation Equity' in Richard M Bird and John G Head (eds), *Modern Fiscal Issues: Essays in the Honour of Carl S. Shoup* (University of Toronto Press 1972) 82, 85.

<sup>113</sup> For greater explanation of this alternative see Kerrie Sadiq, 'Unitary Taxation – The Case for Global Formulary Apportionment' (2001) 55 *Bulletin for Int'l Fiscal Documentation* 275; Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises' (2008) 62 *Bulletin for Int'l Taxation* 201.

a formula for unitary taxation of MNEs'.<sup>114</sup> The Panel was of the view that this would 'thwart the misuse of transfer pricing', which will be of 'much benefit to developing countries'.<sup>115</sup> Since 2001, the European Union (EU) has engaged with the idea of a common consolidated tax base (CCCTB).<sup>116</sup> If it were to be realised, it would offer companies operating in the EU a single set of rules to calculate their EU wide taxable income, which would be apportioned to EU countries based on a set of factors. In June 2015, the European Commission (EC) re-launched the CCCTB in the form of the Common Consolidated Corporate Tax initiative. The aim is to 'kick-start negotiations on the CCCTB in the Council, which have stalled largely due to the scale of the proposal'.<sup>117</sup> Accordingly, the EC will first focus on securing a common tax base, with consolidation being postponed till the common tax base has been implemented.<sup>118</sup> The Chinese position in chapter 10 of the UN TPM, which was introduced in 2012, states that 'assets and people should largely dictate where the

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<sup>114</sup> UN General Assembly (UNGA), 'Letter from the Secretary General to the President of the General Assembly' (25 June 2001) A/55/1000, 28.

<sup>115</sup> *ibid* 9.

<sup>116</sup> EC, 'Company Taxation in the Internal Market' COM (2001) 582 final; CCCTB Working Group (WG), 'General Tax Principles' (Working Document, EC 2004) <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/ccctbwp1finalrev1\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp1finalrev1_en.pdf)> accessed 3 September 2015; CCCTB WG, 'Possible Elements of a Technical Outline' (Working Document, EC 2007) <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/ccctbwp057\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp057_en.pdf)> accessed 3 September 2015; CCCTB WG, 'Possible Elements of the Sharing Mechanism' (Working Document, EC 2007) <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/ccctbwp060\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp060_en.pdf)> accessed 3 September 2015; CCCTB WG, 'Possible Elements of the Administrative Framework' (Working Document, EC 2007) <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/ccctbwp061\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp061_en.pdf)> accessed 3 September 2015. See also Clemens Fuest, 'The European Commission's Proposal for a Common Consolidated Corporate Tax Base' (2008) 24 *Oxford Rev of Economic Policy* 720.

<sup>117</sup> EC, 'A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action' COM (2015) 302 final, 7-8 <[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/fairer\\_corporate\\_taxation/com\\_2015\\_302\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf)> accessed 10 August 2015.

<sup>118</sup> *ibid* 8.

group's profits should stay' and a global formulary approach is a 'realistic and appropriate option' to achieve this end.<sup>119</sup>

The preceding paragraph briefly reflects that there is an interest in global formulary apportionment internationally, regionally, and even at the level of an individual country. The approach has several advantages. Conceptually, it is an advance over the existing rules for assignment of taxing rights between countries because it recognises the integrated nature of MNEs and the reality of profit creation by them.<sup>120</sup> Practically, because a country will be allocated an MNE's income to tax only if a factor of the formula is present in the country, it can help reduce profit shifting.<sup>121</sup> Additionally, the prospect of ignoring the nature of group entities and intra-group transactions, as well as the distinction between active and passive income, will be a step towards greater simplicity in the international taxation framework.<sup>122</sup>

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<sup>119</sup> UN TPM (n 87) para 10.3.6.3. Referring to a statement by the OECD's Secretary General that BEPS is all about 'revenue, sovereignty, and fairness', the Director General of SAT - Tizhong Liao has stated that, 'to strike the balance between these paradigms, it may be helpful to remind the world of good old days when people believed that labour was the primary force that created value. Today's transfer pricing economics seems to reward technology, institutional synergies and legal infrastructure far too disproportionately, with the people who are actually working, suffering and generating value far under-rewarded. If a global formulary approach were to be designed, I wish the world could wake up to the fact that, at the end of the day, it is labour that is the most important factor to be considered'. See Sophie Ashley, 'SAT's Tizhong Liao Discusses China's Transfer Pricing Position – Part Two' (TP Week, 2013) 1 <[www.tpweek.com/article/3194614/SATs-Liao-Tizhong-discusses-Chinas-transfer-pricing-position-Part-two.html](http://www.tpweek.com/article/3194614/SATs-Liao-Tizhong-discusses-Chinas-transfer-pricing-position-Part-two.html)> accessed 10 May 2014.

<sup>120</sup> Robert H Cutler, 'Formulary Apportionment - Is this Alternative to the Arm's Length Standard Possible and Practical under United States' Current Tax Treaties' (1997) 3 Int'l Trade & Business L Annual 153, 160; Arthur J Cockfield, 'Formulary Taxation Versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists' (2004) 52 Canadian Tax Journal 114, 116-117. See also Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' in Charles E McLure Jr (ed), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover Institution Press 1984) 228, 236.

<sup>121</sup> Michael C Durst, *The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment* (International Centre for Tax and Development (ICTD) 2015) 11.

<sup>122</sup> Richard Pomp, 'Issues in the Design of Formulary Apportionment in the Context of NAFTA' 49 (1994) Tax L Rev 795, 805; Walter Hellerstein, 'International Income Allocation in the 21st Century: The Case for Formulary Apportionment' (2005) 12 Int'l Transfer Pricing Journal 103, 108-109; François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)' (2005) 53 Canadian

Importantly, global formulary apportionment can be developed more easily to better advance the findings from chapters IV and V mentioned at the start of this chapter and the idea of substantive fairness in the international division of taxing rights established in chapter II.<sup>123</sup>

The choice of the factors for apportionment of an MNE's profits between countries and the weight given to them will play a key role in accomplishing this objective. Avi-Yonah and Clausing have suggested a sales-based formula, which is simple and has a direct relation with countries' desires to tax imports and exempt exports for enhancing national competitiveness and reducing trade deficits.<sup>124</sup> A three-factor formula comprising of assets, a labour element, and sales, with each element weighing equally will, however, cover the demand as well as the supply side of profit creation.<sup>125</sup> There would be winners and losers under any formula.<sup>126</sup> As stated by Picciotto, a three-factor formula would nevertheless be more balanced from the perspective of countries across the world with different economic interests.<sup>127</sup> From the standpoint of developing countries particularly, research by Cobham and Loretz suggests that whereas payroll may have an adverse impact on revenue gains,

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Tax Journal 409, 416; Susan C Morse, 'Revisiting Global Formulary Apportionment' (2010) 29 Virginia Tax Rev 593, 601.

<sup>123</sup> Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 L & Policy in Int'l Business 145, 200-201.

<sup>124</sup> Reuven S Avi-Yonah and Kimberley Clausing, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment' (Hamilton Project, The Brookings Institution 2007) 13 <[www.brookings.edu/~media/research/files/papers/2007/6/corporatetaxes-clausing/200706clausing\\_aviyonah.pdf](http://www.brookings.edu/~media/research/files/papers/2007/6/corporatetaxes-clausing/200706clausing_aviyonah.pdf)> accessed 3 September 2015.

<sup>125</sup> A three-factor formula or the 'Massachusetts formula' has been applied at the intra-State level in the US. Peggy Musgrave has written in favour of using this formula in global formulary apportionment. See Peggy B Musgrave, 'Sovereignty, Entitlement, and Cooperation in International Taxation' (2001) 26 Brooklyn J Int'l L 1335, 1342.

<sup>126</sup> For a discussion of this issue in the context of the CCCTB see Michael P Devereux and Simon Loretz, 'The Effects of EU Formula Apportionment on Corporate Tax Revenues' (2008) 29 Fiscal Studies 1, 28-29.

<sup>127</sup> Sol Picciotto, *Is the International Taxation System Fit for Purpose, Especially for Developing Countries* (ICTD 2013) 28.

headcount could have a positive one.<sup>128</sup> Therefore, the latter or at least a mix of payroll and headcount should be favoured. From these countries' viewpoint, it will also be advisable to keep intangibles out of the formula. In any case, as argued by Hellerstein and also McLure, intangibles do not really have a real location and their value is inherent in the whole of the MNE.<sup>129</sup>

Sadiq and also McIntyre have suggested that the presence of one or more factors of the formula in a country should be sufficient for the country to assume the right to tax.<sup>130</sup> Promoting administrative feasibility and certainty, however, makes it desirable to maintain a specific threshold for determining whether or not the profits of an enterprise are taxable in a country. For this purpose, using the concept of PE, even as revised by the BEPS project, would mean persistence of issues relating to it highlighted in part I of this chapter. Setting quantitative limits with respect to the chosen factors,<sup>131</sup> or using a similarly orientated approach to nexus and threshold for taxation like the significant economic presence test, will provide a more effective solution. Overall, such combinations will be more comprehensive in terms of taxation based on economic as opposed to physical presence of an enterprise in a country, and recognition of a country's contribution in the profitability of an enterprise than the changes to the existing international rules for allocation of taxing rights discussed in

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<sup>128</sup>Alex Cobham and Simon Loretz, *International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation* (ICTD 2014) 29.

<sup>129</sup>Jerome R Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment' (23 August 1993) 60 Tax Notes 1131, 1141-42; Charles E McLure Jr, 'U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles' (10 March 1997) 14 Tax Notes Int'l 859, 868.

<sup>130</sup>Michael J McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance' (1994) 49 Tax L Rev 769, 789; Kerrie Sadiq, 'Jurisdiction to Tax and the Case for Threshold Reform' (2005) 1 Journal of Australasian Tax Teachers Association 162, 189-190; Kerrie Sadiq, *Unitary Taxation of the Finance Sector* (ICTD 2014) 14.

<sup>131</sup>Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy' (2001) 26 Brooklyn Journal of Int'l Law 1357, 1417.

part I.<sup>132</sup> Therefore, it would better advance a fairer division of taxing rights from the BICs' perspective than those alterations. The potential increase in source taxing rights will also be advantageous for other developing countries.

Practical realisation of global formulary apportionment, however, involves several challenges and issues that need further consideration. The first among these is the concept of a unitary business. An ownership test will be a simple option to define a unitary business.<sup>133</sup> However, it might not give a true reflection of the exact scope of an enterprise. This, in turn, could be obtained by focusing on economic and operational control and integration.<sup>134</sup> Ascertaining these aspects would nevertheless be a complex exercise with much room for uncertainty. A combination of legal and economic features would be a possible solution,<sup>135</sup> but developing one that is broadly acceptable to countries across the world will need more study and discussion at the international level.

The second challenge is determining the tax base that is to be allocated to countries. Till now, formulary apportionment has only been applied in an intra-State context where it is easier to find an overlaying definition of income for tax

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<sup>132</sup> Note that even this might not account precisely for a country's contribution in the profitability of an enterprise. However, as stated in chapter II and also earlier in this chapter, achieving quantitative exactitude is not even the aim of this parameter for advancing fairness in the rules for assignment of taxing rights between countries. Instead, it is to ensure that the rules facilitate this idea to the extent possible or that they do not undermine a country's input in the creation of profits by an MNE. As discussed in the above text, in this respect, global formulary apportionment will be an improvement over the existing international framework for allocation of taxing rights.

<sup>133</sup> Peggy B Musgrave, 'Principles for Dividing the State Corporate Tax Base' (n 120) 237.

<sup>134</sup> Charles E McLure Jr, 'Defining a Unitary Business' in McLure Jr, *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (n 120) 105-108; Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56 Bulletin for Int'l Fiscal Documentation 586, 592.

<sup>135</sup> Avi-Yonah and Clausing (n 124) 20-21.

purposes.<sup>136</sup> Such an understanding is absent in the international sphere. One of Li's recommendations is to develop an approach based on principles that are commonly used across countries for taxation of enterprises' profits.<sup>137</sup> Like Avi-Yonah, Clausing, and Durst, Li also highlights the role of greater adoption of International Accounting Standards (IAS) in dealing with this issue.<sup>138</sup> As the number of MNEs using IAS for financial reporting is growing, this will be a suitable starting point towards establishing the tax base to be divided among countries. As pointed out by Mintz, accounting is, at times, judgmental and, even when using the same principles, there can be variations in practices across countries and companies.<sup>139</sup> Also, businesses that are less concerned over reported earnings may manipulate tax payments by choosing alternative payments and deductions.<sup>140</sup> These issues demand a fairly common set of rules for ascertaining the tax base.<sup>141</sup>

The rules would need to be accompanied with at least a broad agreement on determining when an enterprise's profits will be taxable in a country and the factors of the formula for apportionment of the profits among countries as well as the weight to be attached to those factors. This is because the greater the absence of a shared understanding on all these aspects, including the idea of a unitary business, the more

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<sup>136</sup> Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (Springer 2006) 68.

<sup>137</sup> Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation' (2002) 50 *Canadian Tax Journal* 823, 846.

<sup>138</sup> *ibid.* See also Reuven S Avi-Yonah, Kimberley Clausing, and Michael C Durst, 'Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split' (2009) 9 *Florida Tax Rev* 497, 522-523.

<sup>139</sup> Jack M Mintz, 'Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake' (2007) OUCBT Working Paper 07/14, 4 <[www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/Series\\_07/WP0714.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_07/WP0714.pdf)> accessed 20 October 2015.

<sup>140</sup> *ibid.*

<sup>141</sup> *ibid.*

intense will be the third challenge under global formulary apportionment: dealing with double taxation.<sup>142</sup>

It is undoubtedly more difficult to relocate economic activity than paper profits. Depending on other factors influencing investment decisions, countries with low tax rates will nevertheless remain appealing for companies. This makes the intensity of tax competition under global formulary apportionment, as compared to separate accounting, an important issue to consider while evaluating the overall impact of a shift. Under a set tax base and the basis for dividing it, tax rates will be a major tax-related factor left with countries to attract MNEs. The expected impact, as discussed by Gordon and Wilson, is a reduction in tax rates across countries.<sup>143</sup> However, Sørensen argues that if positive and negative spill-over effects of capital reallocation under global formulary apportionment are taken into account, countries would be encouraged to maintain high tax rates.<sup>144</sup> The picture becomes more complex when research suggesting variation in tax competition under different formulas is taken into account, indicating that the issue needs further analysis.<sup>145</sup>

More study will also be required of the potential for tax avoidance under global formulary apportionment through manipulation of exposure to the factors of the

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<sup>142</sup> For a counter to this criticism of the global formulary approach see Michael C Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws' (18 January 2010) *Tax Notes Int'l* 247, 255.

<sup>143</sup> Roger Gordon and John D Wilson, 'An Examination of Multijurisdictional Corporate Income Taxation Under Formula Apportionment' (1986) 54 *Econometrica* 1357, 1363-1372.

<sup>144</sup> Peter Birch Sørensen, 'Company Tax Reform in the European Union' (2004) 11 *Int'l Tax and Public Finance* 91, 98-101.

<sup>145</sup> Rüdiger Pethig and Andreas Wagener, 'Profit Tax Competition and Formula Apportionment' (2007) 14 *Int'l Tax and Public Finance* 631, 632-634. See also Kirk J Stark, 'The Quiet Revolution in U.S. Subnational Corporate Income Taxation' (2001) 55 *Bulletin for Int'l Fiscal Documentation* 523, 527-528.

formula in different countries. In the case of payroll or headcount and assets, enterprises could attempt to reduce their tax liability in high-tax countries by outsourcing activities to independent contractors.<sup>146</sup> A sufficiently broad formulation of these factors and an equally robust nexus for taxation could help address this issue.<sup>147</sup> Another problem relating to assets, however, are intangibles. These can be concentrated in low-tax jurisdictions to reduce profits of entities in high-tax jurisdiction through regular payments for their use. Also for this reason, as has been said before, it will be best to keep intangibles out of the formula, with another factor acting as a proxy for them. Roin has suggested overweighting the sales factor as a possible option.<sup>148</sup> This, of course, will mean that the sales factor will have to be considered based on where the product or the service is ultimately received or consumed rather than where the title to the goods passes or the services are performed.<sup>149</sup> Tracing the final destination of goods and services, however, might not be an easy exercise.<sup>150</sup>

A final issue to consider will be the interaction of global formulary apportionment with the prevailing rules for assignment of taxing rights between

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<sup>146</sup> Julie Roin, 'Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment' (2008) 61 Tax L Rev 169, 204-206.

<sup>147</sup> *ibid.*

<sup>148</sup> *ibid* 206-207.

<sup>149</sup> This is also necessary from the standpoint of accounting for the demand State's contribution in the division of taxing rights between countries.

<sup>150</sup> As compared to B-to-C sales, in B-to-B cases, it is easier for deliveries to be made to or payments to be made from low-tax countries, with the goods then being shipped to a high-tax country where they are finally used or the services being furnished to a high-tax State. Such manipulations by MNEs will depend on the overall balance of the costs involved in the process and the tax advantage obtained from it. Further, jurisdiction where relevant deductions are claimed in respect of the purchase will be important in establishing where the goods and services actually end up. In view of these tax avoidance concerns, the source rule for taxation of services in India's domestic law discussed in chapter IV, which depends on the country being both the place of payment and the place of utilisation of services, is superior to just the source of payment rule.

countries. Avi-Yonah and Clausing have attempted to justify the global formulary approach under Articles 5 and 7 of the OECD Model and the UN Model. They consider subsidiaries as dependent agents of the parent.<sup>151</sup> The rationale for this view is the integrated nature of the operations of modern MNEs, and thus the legal and economic control exercised by parents over subsidiaries.<sup>152</sup> Avi-Yonah and Clausing argue that if a subsidiary is an agent of the parent, Article 7 of the OECD Model (pre-2010 version) and the UN Model will apply for determining the profits attributable to the subsidiary. According to them, even a formulary approach will align with the ALP contained in those Articles, because the usual absence of precise comparables in any case makes it impossible to determine the exact profits that would have been attributable to the subsidiary under separate accounting.<sup>153</sup> The whole argument is made easier when the provision allows for apportionment of profits of an enterprise to its parts.<sup>154</sup>

Moving to global formulary apportionment under this familiar framework could mean lesser transition costs and greater political acceptability. Equally, a whole new set of rules might be better from the perspective of giving solid foundations to global formulary apportionment. In either case, as noted by Sadiq, unless the degree of international agreement over the key aspects of the system emphasised throughout this part is achieved, the shift to this option could amount to inviting distortions,

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<sup>151</sup> Avi-Yonah and Clausing (n 124) 23.

<sup>152</sup> *ibid.*

<sup>153</sup> *ibid.*

<sup>154</sup> *ibid.* 24.

complexities and aggressive tax planning.<sup>155</sup> When a relatively homogenous collection of countries like the European Union has been unable to achieve much progress in this direction, as pointed out by Spencer, for countries across the world with diverse economic interests that change over time, the end will certainly not be quick and easy to realise.<sup>156</sup> For this reason, the author believes that unitary taxation with global formulary apportionment is more of a long-term alternative to the existing rules for allocation of taxing rights between countries.

For it to even be that, as discussed by Durst, serious and comprehensive review at the global level will be vital.<sup>157</sup> This will not only involve further study by experts. It will also entail careful scrutiny of any practical experiments, such as industry specific trials like that proposed by Sadiq in the case of multinational financial institutions,<sup>158</sup> or even regional application of formulary apportionment<sup>159, 160</sup>. This will be particularly important to check developments perpetuating narrow interests that will make reaching the eventual goal of a broad consensus difficult. For the same reason unilateral resort to unitary taxation and formulary apportionment mentioned in

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<sup>155</sup> Kerrie Sadiq, *Unitary Taxation of the Finance Sector* (n 130) 28. Writing in 1972, the Musgraves believed that success of global formulary apportionment needs an international tax administration. See Richard A Musgrave and Peggy B Musgrave (n 112) 85.

<sup>156</sup> David Spencer, 'Formulary Apportionment is not a Panacea – Part 2' (May 2014) *Journal of International Taxation* 35, 48; David Spencer, 'UN Tax Committee, Developing Countries and Civil society Organizations' (January 2016) *Journal of International Taxation* 45, 58.

<sup>157</sup> Michael Durst, *Beyond BEPS: A Tax Policy Agenda for Developing Countries* (ICTD 2014) 14.

<sup>158</sup> Kerrie Sadiq, *Unitary Taxation of the Finance Sector* (n 130) 3.

<sup>159</sup> For discussion on regional application of unitary taxation with formulary apportionment see Siu et al, *Unitary Taxation in Federal and Regional Integrated Markets* (ICTD 2014).

<sup>160</sup> Both these options will be supported by developments such as country-by-country reporting.

the past by Picciotto must be avoided.<sup>161</sup> As discussed in chapter II, such measures also lead to certainty and instability in the international taxation framework.

Based on the OECD TPG's criticism of global formulary apportionment, it can be said that the OECD has little interest in this option.<sup>162</sup> Ignoring the calls to the contrary, the UN's work on the UN TPM also refused to deal with this alternative.<sup>163</sup> The BEPS project too did not engage with it.<sup>164</sup> Such a blanket rejection overlooks the potential advantages discussed in this part. The key one among these is the ability to deliver a fairer assignment of taxing rights from the perspective of the BICs and other developing countries in a more coherent and simpler manner than the multiple changes to these rules at various levels discussed in part I. This aspect will also provide a better groundwork for a more durable international framework for allocation of taxing rights.

## **Conclusion**

This chapter began by highlighting the two main findings from chapters IV and V. The first is the BICs' interest in protecting and enhancing their tax base as a host country. The second is their effort to seek recognition of their distinct input, particularly their consumer base, in the assignment of rights to tax active business

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<sup>161</sup> Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' (December 2012) TJN, 11 <[http://www.taxjustice.net/cms/upload/pdf/Towards\\_Unitary\\_Taxation\\_1-1.pdf](http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf)> accessed 11 July 2016. In his recent work, Picciotto has, however, shifted his attention to regional as opposed to unilateral trials. See Sol Picciotto, *Taxation Multinational Enterprises as Unitary Firms* (ICTD 2016) 30-31.

<sup>162</sup> OECD TPG (n 87) para 1.16-1.32.

<sup>163</sup> UN TPM (n 87) para 1.4.13. Compared to the OECD TPG's critical position, the UN TPM, however, has a neutral stand towards global formulary apportionment.

<sup>164</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 14.

income between countries. These results are connected by the BICs' motivation to ensure that their contribution in the profitability of an enterprise is reflected in the international division of taxing rights. Chapter II established acknowledgement of a country's role or contribution in the generation of profits by an MNE, in the rules for allocation of rights to tax active business income between countries, as an indicator of substantive fairness in the rules. Thus, this chapter examined short- and medium-term options that could further the findings from chapters IV and V. An attempt was also made to reflect on the implications of the suitable proposals for developing countries more generally.

Section (a) of part I highlighted that the changes to the existing concept of PE proposed under Action Point 7 of the BEPS project would restore the tax base of demand countries to the extent it is eroded by artificial avoidance of PE status in these countries. They do not, however, reflect a broader shift towards taxation based on economic as opposed to physical presence of an enterprise in a country. They also do not lead to a wider recognition of the demand element in the assignment of rights to tax active business income between countries sought by the BICs. Part I showed that suggestions from academic and policy literature in international taxation address these concerns to varying degrees. However, the problem with all but one is that either their impact is limited to particular types of businesses or activities, or they treat the demand State's right to tax as secondary.

The exception is the significant economic presence test. This will involve determining a country's right to tax active business income of a non-resident enterprise based on the existence of certain supply and demand side factors. In this

way, as compared to the other alternatives discussed in section (a) of part I, it will address the areas for working towards a fairer division of taxing rights from the BICs' perspective in a comprehensive manner. Potentially greater source taxing rights than any of the other options considered in part I make it advantageous for other developing countries as well. These merits add to the case for a serious consideration of the significant economic presence test at the international level. The focus should be on devising a combination of factors for establishing a non-resident enterprise's significant economic presence in a country that maximises administrative feasibility and certainty and on achieving uniform application of the test across countries.

Section (b) of part I pointed out the difficulty in using the existing rules for attributing profits to PEs to determine how much of the profits of an enterprise, which has a significant economic presence in a country, are taxable in the country. A low-rate withholding tax acting as a proxy for net-based taxation was discussed as a useful mechanism to serve this end. It will need appropriate delineation of the transactions to which the tax will apply and setting the right level of the tax along with the option of filing on net basis. An efficient withholding system will be key. This will also provide a vital enforcement and collection tool in the case of a significant economic presence nexus for host State taxation. Section (b) also highlighted some other options for ascertaining profits of an enterprise taxable in a country based on this nexus, such as fractional apportionment and deemed profit methods. These will be administratively more complex than a low-rate withholding tax, and that can be a factor against their attractiveness from the standpoint of the BICs and other developing countries. Yet, if the goal is to develop the significant economic presence test for nexus as a sound and workable replacement of the concept of PE, at this early stage of consideration, there

must be openness towards studying all options that show some promise in facilitating this move.

Section (b) of part I discussed that an open perspective should also be adopted towards applications of the ALP for apportionment of profits between associated enterprises that are better suited to recognise the contribution an enterprise to the profitability of an MNE. The PSM is a sound starting point for reaching these, because, as compared to the other transfer pricing methods, it is more orientated towards looking inwards into the actual role or contribution of associated enterprises in the profits generated by MNEs. Accounting for location rents and marketing intangibles were discussed as areas worthy of exploring the greater use of the PSM. Realising the full potential of PSM in these cases and even generally will, however, depend on devising better methods of splitting profits between associated enterprises. Developments like country-by-country reporting and greater exchange of information between countries will aid in the process. To enhance certainty and address double taxation, instruments like bilateral or multilateral APAs could be used. APAs will be particularly relevant in cases concerning marketing intangibles and location rents, which involve the preliminary step of establishing their existence. Technical support will be vital to help developing countries acquire administrative ease in efficient application of any formulation of PSM. From these countries' perspective, it is also important to continue the search for fairer yet simple transfer pricing methods.

Part II presented global formulary apportionment as a conceptually superior and practically less complex alternative to the existing transfer pricing rules. A global formulary approach that uses an equally weighted combination of supply as well as

demand side factors for apportionment of an MNE's profits among countries better advances taxation based on an enterprise's economic presence in a country and recognition of a country's contribution in the profitability of an enterprise. Combining these factors with a similarly orientated nexus and threshold for taxation will enhance certainty and administrative feasibility in the application of global formulary apportionment. As compared to the multiple short-term changes discussed in part I, it offers a more coherent reform option, and it is thus a better starting point for a more stable international taxation framework.

In view of such potential benefits, world bodies engaging with international taxation should devote resources to a serious and comprehensive consideration of global formulary apportionment. This would involve further expert analysis and careful scrutiny of any practical experiments. The latter, along with the rejection of any unilateral trials is important to check perpetuation of narrow interests that will make reaching the level of international agreement on core elements of this option vital to avoid distortions, complexities, and aggressive tax planning, difficult to attain. In view of the time and effort that will be required to attain this, global formulary apportionment is at best a long-term alternative to the existing rules for division of taxing rights between countries.

## Chapter VIII

### Conclusion

Tax on corporate profits is an important source of revenue for countries, especially those classified as developing economies.<sup>1</sup> The global economic crisis of 2008 got governments across the world thinking about their ‘fair’ share in the profits of multinational enterprises (MNEs). The OECD/G20 Base Erosion and Profit Shifting (BEPS) project is a reflection of the unprecedented interest in this issue since the existing international framework for division of rights to tax profits of MNEs was established by the League of Nations (LONs). The project acknowledged that, in view of the developments in technology and business methods, decisive changes to the set-up would be needed to achieve a ‘fairer global economy’.<sup>2</sup>

Such references to fairness are common in the reform discourse at the global level. A utilitarian rationale for this is the appeal of fairer processes and outcomes for the stakeholders of any legal or regulatory system. This increases the likelihood of stakeholders’ compliance with the structure, which in turn helps maintain certainty and stability in it. Understandably, the importance of this function of the norm increases in cases like the international taxation framework, where there are no express sanctions for divergent acts of countries.<sup>3</sup> Thus, even though fairness is notoriously difficult to define, it is important to have some pragmatic notion of it, if

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<sup>1</sup> IMF Fiscal Affairs Department, ‘Spillovers in International Corporate Taxation’ (IMF Policy Paper, IMF 9 May 2014) 7 <[www.imf.org/external/np/pp/eng/2014/050914.pdf](http://www.imf.org/external/np/pp/eng/2014/050914.pdf)> accessed 18 September 2014.

<sup>2</sup> OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 35-36, 48-53.

<sup>3</sup> This is especially so when, as recognised in the Action Plan of the BEPS project, uncoordinated actions of countries are capable of resulting in uncertainty and double taxation. All of these have an adverse impact on the other main actors of the international taxation framework – global businesses.

only to assess the suitability of the order from the standpoint of countries with diverse economic interests and to guide the future developments.

This thesis provides such a concept of fairness and applies it to explore the following questions. Whether the prevailing international framework for allocation of rights to tax active business income could be considered fair from the BICs' perspective? If not, what directions of reform could be pursued in the short- and medium-term to address this issue? The BICs were chosen as the focus of this study not only because of their own economic clout in the world, which in the recent years has allowed them to take strong positions on the rules for division of taxing rights between countries. They were also selected as proxies to initiate this study from the standpoint of developing countries more generally. Therefore, the author has made an attempt to highlight the implications of the options towards a fairer international taxation framework from the BICs' viewpoint for other developing countries as well.<sup>4</sup> The following parts present conclusions from the core parts of this research and also how some of these can be developed in the future.

## **I. Understanding fairness in the international taxation framework**

Chapter II highlighted that it is important to think of the concept of fairness in the global settings or INE at two levels: fairness in the rule-making process or procedural fairness, and fairness in the outcome or substantive fairness. This is because fairness in process has the potential to influence the outcome. Importantly, it is also vital outside of this link because it affects the involved stakeholders' perception of a set of

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<sup>4</sup> Such an analysis becomes particularly important in light of the BICs' gradually growing interests as home economies.

rules and hence, their commitment towards it. A study of fairness in the international taxation literature showed disproportionate engagement with the rules for division of taxing rights between countries and thus, the absence of a comprehensive notion of fairness.

The author filled this gap by relying on international law and international relations literature to devise a set of basic parameters for assessing and advancing fairness in the international taxation rule-making process. These are participation in the process and the effectiveness of that participation, with the latter being reflected by equal involvement in all stages of the process, from agenda-setting to discussions and decision-making. Different bargaining powers and technical capabilities of countries with varying levels of economic development were accepted as a reality of rule-making at the international level. As discussed in chapter II, appropriate design of the process and technical assistance to economically and politically less influential countries can help mitigate the impact of these aspects.<sup>5</sup>

As the international taxation literature is comparatively rich on this point, the author relied on it for finding a suitable approach for evaluating and furthering fairness in the division of taxing rights between countries. It was concluded that the Musgraves' seminal concept of INE is a crude but useful metric for assessing whether or not a particular outcome in this regard could be considered fair from a country's perspective.<sup>6</sup> This is because of the idea of loss or gain in a country's national wealth that is at the centre of the Musgraves' notion of INE and its possible relation with a

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<sup>5</sup> Text to n 129-136 in chapter II.

<sup>6</sup> Richard A Musgrave and Peggy B Musgrave, 'Inter-Nation Equity' in Richard M Bird and John G Head (eds), *Modern Fiscal Issues: Essays in the Honour of Carl S. Shoup* (University of Toronto Press 1972) 63.

country's compliance with or deviation from the international rules for assignment of taxing rights between countries. Arguably, if an allocation of taxing rights leads to an acceptable gain or loss in a country's national wealth or, in other words, is fair from a country's perspective, the country is likely to comply with the rules giving rise to it. Likewise, a possible reason behind a country's divergence from those rules could be its dissatisfaction with the gain or loss in its national wealth that the rules result in.<sup>7</sup> Phrased differently, the rules could be considered unfair from the country's standpoint.

The Musgraves' construct of INE, however, is not of equal utility when analysing proposals for furthering substantive fairness. This is because it can indicate that an acceptable gain or loss in a country's national wealth will be a fairer or more equitable outcome from a country's perspective, but it does not tell us the basis on which this conclusion is justifiable. To address this drawback, the author relied on Kaufman's suggestion to pursue the doctrine of economic allegiance for developing a notion of substantive fairness in the international taxation framework.<sup>8</sup> Based on it, recognition of a country's role or contribution in the profitability of an MNE was established as a parameter for advancing fairness in the assignment of rights to tax active business income.<sup>9</sup> To make this idea more robust and durable, the issue was considered from the viewpoint of the other key stakeholders of this structure: the MNEs. Certainty, stability, and alleviation of double taxation were selected as the

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<sup>7</sup> As mentioned in chapter II, there could be other reasons for this divergence, such as historical or cultural. Arguably, an improvement in its economic position is, however, difficult for a country to resist for long. Therefore, if the rules lead to a more acceptable gain or loss in a country's national wealth, the country would move in their direction rather than away from them.

<sup>8</sup> Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 L & Policy in Int'l Business 145, 198.

<sup>9</sup> Text to n 138-149 in chapter II.

basic indicators of a fair outcome from the viewpoint of businesses for the purpose of this research.<sup>10</sup>

The parameter-based approach to fairness in process and outcome proposed in this thesis has shown that a more objective and comprehensive notion of fairness in the international taxation framework is possible. Importantly, it has laid the groundwork for such a concept of fairness. Refining the parameters proposed at both the levels and adding more to them are areas for future research. Also, the relevance of the approach to substantive fairness established in chapter II in the case of allocation of rights to tax passive income remains to be analysed.

## **II. Whether the existing international framework for allocation of rights to tax active business income can be considered fair from the BICs' perspective**

Chapter III analysed the evolution of the existing international rules for assignment of taxing rights under the LONs based on the parameters established for this purpose in chapter II. It showed that up until the Mexico conferences of 1940 and 1943, the participation of the BICs and other developing countries in this process was limited. The change brought by the Mexico conferences, however, did not last for long. This is in terms of both the representation of developing countries in the international taxation rule-making process under the LONs' and the nature of the rules for division of taxing rights between countries. In the London conference of 1946, a greater number of the delegates came from developed nations. Importantly, the conference resulted in the rejection of some of the changes to the LONs' position on these rules

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<sup>10</sup> Text to n 150-154 in chapter II.

that the Mexico conferences had introduced to further the interests of developing countries.<sup>11</sup> This reflects the limited influence of these countries in the final decision-making process of the LONs. As the BICs and other developing countries were not really involved in the initial stages of the LONs' work on the rules for allocation of taxing rights between countries, the same can be said about their engagement with setting the agenda in this regard in the early 1920s.

Indicating the potential link between fairness in process and outcome, the LONs' Fiscal Committee had desired that its output be reviewed by a more balanced group of experts and tax administrators from developed and developing countries.<sup>12</sup> The OECD – a largely homogenous group of rich countries – was, however, the first to take up this task. The BICs and other developing countries did not participate in the development of the OECD Model. Understandably, the result was a set of rules that has long been recognised as being more favourable towards home States, which generally tend to be developed countries. Experts from two of the BICs, and also several other developing countries, were involved on an equal footing with those from the others in the drafting of the UN Model.<sup>13</sup> However, the process could still not be viewed as entirely fair from these countries' perspective because of a largely pre-set agenda. This meant that some of the core aspects of the existing international rules for division of taxing rights with respect to which the BICs and other developing

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<sup>11</sup> This included the Mexico Model's position of the concept of PE being one instance allowing the host State to tax the active business income of a non-resident enterprise operating in the country rather than being the sole determinant in this regard.

<sup>12</sup> LONs, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text* (C88.M.88.1946.IIA, LONs 1946) 6.

<sup>13</sup> As stated in chapter III, these experts were from Brazil and India.

countries had often expressed concerns, or whose greater scrutiny could have benefited these countries, were entirely off the negotiating table.<sup>14</sup>

In view of the above-mentioned findings it can be concluded that, overall, the process of evolution and development of these rules could not be considered fair from the standpoint of the BICs and other developing countries. Importantly, in the context of the international taxation framework, fairness in process does appear to have affected the outcome of the rules. Chapters IV and V explored the latter result further. They focused on some of the basics of the prevailing international rules for assignment of rights to tax active business income and analysed whether they could be considered as resulting in a fair division from the BICs' standpoint. The first of these fundamental aspects was the requirement of physical presence of a non-resident enterprise as envisaged in the concept of PE in Article 5 of the OECD Model and the UN Model in a country for determining the country's right to tax the income generated by the enterprise.<sup>15</sup> The second was the arm's length principle (ALP) and its application for attributing profits to PEs and for apportionment of profits between associated enterprises, as discussed in Articles 7 and 9 of the OECD Model and the UN Model, as well as the OECD's Transfer Pricing Guidelines (OECD TPG) and the UN's Transfer Pricing Manual (UN TPM).<sup>16</sup>

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<sup>14</sup> The concept of PE being the main determinant of a State's right to tax active business income of a non-resident enterprise and the use of the arm's length principle (ALP) based separate accounting for apportionment of profits between associated enterprises are notable examples.

<sup>15</sup> OECD, *Model Tax Convention on Income and on Capital* (OECD 2014) Article 5; UN DESA, *UN Model Double Taxation Convention between Developed and Developing Countries* (UN 2011) Article 5.

<sup>16</sup> OECD Model 2014 (n 15) Articles 7 and 9; UN Model 2011 (n 15) Articles 7 and 9; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010) (OECD TPG); UN DESA, *UN Practical Manual on Transfer Pricing for Developing Countries* (UN 2013) (UN TPM).

The author undertook an empirical analysis of the BICs' bilateral tax treaties,<sup>17</sup> and studied developments in their domestic laws as well as the positions expressed by experts and representatives from these countries at the international level in the recent years on the above-mentioned aspects. It was found that the BICs diverge from the fundamentals of the prevailing international rules for allocation of rights to tax active business income mentioned in the preceding paragraph to varying degrees. Based on the Musgraves' construct of INE, the issues on which they depart could be viewed as areas for working on a fairer international division of taxing rights from the BICs' perspective.

Two broad reasons underlie this result. The first is the BICs' interest in protecting and enhancing their tax base as a host country. The second is their effort to seek recognition of their distinct input, particularly their consumer base, in the assignment of rights to tax active business income between countries. Underlying both of these is the BICs' desire to ensure that their contribution in the profitability of an enterprise is reflected in the allocation of taxing rights between countries. This was established in chapter II as the indicator of fairness in the international rules for division of rights to tax active business income.

Due to the restraint placed by time and word count on this research, the author focused on those basics of the existing rules for assignment of rights to tax active business income that have emerged as particular concerns of the BICs and have also

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<sup>17</sup> The results of this study, which were used in chapters IV-VII, were derived based on the information contained in Annexures I-VI.

seen important developments in the OECD Model and the UN Model.<sup>18</sup> Future research can cover other aspects in this area. It can also be extended to the allocation of rights to tax passive income.

### **III. Options for a fairer international framework for assignment of rights to tax active business income**

Chapter VI explored options towards a fairer international taxation rule-making process from the standpoint of the BICs and also other developing countries. The first of these was the emergence of the OECD as a world tax body in terms of effective participation of countries across the globe in its tax work. The chapter highlighted that the OECD's membership is largely comprised of developed countries and there is not much to suggest that it will increase substantially in the coming years.<sup>19</sup> Nevertheless, since 2004 and 2007, China and India have participated regularly in the meetings of the OECD's Committee for Fiscal Affairs (CFA). Brazil too has had the opportunity to give its views on transfer pricing issues. Thus, there has been room for the BICs' indirect influence on the OECD's engagement with the international rules for division of taxing rights. Their participation has, however, lacked direct input in shaping its agenda and/or the outcome and thus, cannot be considered effective. Over the years, the OECD has also become more open towards interacting with developing countries more generally with respect to its tax work. This, however, does not equate to a country's equal participation in all stages of the rule-making process – from agenda-

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<sup>18</sup> The author's observations from the Eighth (2012) and Ninth sessions (2013) of the UN Tax Committee, and interviews with Committee members and government representatives from other developing countries present at these sessions revealed that the selected aspects are problems areas for these countries as well. This position is substantiated by reading the reports of the UN Tax Committee, especially those from the annual sessions in the last 8 years.

<sup>19</sup> Text to n 7-10 in chapter VI.

setting and discussions to final decision-making. Displaying the previously mentioned link between a fair process and the outcome, as discussed in chapter VI, there has been no significant increase in source taxing rights under the OECD Model in the recent years.<sup>20</sup> Instead, there have been developments, such as the introduction of the new Article 7, which are questionable from the perspective of these countries.

The BICs participated in the BEPS project on an equal footing with OECD members and associates from other countries. In the first year of the project, the involvement of developing countries more generally, however, was largely indirect. In 2014, 14 developing countries were called to the negotiating table, but because they became directly involved in the BEPS project only when the first set of deliverables was released, they did not have the same influence on the project's agenda as the OECD members or associates. As invitees, they also lacked participation in the final decision-making. This undermining of the parameters of a fair rule-making process affected the outcome of the project from the standpoint of these countries and even the BICs. The BEPS project does not really engage with the allocation of taxing rights between countries, an area that is of particular concern to these countries.

All countries can participate as equals in the process of drafting of the legally binding multilateral instrument to implement some of the proposals from the BEPS project.<sup>21</sup> The persistence of this position could have set the stage for the OECD's emergence as a world tax body. The OECD has, however, made it clear that this is not

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<sup>20</sup> Text to n 20-21 in chapter VI.

<sup>21</sup> OECD, 'Multilateral Instrument for BEPS Tax Treaty Measures: The Ad hoc Group' (OECD) <[www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm](http://www.oecd.org/tax/treaties/multilateral-instrument-for-beps-tax-treaty-measures-the-ad-hoc-group.htm)> accessed 5 December 2015.

to be taken as a precedent for its tax work.<sup>22</sup> In any case, a global tax body is expected to consider the concerns of countries across the world. This, in turn, means that certain issues, such as the assignment of taxing rights between countries cannot always be kept off the negotiating table. Conventionally, the OECD has been reluctant to deal with this matter. Thus, overall, in the short- and even medium-term, it is difficult to expect the OECD to serve as such a forum.

An intergovernmental body offering countries equal participation in all stages of rule-making and open to dealing with all international taxation matters would address these drawbacks. Historical and pragmatic reasons present the UN as a more suitable host for a platform like this, as compared to the other organisations that often engage with international taxation issues, such as the OECD, the IMF, and the World Bank, as well as those like the WTO, which till now have not really worked on these matters. As discussed in chapter VI, even the idea of such a forum faces some preliminary technical issues like determining how the body will take decisions and the nature of its output.<sup>23</sup> These could be addressed through a study of relevant academic literature and also examples from other international structures where similar barriers, such as sovereignty concerns have been successfully overcome. This analysis should be undertaken keeping in mind the developments in the international taxation framework like the move towards multilateralism, and the objective of achieving a certain and stable international taxation framework that also promotes the interests of developing countries. The pragmatic question of resources to set-up and maintain such a body can also be dealt with through various means, ranging from increased

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<sup>22</sup> OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15-2015 Final Report* (OECD 2015) 11.

<sup>23</sup> Text to n 73-102 in chapter VI.

assistance from the UN to mandatory contributions from member countries.<sup>24</sup> These solutions will, however, not be easy and quick. In view of the political obstacles in the way of this alternative as well, it is more of a long-term option for a fairer international taxation rule-making process from the perspective of the BICs, and importantly, developing countries more generally.

Being the other leading forum for setting the standards in international taxation, the UN Tax Committee was the obvious alternative to explore a more immediate solution. As highlighted through chapters III-V, the Committee is the only body where members from developing countries have always participated as equals with those from other countries in the development of the international rules for assignment of taxing rights. The Committee has also been increasingly open towards engaging with issues that are of particular concern to the BICs and other developing countries, irrespective of the fact that the matters have the potential to alter the basics of the existing division of taxing rights between countries. The work on the provision for taxation of fees for technical (FTS) for the UN Model and the UN TPM, especially in view of the Manual's chapter 10, are useful examples in this regard. Achieving a fairer international taxation rule-making process from the perspective of the BICs and other developing countries at the level of the UN Tax Committee, however, needs dealing with the problem of shortage of resources for the Committee.

This affects the number of matters that the Committee can take up and deliver on. Importantly, it limits the wider participation of developing countries in the UN's tax work, which although will not guarantee a more equitable division of taxing rights

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<sup>24</sup> Text to n 103-109 in chapter VI.

from developing countries' perspective,<sup>25</sup> but can increase the chances of it by allowing developing countries to use the sheer force of numbers and reach a better starting point for bilateral tax treaty negotiations. Bigger developing countries like the BICs cannot be considered adequate substitutes for developing countries' effective participation in the rule-making process. This is due to the growing difference of economic interests between the BICs and other developing countries. This is also because the author's empirical analysis of the BICs' bilateral tax treaties reveals that there is little to suggest that countries like India and China would support international tax policy positions favourable to the broad group of developing countries regardless of their economic interests.

The Third Financing for Development conference in 2015 was a failure in terms of the G77, China, and civil society organisations' demand for a global body for dealing with international taxation issues. It did, however, raise the UN Tax Committee's resources.<sup>26</sup> This is a welcome step in the direction of addressing the problem that affects the legitimacy and authority of the Committee's work. In view of the Committee offering the best prospect of a fairer international-taxation rule-making process from the perspective of these countries in the short-term, they should also consider contributing towards the cause. Civil society organisations can also help by raising the profile and the uptake of the Committee's output.

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<sup>25</sup> As stated in chapter II and VI, fairer international taxation rule-making does not guarantee an equitable division of taxing rights. In a set-up comprising of model documents and bilateral tax treaties, the chances of a fair outcome are undoubtedly influenced by relative economic powers of the treaty partners.

<sup>26</sup> UNGA, 'Addis Ababa Action Agenda of the Third International Conference on Financing for Development' (27 July 2015) A/RES/69/313, para 29.

Finally, chapter VII focused on the findings from chapters IV and V. As stated before, the two main reasons for the BICs' divergence from the prevailing international rules for assignment of taxing rights can be rationalised in light of the parameter for advancing fairness in these rules established in chapter II. Therefore, chapter VII examined proposals that could address these causes. It was highlighted that the changes to the existing concept of PE proposed under Action Point 7 of the BEPS project would restore the tax base of demand countries to the extent that is eroded by the artificial avoidance of PE status in these countries.<sup>27</sup> However, they will not deliver a wider shift towards taxation based on economic as opposed to physical presence of an enterprise in a country. They will also not lead to a broader recognition of the demand element in the division of rights to tax active business income between countries sought by the BICs.

Several reform proposals in academic and policy literature in international taxation address these issues to varying degrees. The majority of these do so by taking particular types of businesses or economic activities out of the concept of PE and treating them separately for the purposes of host State taxation.<sup>28</sup> This, in turn, limits their impact. The significant economic presence test for nexus for host State taxation, however, is an exception.<sup>29</sup> This will involve replacing the concept of PE with certain supply and demand side factors, which if met in the case of a non-resident enterprise's operations in a country, will give the country the right to tax the enterprise's profits. As compared to the other alternatives examined in chapter VII, the significant

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<sup>27</sup> OECD, *Preventing the Artificial Avoidance of PE Status, Action 7 – 2015 Final Report* (OECD 2015).

<sup>28</sup> Text to n 7-32 in chapter VII.

<sup>29</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* (OECD 2015) para 277-308.

economic presence test has a greater focus on an enterprise's economic presence in the host country and can also better account for the contribution of the market country in the allocation of taxing rights between countries. Thus, it would advance a fairer division of rights to tax active business income from the BICs' standpoint to a greater degree. The increase in source taxation under this option will be beneficial for other developing countries as well. These merits add to the case for a serious consideration of the significant economic presence test at the international level. The idea will, however, need much further study. Devising a combination of factors for establishing a non-resident enterprise's significant economic presence in a country that maximises administrative feasibility and certainty, and a method for achieving uniform application of the test across countries, will be integral parts of this analysis.

Chapter VII highlighted the difficulty in using the existing rules for attributing profits to PEs to determine how much of the profits of an enterprise, which has a significant economic presence in a country, will be taxable in the country. A low-rate withholding tax acting as a proxy for net-based taxation was discussed as a useful mechanism to serve this end.<sup>30</sup> It will need appropriate delineation of the transactions to which the tax will apply, and setting the right level of the tax along with the option of filing on net basis. An efficient withholding mechanism will be key. This will also provide a vital enforcement and collection tool for the significant economic presence test. Other plausible options for ascertaining the profits of an enterprise taxable in a country based on this nexus include fractional apportionment and deemed profit methods.<sup>31</sup> These will be administratively more complex than a low-rate withholding tax, and that can be a factor against their attractiveness from the standpoint of the

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<sup>30</sup> *ibid* para 292-301.

<sup>31</sup> *ibid* para 287-291.

BICs and other developing countries. Yet, if the goal is to develop the significant economic presence test for nexus as a sound and workable replacement of the concept of PE, at this early stage of consideration, there must be openness towards studying all options that show some promise in facilitating this move.

A more open perspective should also be adopted towards applications of the ALP for apportionment of profits between associated enterprises that are better suited to recognise the contribution of an enterprise to the profitability of an MNE. As explained in chapter VII, the design of the PSM makes it the most promising among the existing transfer pricing methods to pursue this end. The BEPS project has, however, been significantly reserved with regards to exploring greater use of the PSM.<sup>32</sup> Accounting for location rent and marketing intangibles are areas that could benefit from recourse to the PSM. However, the effectiveness of the PSM in these cases, and even more generally, will depend on devising better methods of splitting profits between associated enterprises. Developments like country-by-country reporting and greater exchange of information between countries will help in the process. To enhance certainty and address double taxation, instruments like bilateral or multilateral APAs could be used. APAs will be particularly relevant in cases concerning marketing intangibles and location rents, which involve the preliminary step of establishing their existence. Technical support will be vital to help developing countries acquire administrative ease in efficient application of any formulation of PSM. From these countries' perspective, it is also important to continue the search for fairer yet simple transfer pricing methods.

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<sup>32</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (OECD 2015) 60-61.

Part II presented global formulary apportionment as a conceptually superior and practically less complex alternative to the existing transfer pricing rules. As compared to these rules, a global formulary approach that uses an equally weighted combination of supply and demand side factors for apportionment of an MNE's profits among countries, would better advance taxation based on an enterprise's economic presence in a country. It would also further the recognition of a country's contribution in the profitability of an enterprise to a greater degree. Introducing a similarly orientated nexus and threshold for taxation will enhance certainty and administrative feasibility in the application of global formulary apportionment. As compared to the multiple short-term changes discussed in part I of chapter VII, this offers a more coherent reform option, and it is thus a better starting point for a more stable international taxation framework.

Despite these advantages, neither the OECD, nor the UN, has engaged with global formulary apportionment. Admittedly, the practical realisation of the option will need accurate comparison of issues like the scope for double taxation, the potential for tax competition, and tax avoidance opportunities under global formulary apportionment and the prevailing transfer pricing rules.<sup>33</sup> Importantly, it will require refining the core components of this approach and reaching broad international consensus on them.<sup>34</sup> This demands not just further academic study at the global level but also a careful scrutiny of any practical experiments. As regards the latter, caution would have to be maintained against unilateral trials perpetuating narrow interests that can make reaching the level of international agreement vital to avoid distortions,

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<sup>33</sup> Text to n 142-150 in chapter VII.

<sup>34</sup> Text to n 133-141 in chapter VII.

complexities and aggressive tax planning under global formulary apportionment difficult to attain.<sup>35</sup> In view of the time and effort that the overall exercise needs, global formulary apportionment is at best a long-term alternative to the existing rules for division of taxing rights between countries.

A detailed analysis of the proposals examined in chapters VI and VII from the standpoint of developing countries more generally remains a subject for further research. The parameter-based approach to fairness developed in this thesis provides an easily applicable tool for evaluating the ability of such suggestions to advance a fairer international taxation framework from the perspective of these countries. It will be vital to supplement the list of parameters for assessing substantive fairness with those particularly relevant to developing countries, such as administrative ease.

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<sup>35</sup> As discussed in chapter II, such measures also impact stability and certainty in the international taxation framework that are indicators of fairness in the international taxation framework from the standpoint of businesses. A fair outcome from the perspective of these key stakeholders of the set-up is integral to the robustness of a fair system from the viewpoint of countries.

## Annexure I

**Table 1**

**Brazil's bilateral tax treaties with OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE</b>	<b>Fees for technical services and technical assistance covered in the definition of royalties</b>	<b>Application of the source of payment rule to income arising from independent personal services (IPS) + Provision applies even if a company provides IPS</b>
<i>Brazil-France Income Tax Treaty, 1971</i>	10 Sep 1971	1 Jan 1973	In force	0	0	1 + 0
<i>Brazil-Italy Income Tax Treaty, 1978</i>	3 Oct 1978	1 Jan 1982	In force	0	1	1 + 1
<i>Brazil-Germany Income and</i>	27 Jun 1975	1 Jan 1976	Terminated	0	1	1+1

<i>Capital Tax Treaty, 1975</i>						
<i>Brazil-Canada Income Tax Treaty, 1984</i>	4 Jun 1984	1 Jan 1986	In force	0	1	1+1
<i>Brazil-Japan Income Tax Treaty, 1967</i>	24 Jan 1967	1 Jan 1968	In force	0	0	1+0
<i>Brazil-Austria Income and Capital Tax Treaty, 1975</i>	24 May 1975	1 Jan 1977	In force	0	0	1+0
<i>Brazil-Belgium Income Tax Treaty, 1972</i>	23 Jun 1972	1 Jan 1974	In force	0	1	1+0
<i>Brazil-Czech Republic Income Tax Treaty, 1986</i>	26 Aug 1986	1 Jan 1991	In force	0	1	1+1
<i>Brazil-Denmark Income Tax Treaty, 1974</i>	27 Aug 1974	1 Jan 1975	In force	0	1	1+1

<i>Brazil-Finland Income Tax Treaty, 1972</i>	16 Feb 1972	1 Jan 1974	Terminated	0	0	1+0
<i>Brazil-Finland Income Tax Treaty, 1996</i>	2 Apr 1996	1 Jan 1998	In force	0	0	1+0
<i>Brazil-Israel Income Tax Treaty, 2002</i>	12 Dec 2002	1 Jan 2006	In force	0	1	1+0
<i>Brazil- Luxembourg Income and Capital Tax Treaty, 1978</i>	8 Nov 1978	1 Jan 1981	In force	0	1	1+1
<i>Brazil- Netherlands Income Tax Treaty, 1990</i>	8 Mar 1990	1 Jan 1992	In force	0	1	1+0
<i>Brazil-Norway Income and Capital Tax Treaty, 1980</i>	21 Aug 1980	1 Jan 1982	In force	0	1	1+1

<i>Brazil-Portugal Income Tax Treaty, 1971</i>	22 Apr 1971	1 Jan 1972	Terminated	0	0	1+0
<i>Brazil-Portugal Income Tax Treaty, 2000</i>	16 May 2000	1 Jan 2000	In force	0	1	1+0
<i>Brazil-Korea Income Tax Treaty, 1989</i>	7 Mar 1989	1 Jan 1992	In force	0	1	1+1
<i>Brazil-Spain Tax Treaty, 1974</i>	14 Nov 1974	1 Jan 1976	In force	0	1	1+1
<i>Brazil-Sweden Income Tax Treaty, 1975</i>	25 Apr 1975	1 Jan 1976	In force	0	0	1+0
<i>Brazil-Slovak Republic Income Tax Treaty, 1986</i>	26 Aug 1986	1 Jan 1991	In force	0	1	1+1
<i>Brazil-Hungary Income Tax Treaty, 1986</i>	20 Jun 1986	1 Jan 1991	In force	0	1	1+1
<i>Brazil-Mexico Income Tax</i>	25 Sep 2003	1 Jan 2007	In force	0	1	1+1

<i>Treaty, 2003</i>						
<i>Brazil-Turkey Income Tax Treaty, 2010</i>	16 Dec 2010	1 Jan 2013	In force	0	1	0+1
<i>Brazil-Chile Income Tax Treaty, 2001</i>	3 Apr 2001	1 Jan 2004	In force	0	1	1+1

**Table 2**

**Brazil's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE</b>	<b>Fees for technical services and technical assistance covered in the definition of royalties</b>	<b>Application of the source of payment rule to income arising from IPS + Provision applies even if a company provides IPS</b>
<i>Brazil-Trinidad and Tobago Income Tax Treaty, 2008</i>	23 Jul 2008	23 Sep 2011	In force	0	1	1+0

<i>Brazil-Russia Income Tax Treaty, 2004</i>	22 Nov 2004	Not yet effective	Not yet in force	0	1	1+1

**Table 3**

**Brazil's bilateral tax treaties with other developing countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE</b>	<b>Fees for technical services and technical assistance covered in the definition of royalties</b>	<b>Application of the source of payment rule to income arising from IPS + Provision applies even if a company provides IPS</b>
<i>Brazil-India Income Tax Treaty, 1988</i>	26 Apr 1988	1 Apr 1993 (India); 1 Jan 1993 (Brazil)	In force	0	1	1+0
<i>Brazil-China Income Tax Treaty, 1991</i>	5 Aug 1991	1 Jan 1994	In force	1	1	1+0
<i>Brazil-Philippines</i>	29 Sep 1983	1 Jan 1992	In force	0	1	1+1

<i>Income Tax Treaty, 1983</i>						
<i>Brazil-Ukraine Income Tax Treaty, 2002</i>	16 Jan 2002	1 Jan 2007	In force	0	1	1+0
<i>Brazil-Peru Income Tax Treaty, 2006</i>	17 Feb 2006	1 Jan 2010	In force	0	1	1+0
<i>Brazil-Argentina Income Tax Treaty, 1980</i>	17 May 1980	1 Jan 1983	In force	0	1	1+1
<i>Brazil-Ecuador Income Tax Treaty, 1983</i>	26 May 1983	1 Jan 1988	In force	0	1	1+1
<i>Brazil-Venezuela Income Tax Treaty, 2005</i>	14 Feb 2005	1 Jan 2011	In force	0	1	1+0

**Table 4**

**Brazil's bilateral tax treaties with African countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE</b>	<b>Fees for technical services and technical assistance covered in the definition of royalties</b>	<b>Application of the source of payment rule to income arising from IPS + Provision applies even if a company provides IPS</b>
<i>Brazil-South Africa Income Tax Treaty, 2003</i>	8 Nov 2003	1 Jan 2007	In force	0	1	1+0

**Annexure II**

**Table 1**

**India's bilateral tax treaties with OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit less than 183 days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS + Wider concept of FTS</b>
<i>India-United States Income Tax Treaty, 1989</i>	12 Sep 1989	1 Jan 1991 (USA); 1 Apr 1991 (India)	In force	1+1+1	1+0
<i>India-Japan Income Tax Treaty, 1960</i>	5 Jan 1960	1 Apr 1961 (India); 1 Jan 1960 (Japan)	Terminated	0	1
<i>India-Japan Income Tax Treaty, 1989</i>	7 Mar 1989	1 Jan 1990 (Japan); 1 Apr 1990 (India)	In force	0	1+1

<i>India-France Income Tax Treaty, 1969</i>	26 Mar 1969	1 Jan 1970	Terminated	0	1
<i>India-France Income and Capital Tax Treaty, 1992</i>	29 Sep 1992	1 Jan 1995 (France); 1 Apr 1995 (India)	In force	0	1+1
<i>India-Italy Income Tax Treaty, 1981</i>	12 Jan 1981	1 Jan 1977 (Italy); 1 Apr 1977 (India)	Terminated	0	1
<i>India-Italy Income Tax Treaty, 1993</i>	19 Feb 1993	1 Jan 1996 (Italy); 1 Apr 1996 (India)	In force	0	1+1
<i>India-United Kingdom Income Tax Treaty, 1981</i>	16 Apr 1981	1 Apr 1982 (India) 1 Apr/6 Apr 1982 (United Kingdom)	Terminated	0	1+1
<i>India-United Kingdom Income Tax Treaty, 1993</i>	25 Jan 1993	1 Apr 1994 (India); 1 Apr/6 Apr 1994 (United Kingdom)	In force	1+1+1	1+0
<i>India-Germany Income and Capital Tax Treaty, 1959</i>	18 Mar 1959	1 Jan 1957 (Germany); 1 Apr 1958 (India)	Terminated	0	1+1

<i>India-Germany Income and Capital Tax Treaty, 1995</i>	19 Jun 1995	1 Jan 1997 (Germany); 1 Apr 1997 (India) (see Article 28)	In Force	0	1+1
<i>India-Canada Capital and Income Tax Treaty, 1985</i>	30 Oct 1985	1 Jan 1987 (Canada); 1 Apr 1987 (India)	Terminated	0	1+1
<i>India-Canada Capital and Income Tax Treaty, 1996</i>	11 Jan 1996	1 Jan 1998 (Canada); 1 Apr 1998 (India)	In force	1+1+1	1+0
<i>India-Australia Income Tax Treaty, 1991</i>	25 Jul 1991	1 Apr 1992 (India); 1 Jul 1992 (Australia)	In force	1+0+0	1+0
<i>India-Austria Income Tax Treaty, 1963</i>	24 Sep 1963	1 Jan 1962 (Austria); 1 Apr 1962	Terminated	0	1
<i>India-Austria Income Tax Treaty, 1999</i>	8 Nov 1999	1 Jan 2002 (Austria); 1 Apr 2002 (India)	In force	0	1+1

<i>India-Belgium Income Tax Treaty, 1974</i>	7 Feb 1974	1 Jan 1975	Terminated	0	1+1
<i>India-Belgium Income Tax Treaty, 1993</i>	26 Apr 1993	1 Jan 1998 (Belgium); 1 Apr 1998 (India)	In force	0	1+1
<i>India-Czech Republic Income Tax Treaty, 1986</i>	7 Jan 1986	1 Jan 1985 (Czech Republic); 1 Apr 1985 (India)	Terminated	0	1+1
<i>India-Czech Republic Income Tax Treaty, 1998</i>	1 Oct 1998	1 Jan 2000 (Czech Republic); 1 Apr 2000 (India)	In force	0	1+1
<i>India-Denmark Income and Capital Tax Treaty, 1959</i>	16 Sep 1959	Unknown	Terminated	0	0
<i>India-Denmark Income and Capital Tax Treaty, 1989</i>	8 Mar 1989	1 Jan 1990	In force	0	1+1
<i>India-Estonia Income Tax Treaty, 2011</i>	19 Sep 2011	1 Jan 2013 (Estonia); 1 Apr 2013 (India)	In force	1+0+0	1+1

<i>India-Finland Income and Capital Tax Treaty, 1983</i>	10 Jun 1983	1 Jan 1985 (Finland); 1 Apr 1985 (India)	Terminated	0	1+0
<i>India-Finland Income Tax Treaty, 2010</i>	15 Jan 2010	1 Jan 2011 (Finland); 1 Apr 2011 (India)	In force	1+0+0	1+1
<i>India-Greece Income Tax Treaty, 1965</i>	11 Feb 1965	1 Jan 1964 (Greece); 1 Apr 1964 (India)	In force	0	0
<i>India-Iceland Income Tax Treaty, 2007</i>	23 Nov 2007	1 Jan 2008 (Iceland); 1 April 2008 (India)	In force	1+1+0	1+1
<i>India-Ireland Income Tax Treaty, 2000</i>	6 Nov 2000	1 Jan 2002 (Ireland); 1 Apr 2002 (India)	In force	0	1+1
<i>India-Israel Income and Capital Tax Treaty, 1996</i>	29 Jan 1996	1 Apr 1994 (India); 1 Jan 1994 (Israel); 1 Jun 1996 (withholding taxes)	In force	0	1+1

<i>India-Luxembourg Income and Capital Tax Treaty, 2008</i>	2 Jun 2008	1 Jan 2010 (Luxembourg); 1 Apr 2010 (India)	In force	1+0+0	1+1
<i>India-Netherlands Income and Capital Tax Treaty, 1988</i>	30 Jul 1988	1 Apr 1989 (India); 1 Jan 1989 (Netherlands)	In force	0	1+1
<i>India-Norway Income Tax Treaty, 1959</i>	20 Jul 1959	1 Jan 1958 (Norway); 1 Apr 1958 (India)	Terminated	0	0
<i>India-Norway Income and Capital Tax Treaty, 1986</i>	31 Dec 1986	1 Jan 1978 (Norway); 1 Apr 1978 (India)	Terminated	1+0+0	1+1
<i>India-Norway Income and Capital Tax Treaty, 2011</i>	2 Feb 2011	1 Jan 2012 (Norway); 1 Apr 2012 (India)	In force	1+0+0	1+1
<i>India-New Zealand Income Tax Treaty, 1986</i>	17 Oct 1986	1 Apr 1987	In force	0	1+1
<i>India-Portugal</i>	11 Sep 1998	1 Jan 2001	In force	0	1+0

<i>Income Tax Treaty, 1998</i>		(Portugal); 1 Apr 2001 (India)			
<i>India-Slovenia Income Tax Treaty, 2003</i>	13 Jan 2003	1 Apr 2006 (India); 1 Jan 2006 (Slovenia)	In force	0	1+1
<i>India-Korea Income Tax Treaty, 1985</i>	19 Jul 1985	1 Apr 1984 (India); 1 Jan 1984 (Korea)	In force	0	1+1
<i>India-Spain Income and Capital Tax Treaty, 1993</i>	8 Feb 1993	1 Jan 1996 (Spain); 1 Apr 1996 (India)	In force	0	1+1
<i>India-Sweden Income Tax Treaty, 1958</i>	30 Jul 1958	1 Jan 1958 (Sweden); 1 Apr 1958 (India)	Terminated	0	0
<i>India-Sweden Income and Capital Tax Treaty, 1988</i>	7 Jun 1988	1 Jan 1989 (Sweden); 1 Apr 1989 (India)	Terminated	0	1+1
<i>India-Sweden Income and Capital Tax</i>	24 Jun 1997	1 Jan 1998 (Sweden); 1 Apr 1998 (India)	In force	0	1+1

<i>Treaty, 1997</i>					
<i>India-Switzerland Income Tax Treaty, 1994</i>	2 Nov 1994	1 Jan 1995 (Switzerland); 1 Apr 1995 (India)	In force	1+1+1	1+1
<i>India-Hungary Income Tax Treaty, 1986</i>	30 Oct 1986	1 Apr 1988 (India); 1 Jan 1988 (Hungary)	Terminated	0	1+1
<i>India-Hungary Income Tax Treaty, 2003</i>	3 Nov 2003	1 Jan 2006 (Hungary); 1 Apr 2006 (India)	In force	0	1+1
<i>India-Poland Income Tax Treaty, 1989</i>	21 Jun 1989	1 Apr 1990 (India); 1 Jan 1990 (Poland)	In force	1+0+0	1+1
<i>India-Mexico Income Tax Treaty, 2007</i>	10 Sep 2007	1 Jan 2011 (Mexico); 1 Apr 2011 (India)	In force	1+1+0	1+1
<i>India-Turkey Income Tax Treaty, 1995</i>	31 Jan 1995	1 Jan 1994 (Turkey); 1 Apr 1994 (India)	In force	0	1+1

**Table 2**

**India's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit less than 183 days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS + Wider concept of FTS</b>
<i>India-Saudi Arabia Income Tax Treaty, 2006</i>	25 Jan 2006	1 Jan 2007 (Saudi Arabia); 1 Apr 2007 (India)	In force	1+1+0	0
<i>India-Oman Income Tax Treaty, 1997</i>	2 Apr 1997	1 Jan 1998 (Oman); 1 Apr 1998 (India)	In force	0	1+1
<i>India-Qatar Income Tax Treaty, 1999</i>	7 Apr 1999	1 Jan 2001 (Qatar); 1 Apr 2001 (India)	In force	0	1+1
<i>India-Kuwait Income Tax Treaty, 2006</i>	15 Jun 2006	1 Apr 2008	In force	1+0+1	1+1

<i>India-United Arab Emirates Income and Capital Tax Treaty, 1992</i>	29 Apr 1992	1 Jan 1994 (United Arab Emirates); 1 Apr 1994 (India)	In force	1+0+0	0
<i>India-Trinidad and Tobago Income Tax Treaty, 1999</i>	8 Feb 1999	1 Apr 2000 (India); 1 Jan 2000	In force	0	1+1
<i>India-Cyprus Income and Capital Tax Treaty, 1994</i>	13 Jun 1994	1 Jan 1993 (Cyprus); 1 Apr 1993 (India)	In force	0	1+1
<i>India-Malta Income Tax Treaty, 1994</i>	28 Sep 1994	1 Jan 1996 (Malta); 1 Apr 1996 (India)	Terminated	0	1+1
<i>India-Malta Income Tax Treaty, 2013</i>	8 Apr 2013	1 Jan 2015 (Malta); 1 Apr 2015 (India)	In force	1+1+0	1+1
<i>India-Singapore Income Tax Treaty, 1981</i>	20 Apr 1981	1 Jan 1979 (Singapore); 1 Apr 1979 (India)	Terminated	0	0
<i>India-Singapore</i>	24 Jan 1994	1 Jan 1994	In force	1+1+0	1+0

<i>Income Tax Treaty, 1994</i>		(Singapore); 1 Apr 1994 (India)			
<i>India-Taiwan Income Tax Agreement 2011</i>	12 Jul 2011	1 Jan 2012 (Taiwan); 1 Apr 2012 (India)	In force	1+1+0	1+1
<i>India-Russia Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Russia Income Tax Treaty, 1997</i>	25 Mar 1997	1 Jan 1999 (Russia); 1 Apr 1999 (India)	In force	0	1+1

**Table 3**

**India's bilateral tax treaties with other developing countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit less than 183 days in a 12 month period + No same or connected</b>	<b>Taxation of FTS + Wider concept of FTS</b>
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**project  
requirement**

<i>India-Brazil Income Tax Treaty, 1988</i>	26 Apr 1988	1 Apr 1993 (India); 1 Jan 1993 (Brazil)	In force	0	1+1
<i>India-China Income Tax Treaty, 1994</i>	18 Jul 1994	1 Jan 1995 (China); 1 Apr (1995)	In force	1+0+1	1+1
<i>India-Malaysia Income Tax Treaty, 1976</i>	25 Oct 1976	1 Apr 1972 (India); 1 Jan 1972 (Malaysia)	Terminated	0	0
<i>India-Malaysia Income Tax Treaty, 2012</i>	9 May 2012	1 Jan 2013 (Malaysia); 1 Apr 2013 (India)	In force	1+1+0	1+1
<i>India-Thailand Income Tax Treaty, 1985</i>	22 Mar 1985	1 Jan 1987 (Thailand); 1 Apr 1987 (India)	In force	1+0+0	0
<i>India-Vietnam Income Tax Treaty, 1994</i>	7 Sep 1994	1 Jan 1996 (Vietnam); 1 Apr 1996 (India)	In force	0	1+1
<i>India-Philippines Income Tax</i>	12 Feb 1990	1 Jan 1995 (Philippines); 1	In force	0	0

<i>Treaty, 1990</i>		Apr 1995 (India)			
<i>India-Indonesia Income Tax Treaty, 1987</i>	7 Aug 1987	1 Apr 1988 (India); 1 Jan 1988 (Indonesia)	In force	1+1+0	0
<i>India-Indonesia Income Tax Treaty, 2012</i>	27 Jul 2012	Not yet in force	Not yet effective	1+1+0	1+1
<i>India-Bulgaria Income and Capital Tax Treaty, 1994</i>	26 May 1994	1 Jan 1996 (Bulgaria); 1 Apr 1996 (India)	In force	0	1+1
<i>India-Nepal Income Tax Treaty, 1987</i>	18 Jan 1987	1 Apr 1989 (India); 1 Jan 1989 (Nepal)	Terminated	1+0+1	0
<i>India-Nepal Income Tax Treaty, 2011</i>	27 Nov 2011	1 Apr 2013 (India); 16 Jul 2013 (Nepal)	In force	1+1+0	0
<i>India-Bangladesh Income Tax Treaty, 1991</i>	27 Aug 1991	1 Apr 1993 (India); 1 Jul 1993 (Bangladesh)	In force	0	0
<i>India-Sri Lanka Income and Capital</i>	27 Jan 1982	1 Apr 1979/1 Apr 1980 (India); 1	Terminated	1+0+1	0

<i>Tax Treaty, 1982</i>		Apr 1980 (Sri Lanka)			
<i>India-Sri Lanka Income Tax Treaty, 2013</i>	22 Jan 2013	1 Apr 2014	In force	1+1+0	1+1
<i>India-Syria Income Tax Treaty, 1984</i>	6 Feb 1984	1 Apr 1983 (India); 1 Jan 1983 (Syria)	Terminated	0	0
<i>India-Syria Income Tax Treaty, 2008</i>	18 Jun 2008	1 Jan 2009 (Syria); 1 Apr 2009 (India)	In force	1+0+0	0
<i>India-Mongolia Income and Capital Tax Treaty, 1994</i>	22 Feb 1994	1 Jan 1994 (Mongolia); 1 Apr 1994 (India)	In force	0	1+1
<i>India-Belarus Income Tax Treaty, 1988</i>	20 Nov 1988	5 Jun 1989	Terminated	0	1+1
<i>India-Belarus Income and Capital Tax Treaty, 1997</i>	27 Sep 1997	1 Apr 1999 (India); 1 Jan 1999 (Belarus)	In force	0	1+1
<i>India-Georgia Income Tax Treaty,</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr	Terminated	0	1+1

1988		1990 (India)			
<i>India-Georgia Income and Capital Tax Treaty, 2011</i>	24 Aug 2011	1 Jan 2012 (Georgia); 1 Apr 2012 (India)	In force	1+1+0	1+1
<i>India-Kazakhstan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Kazakhstan Income and Capital Tax Treaty, 1996</i>	9 Dec 1996	1 Jan 1998 (Kazakhstan); 1 Apr 1998 (India)	In force	0	1+1
<i>India-Ukraine Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Ukraine Income and Capital Tax Treaty, 1999</i>	7 Apr 1999	1 Jan 2002 (Ukraine); 1 Apr 2002 (India)	In force	0	1+1
<i>India-Tajikistan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Tajikistan Income Tax Treaty, 2008</i>	20 Nov 2008	1 Jan 2010 (Tajikistan); 1 Apr 2010 (India)	In force	0	0

<i>India-Armenia Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Armenia Income Tax Treaty, 2003</i>	31 Oct 2003	1 Jan 2005 (Armenia); 1 Apr 2005 (India)	In force	0	1+1
<i>India-Kyrgyzstan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Kyrgyzstan Income Tax Treaty, 1999</i>	13 Apr 1999	1 Apr 2002 (India); 1 Jan 2002 (Kyrgyzstan)	In force	0	1+1
<i>India-Moldova Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	In force	0	1+1
<i>India-Azerbaijan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	In force	0	1+1
<i>India-Turkmenistan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1

<i>India-Turkmenistan Income and Capital Tax Treaty, 1997</i>	25 Feb 1997	1 Jan 1998 (Turkmenistan); 1 Apr 1998 (India)	In force	0	1+1
<i>India-Uzbekistan Income Tax Treaty, 1988</i>	20 Nov 1988	1 Jan 1990 (USSR); 1 Apr 1990 (India)	Terminated	0	1+1
<i>India-Uzbekistan Income and Capital Tax Treaty, 1993</i>	29 Jul 1993	1 Jan 1993 (Uzbekistan); 1 Apr 1993 (India)	In force	0	1+1
<i>India-Lithuania Income and Capital Tax Treaty, 2011</i>	26 Jul 2011	1 Jan 2012 (Lithuania); 1 Apr 2013 (India)	In force	1+0+0	1+1
<i>India-Romania Income Tax Treaty, 1987</i>	10 Mar 1987	1 Apr 1988 (India); 1 Jan 1988 (Romania)	Terminated	0	1+1
<i>India-Romania Income Tax Treaty, 2013</i>	8 Mar 2013	1 Jan 2014 (Romania); 1 Apr 2014 (India)	In force	1+0+0	1+1
<i>India-Serbia and Montenegro Income and Capital Tax Treaty, 2006</i>	8 Feb 2006	1 Jan 2009 (Serbia); 1 Apr 2009 (India)	In force	0	1+1

		Note: Serbia and Montenegro ceased to exist on 5 June 2006. Serbia is the legal successor of the State Union of Serbia and Montenegro. This treaty was concluded by Serbia and Montenegro and remains applicable in relations between Serbia and India.			
<i>India-Serbia and Montenegro Income and Capital Tax Treaty, 2006</i>	8 Feb 2006	Note: Application of the treaty with Montenegro has to be confirmed by India.	Application of the treaty has to be confirmed by India.	0	1+1
<i>India-Myanmar Income Tax Treaty, 2008</i>	2 Apr 2008	1 Jan 2010 (Myanmar); 1 Apr 2010 (India)	In force	0	0

<i>India-Jordan Income Tax Treaty, 1999</i>	20 Apr 1999	1 Apr 2000 (India); 1 Jan 2000 (Jordan)	In force	0	1+1

**Table 4**

**India's bilateral tax treaties with African countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit less than 183 days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS + Wider concept of FTS</b>
<i>India-Mauritius Income Tax Treaty, 1982</i>	24 Aug 1982	1 Apr 1983 (India); 1 Jul 1983 (Mauritius)	In force	0	0
<i>India-Morocco Income Tax Treaty, 1998</i>	30 Oct 1998	1 Jan 2001 (Morocco); 1 Apr 2001 (India)	In force	0	1+1

<i>India-Sudan Income Tax Treaty, 2003</i>	22 Oct 2003	1 Jan 2005 (Sudan); 1 Apr 2005 (India)	In force	0	1+1
<i>India-Egypt Income Tax Treaty, 1969</i>	20 Feb 1969	30 Sep 1969 (Egypt); 1 Jan 1969 (India)	In force	0	0
<i>India-Ethiopia Income Tax Treaty, 2011</i>	25 May 2011	1 Apr 2013 (India); 8 Jul 2013 (Ethiopia)	In force	1+0+0	1+1
<i>India-Zambia Income Tax Treaty, 1981</i>	5 Jun 1981	1 Apr 1978 (India); 1 Jan 1979 (Zambia)	In force	0	1+1
<i>India-South Africa Income Tax Treaty, 1996</i>	4 Dec 1996	1 Apr 1998 (India); 1 Jan 1998 (South Africa)	In force	0	1+1
<i>India-Botswana Income Tax Treaty, 2006</i>	8 Dec 2006	1 Apr 2009 (India); 1 Jul 2009 (Botswana)	In force	1+0+0	1+1
<i>India-Kenya Income Tax Treaty, 1985</i>	12 Apr 1985	1 Jan 1985 (Kenya); 1 Apr 1985 (India)	In force	0	1+1

<i>India-Namibia Income Tax Treaty, 1997</i>	15 Feb 1997	1 Mar 2000 (Namibia); 1 Apr 2000 (India)	In force	0	1+1
<i>India- Mozambique Income Tax Treaty, 2010</i>	30 Sep 2010	1 Jan 2012 (Mozambique); 1 Apr 2012 (India)	In force	1+0+0	0
<i>India-Tanzania Income Tax Treaty, 1979</i>	5 Sep 1979	1 Jan 1982	Terminated	0	1+1
<i>India-Tanzania Income Tax Treaty, 2011</i>	27 May 2011	1 Apr 2012 (India); 1 Jan 2012 (Tanzania)	In force	1+0+0	0
<i>India-Uganda Income Tax Treaty, 2004</i>	30 Apr 2004	1 Apr 2005 (India); 1 Jul 2005 (Uganda)	In force	0	1+1
<i>India-Libya Income Tax Treaty, 1981</i>	2 Mar 1981	1 Jan 1983 (Libya); 1 Apr 1983 (India)	In force	0	0

**Annexure III**

**Table 1**

**China's bilateral tax treaties with OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit more than 183 days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS</b>
<i>China-United States Income Tax Treaty, 1984</i>	30 Apr 1984	1 Jan 1987	In force	1+0+0	0
<i>China-Japan Income Tax Treaty, 1983</i>	6 Sep 1983	1 Jan 1985	In force	1+0+0	0
<i>China-France Income Tax Treaty, 1984</i>	30 May 1984	1 Jan 1986	Terminated	1+0+0	0
<i>China-France Income Tax</i>	26 Nov 2013	1 Jan 2015	In force	1+0+0	0

<i>Treaty, 2013</i>					
<i>China-Germany Income and Capital Tax Treaty, 1985</i>	10 Jun 1985	1 Jan 1985	In force	1+0+0	0
<i>China-Germany Income and Capital Tax Treaty 2014</i>	28 Mar 2014	Not yet effective	Not yet in force	1+0+0	0
<i>China-Canada Income Tax Treaty, 1986</i>	12 May 1986	1 Jan 1987	In force	1+0+0	0
<i>China-Italy Income Tax Treaty, 1987</i>	31 Oct 1986	1 Jan 1991	In force	1+0+0	0
<i>China-United Kingdom Income Tax Treaty, 1984</i>	26 Jul 1984	1 Apr/6 Apr 1985 (UK); 1 Jan 1985 (China)	Terminated	0	1
<i>China-United Kingdom Income Tax Treaty, 2011</i>	27 Jun 2011	1 Jan 2014 (China); 1 Apr 2014 (UK-Corporate Taxes), 6 Apr (UK-	In force	1+0+0	0

		Income and Capital Gains Tax)			
<i>China-Australia Income Tax Treaty, 1988</i>	17 Nov 1988	1 Jul 1991 (Australia); 1 Jan 1991 (China)	In force	1+0+0	0
<i>China-Austria Income and Capital Tax Treaty, 1991</i>	10 Apr 1991	1 Jan 1993	In force	1+0+0	0
<i>China-Belgium Income Tax Treaty, 1985</i>	18 Apr 1985	1 Jan 1988	Terminated	1+0+0	0
<i>China-Belgium Income Tax Treaty, 2009</i>	7 Oct 2009	1 Jan 2014	In force	1+0+0	0
<i>China-Czech Republic Income Tax Treaty, 1987</i>	11 Jun 1987	1 Jan 1988	Terminated	1+0+0	0
<i>China-Czech Republic Income Tax Treaty, 2009</i>	28 Aug 2009	1 Jan 2012	In force	1+1+1	0
<i>China-Denmark</i>	26 Mar 1986	1 Jan 1987	Terminated	1+0+0	0

<i>Income Tax Treaty, 1986</i>					
<i>China-Denmark Income Tax Treaty, 2012</i>	16 Jun 2012	1 Jan 2013	In force	1+0+0	0
<i>China Estonia Income Tax Treaty, 1998</i>	12 May 1998	1 Jan 2000	In force	0	0
<i>China-Finland Income Tax Treaty, 1986</i>	12 May 1986	1 Jan 1988	Terminated	1+0+0	0
<i>China-Finland Income Tax Treaty, 2010</i>	25 May 2010	1 Jan 2011	In force	1+0+0	0
<i>China-Greece Income Tax Treaty, 2002</i>	3 Jun 2002	1 Jan 2006	In force	0	0
<i>China-Iceland Income Tax Treaty, 1996</i>	3 Jun 1996	1 Jan 1998	In force	1+0+0	0
<i>China-Hungary</i>	17 Jun 1992	1 Jan 1995	In force	1+1+0	0

<i>Income Tax Treaty, 1992</i>					
<i>China-Ireland Income Tax Treaty, 2000</i>	19 Apr 2000	1 Jan 2001	In force	0	0
<i>China-Israel Income and Capital Tax Treaty, 1995</i>	8 Apr 1995	1 Jan 1996	In force	1+1+0	
<i>China-Luxembourg Income and Capital Tax Treaty, 1994</i>	12 Mar 1994	1 Jan 1996	In force	1+0+0	0
<i>China-Netherlands Income Tax Treaty, 1987</i>	13 May 1987	1 Jan 1989	Terminated	1+0+0	0
<i>China-Netherlands Tax Treaty, 2013</i>	31 May 2013	1 Jan 2015	In force	1+0+0	0

<i>China-Norway Income and Capital Tax Treaty, 1986</i>	25 Feb 1986	1 Jan 1987	In force	1+0+0	0
<i>China-New Zealand Income Tax Treaty, 1986</i>	16 Sep 1986	1 Jan 1987	In force	1+0+0	0
<i>China-Portugal Income Tax Treaty, 1998</i>	21 Apr 1998	1 Jan 2001	In force	1+0+0	0
<i>China-Slovenia Income and Capital Tax Treaty, 1988</i>	2 Dec 1988	1 Jan 1990	Terminated	1+0+0	0
<i>China-Slovenia Income Tax Treaty, 1995</i>	13 Feb 1995	1 Jan 1996	In force	1+1+0	0
<i>China-Slovak Republic Income Tax Treaty, 1987</i>	11 Jun 1987	1 Jan 1988	In force	1+0+0	0

<i>China-Korea Income Tax Treaty, 1994</i>	28 Mar 1994	1 Jan 1995	In force	1+0+0	0
<i>China-Spain Income and Capital Tax Treaty, 1990</i>	22 Nov 1990	1 Jan 1993	In force	1+0+0	0
<i>China-Sweden Income Tax Treaty, 1986</i>	16 May 1986	1 Jan 1987	In force	1+0+0	0
<i>China-Switzerland Income and Capital Tax Treaty, 1990</i>	6 Jul 1990	1 Jan 1990	Terminated	1+0+0	0
<i>China-Switzerland Income and Capital Tax Treaty, 2013</i>	25 Sep 2013	1 Jan 2015	In force	1+0+0	0
<i>China-Poland Income Tax Treaty, 1988</i>	7 Jan 1988	1 Jan 1990	In force	1+0+0	0

<i>China-Turkey Income Tax Treaty, 1995</i>	23 May 1995	1 Jan 1997	In force	1+1+0	0
<i>China-Mexico Income Tax Treaty, 2005</i>	12 Sep 2005	1 Jan 2007	In force	0	0

**Table 2**

**China's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit <u>more than 183</u> days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS</b>
<i>China-Saudi Arabia Income Tax Treaty, 2006</i>	23 Jan 2006	1 Jan 2007	In force	1+0+0	0
<i>China-Bahrain Income Tax</i>	16 May 2002	1 Jan 2003	In force	0	0

<i>Treaty, 2002</i>					
<i>China-Oman Income Tax Treaty, 2002</i>	25 Mar 2002	1 Jan 2003	In force	1+1+0	0
<i>China-Qatar Income Tax Treaty, 2001</i>	2 Apr 2001	1 Jan 2009	In force	0	0
<i>China-Kuwait Income Tax Treaty, 1989</i>	25 Dec 1989	1 Jan 1989	In force	1+0+0	0
<i>China-United Arab Emirates Income Tax Treaty, 1993</i>	1 Jul 1993	1 Jan 1995	In force	1+1+0	0
<i>China-Brunei Income Tax Treaty, 2004</i>	21 Sep 2004	1 Jan 2007	In force	1+0+0	0
<i>China-Trinidad and Tobago Income Tax Treaty, 2003</i>	18 Sep 2003	1 Jun 2005 (withholding taxes); 1 Jan 2006 (other taxes)	In force	1+0+0	0

<i>China-Barbados Income Tax Treaty, 2000</i>	15 May 2000	1 Jan 2001	In force	1+0+0	0
<i>China-Cyprus Income Tax Treaty, 1990</i>	25 Oct 1990	5 Oct 1991	In force	1+1+0	0
<i>China-Malta Income Tax Treaty, 1993</i>	2 Feb 1993	1 Jan 2012	Terminated	1+1+0	0
<i>China-Malta Income Tax Treaty, 2010</i>	23 Oct 2010	1 Jan 2012	In force	1+0+0	0
<i>China-Singapore Income Tax Treaty, 1986</i>	18 Apr 1986	1 Jan 2008	Terminated	1+0+0	0
<i>China-Singapore Income Tax Treaty, 2007</i>	11 Jul 2007	1 Jan 2008	In force	1+0+0	0
<i>China-Croatia Income Tax Treaty, 1988</i>	2 Dec 1988	1 Jan 1990	Terminated	1+0+0	0
<i>China-Croatia</i>	9 Jan 1995	1 Jan 2002	In force	1+1+0	0

<i>Income Tax Treaty, 1995</i>					
<i>China-Latvia Income and Capital Tax Treaty, 1996</i>	7 Jun 1996	1 Jan 1998	In force	0	0
<i>China-Hong Kong Income Tax Treaty, 1998</i>	11 Feb 1998	1 Apr 1998	Terminated	1+0+0	0
<i>China-Hong Kong Income Tax Treaty, 2006</i>	21 Aug 2006	1 Jan 2007	In force	1+0+0	0
<i>China-Macau Income Tax Agreement, 2003</i>	27 Dec 2003	1 Jan 2004	In force	1+0+0	0
<i>China-Russia Income Tax Treaty, 1994</i>	27 May 1994	1 Jan 1998	In force	0	0
<i>China-Russia Income Tax Treaty, 2014</i>	13 Oct 2014	Not yet effective	Not yet in force	1+0+0	0

**Table 3**

**China's bilateral tax treaties with other developing countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit <u>more than 183</u> days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS</b>
<i>China-Brazil Income Tax Treaty, 1991</i>	5 Aug 1991	1 Jan 1994	In force	1+0+0	1
<i>China-India Income Tax Treaty, 1994</i>	18 Jul 1994	1 Jan 1995 (China); 1 Apr 1995 (India)	In force	1+0+1	1
<i>China-Malaysia Income Tax Treaty, 1985</i>	23 Nov 1985	1 Jan 1987	In force	1+0+0	0
<i>China-Thailand Income Tax Treaty, 1986</i>	27 Oct 1986	1 Jan 1987	In force	0	0

<i>China-Vietnam Income Tax Treaty, 1995</i>	17 May 1995	1 Jan 1997	In force	1+0+0	0
<i>China-Philippines Income Tax Treaty, 1999</i>	18 Nov 1999	1 Jan 2002	In force	1+0+0	0
<i>China-Indonesia Income Tax Treaty, 2001</i>	7 Nov 2001	1 Jan 2005	In force	1+0+0	0
<i>China-Bulgaria Income and Capital Tax Treaty, 1989</i>	6 Nov 1989	1 Jan 1991	In force	1+0+0	0
<i>China-Pakistan Income Tax Treaty, 1989</i>	15 Nov 1989	1 Jul 1990	In force	0	1
<i>China-Nepal Income Tax Treaty, 2001</i>	14 May 2001	1 Jan 2011 (China); 16 Jan 2011 (Nepal)	In force	1+0+0	0
<i>China-Bangladesh Income Tax Treaty, 1996</i>	12 Sep 1996	1 Jan 1998 (China); 1 Jul 1998 (Bangladesh)	In force	1+0+0	0
<i>China-Sri Lanka</i>	11 Aug 2003	1 Jan 2006	In force	1+0+0	0

<i>Income Tax Treaty, 2003</i>		(China); 1 Apr 2006 (Sri Lanka)			
<i>China-Syrian Arab Republic Income Tax Treaty, 2010</i>	31 Oct 2010	1 Jan 2012	In force	0	0
<i>China-Iran Income Tax Treaty, 2002</i>	20 Apr 2002	1 Jan 2004	In force	0	0
<i>China-Venezuela Income and Capital Tax Treaty, 2001</i>	17 Apr 2001	1 Jan 2005	In force	0	0
<i>China-Cuba Income Tax Treaty, 2001</i>	13 Apr 2001	1 Jan 2004	In force	1+1+0	0
<i>China-Jamaica Income Tax Treaty, 1996</i>	4 Jul 1996	1 Jan 1998	In force	1+1+0	0
<i>China-Papua New Guinea Income Tax Treaty, 1994</i>	14 Jul 1994	1 Jan 1996	In force	1+0+0	0
<i>China-Mongolia Income Tax Treaty,</i>	26 Aug 1991	1 Jan 1993	In force	1+1+0	0

<i>1991</i>					
<i>China-Albania Income and Capital Tax Treaty, 2004</i>	28 Sep 2004	1 Jan 2006	In force	1+1+1	0
<i>China-Belarus Income and Capital Tax Treaty, 1995</i>	17 Jan 1995	1 Jan 1997	In force	1+1+0	0
<i>China-Georgia Income and Capital Tax Treaty, 2005</i>	22 Jun 2005	1 Jan 2006	In force	0	0
<i>China-Kazakhstan Income Tax Treaty, 2001</i>	12 Sep 2001	1 Jan 2004	In force	1+1+0	0
<i>China-Ukraine Income and Capital Tax Treaty, 1995</i>	4 Dec 1995	1 Jan 1997	In force	1+1+0	0
<i>China-Tajikistan Income and Capital Tax Treaty, 2008</i>	27 Aug 2008	1 Jan 2010	In force	1+0+0	0
<i>China-Armenia</i>	5 May 1996	1 Jan 1997	In force	1+1+0	0

<i>Income and Capital Tax Treaty, 1996</i>					
<i>China-Kyrgyzstan Income Tax Treaty, 2002</i>	24 Jun 2002	1 Jan 2004	In force	1+1+0	0
<i>China-Moldova Income Tax Treaty, 2000</i>	7 Jun 2000	1 Jan 2002	In force	0	0
<i>China-Azerbaijan Income Tax Treaty, 2005</i>	17 Mar 2005	1 Jan 2006	In force	1+0+1	0
<i>China-Turkmenistan Income Tax Treaty, 2009</i>	13 Dec 2009	1 Jan 2011	In force	1+0+0	0
<i>China-Uzbekistan Income Tax Treaty, 1996</i>	3 Jul 1996	1 Jan 1997	In force	0	0
<i>China-Lithuania Income and Capital Tax Treaty, 1996</i>	3 Jul 1996	1 Jan 1997	In force	0	0
<i>China-Romania</i>	16 Jan 1991	1 Jan 1993	In force	1+0+0	0

<i>Income Tax Treaty, 1991</i>					
<i>China-Macedonia Income and Capital Tax Treaty, 1988</i>	2 Dec 1988	1 Jan 1990	Terminated	1+0+0	0
<i>China-Macedonia Income and Capital Tax Treaty, 1997</i>	9 Jun 1997	1 Jan 1998	In force	0	0
<i>China-Laos Income Tax Treaty, 1999</i>	25 Jan 1999	1 Jan 2000	In force	0	0

**Table 4**

**China's bilateral tax treaties with African countries**

<i>Treaty</i>	<b>Signed on</b>	<b>Effective from</b>	<b>Status</b>	<b>Deemed Service PE + Time limit more than 183 days in a 12 month period + No same or connected project requirement</b>	<b>Taxation of FTS</b>
<i>China-Mauritius Income Tax Treaty, 1994</i>	1 Aug 1994	1 Jul 1995 (Mauritius); 1 Jan 1996 (China)	In force	1+1+0	0
<i>China-Morocco Income Tax Treaty, 2002</i>	27 Aug 2002	1 Jan 2007	In force	1+0+0	0
<i>China-Sudan Income Tax Treaty, 1997</i>	30 May 1997	1 Jan 2000	In force	1+1+0	0
<i>China-Egypt Income Tax Treaty, 1997</i>	13 Aug 1997	1 Jan 2000	In force	1+1+0	0

<i>China-Seychelles Income Tax Treaty, 1999</i>	26 Aug 1999	1 Jan 2003	In force	1+1+0	0
<i>China-Algeria Income and Capital Tax Treaty, 2006</i>	6 Nov 2006	1 Jan 2008	In force	0	0
<i>China-Ethiopia Income Tax Treaty, 2009</i>	14 May 2009	1 Jan 2013	In force	0	0
<i>China-Zambia Income Tax Treaty, 2010</i>	26 Jul 2010	1 Jan 2012	In force	1+0+0	0
<i>China-South Africa Income Tax Treaty, 2000</i>	25 Apr 2000	1 Jan 2002	In force	1+1+0	0
<i>China-Nigeria Income Tax Treaty, 2002</i>	15 Apr 2002	1 Jan 2010	In force	0	0
<i>China-Tunisia Income Tax Treaty, 2002</i>	16 Apr 2002	1 Jan 2004	In force	0	0

Annexure IV

**Table 1**

**Brazil's bilateral tax treaties with OECD countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used for specifying the deductions allowed in determining a PE's profits	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>Brazil-France Tax Income Treaty, 1971</i>	In force	1+0	0	0	0
<i>Brazil-Italy Income Tax</i>	In force	1+0	0	0	0

<i>Treaty, 1978</i>					
<i>Brazil-Germany Income and Capital Tax Treaty, 1975</i>	Terminated	1+0	0	0	0
<i>Brazil-Canada Income Tax Treaty, 1984</i>	In force	1+0	0	0	0
<i>Brazil-Japan Income Tax Treaty, 1967</i>	In force	1+0	0	0	0
<i>Brazil-Austria Income and Capital Tax Treaty, 1975</i>	In force	1+0	0	0	0
<i>Brazil-Belgium Income Tax Treaty, 1972</i>	In force	1+0	0	0	0
<i>Brazil-Czech Republic Income Tax Treaty, 1986</i>	In force	1+0	0	0	0

<i>Brazil-Denmark Income Tax Treaty, 1974</i>	In force	1+0	0	0	0
<i>Brazil-Finland Income Tax Treaty, 1972</i>	Terminated	1+0	0	0	0
<i>Brazil-Finland Income Tax Treaty, 1996</i>	In force	1+0	0	0	0
<i>Brazil-Israel Income Tax Treaty, 2002</i>	In force	1+0	0	0	0
<i>Brazil- Luxembourg Income and Capital Tax Treaty, 1978</i>	In force	1+0	0	0	0
<i>Brazil- Netherlands Income Tax Treaty, 1990</i>	In force	1+0	0	0	0
<i>Brazil-Norway</i>	In force	1+0	0	0	0

<i>Income and Capital Tax Treaty, 1980</i>					
<i>Brazil-Portugal Income Tax Treaty, 1971</i>	Terminated	1+0	0	0	0
<i>Brazil-Portugal Income Tax Treaty, 2000</i>	In force	1+0	0	0	0
<i>Brazil-Korea Income Tax Treaty, 1989</i>	In force	1+0	0	0	0
<i>Brazil-Spain Tax Treaty, 1974</i>	In force	1+0	0	0	0
<i>Brazil-Sweden Income Tax Treaty, 1975</i>	In force	1+0	0	0	0
<i>Brazil-Slovak Republic Income Tax Treaty, 1986</i>	In force	1+0	0	0	0
<i>Brazil-Hungary</i>	In force	1+0	0	0	0

<i>Income Tax Treaty, 1986</i>					
<i>Brazil-Mexico Income Tax Treaty, 2003</i>	In force	1+1	0	0	0
<i>Brazil-Turkey Income Tax Treaty, 2010</i>	In force	1+0	0	0	0
<i>Brazil Chile Income Tax Treaty, 2001</i>	In force	1+0	0	0	0

**Table 2**

**Brazil's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	<b>Status</b>	<b>Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used</b>	<b>Force of attraction principle</b>	<b>Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)</b>	<b>Use of Article 9(3) of the UN Model</b>
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<i>Brazil-Trinidad and Tobago Income Tax Treaty, 2008</i>	In force	1+0	0	0	0
<i>Brazil-Russia Income Tax Treaty, 2004</i>	Not yet in force	1+0	0	0	0

**Table 3**

**Brazil's bilateral tax treaties other developing countries**

<i>Treaty</i>	<b>Status</b>	<b>Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used</b>	<b>Force of attraction principle</b>	<b>Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)</b>	<b>Use of Article 9(3) of the UN Model</b>
<i>Brazil-India Income Tax</i>	In force	1+0	0	0	0

<i>Treaty, 1988</i>					
<i>Brazil-China Income Tax Treaty, 1991</i>	In force	1+0	0	0	0
<i>Brazil-Philippines Income Tax Treaty, 1983</i>	In force	1+1	0	0	0
<i>Brazil-Ukraine Income Tax Treaty, 2002</i>	In force	1+1	0	0	0
<i>Brazil-Peru Income Tax Treaty, 2006</i>	In force	1+0	0	0	0
<i>Brazil-Argentina Income Tax Treaty, 1980</i>	In force	1+0	0	0	0
<i>Brazil-Ecuador Income Tax Treaty, 1983</i>	In force	1+0	0	0	0
<i>Brazil-Venezuela Income Tax</i>	In force	1+1	0	0	0

<i>Treaty, 2005</i>					
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**Table 4**

**Brazil's bilateral tax treaties African countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>Brazil-South Africa Income Tax Treaty, 2003</i>	In force	1+0	0	0	0

Annexure V

**Table 1**

**India's bilateral tax treaties with OECD countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used for specifying the deductions allowed in determining a PE's profits	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>India-United States Income Tax Treaty, 1989</i>	In force	1+1	1	1	0
<i>India-Japan Tax Treaty, 1960</i>	Terminated	1+0	0	0	0

<i>India-Japan Income Tax Treaty, 1989</i>	In force	1+1	0	1	0
<i>India-France Income Tax Treaty, 1969</i>	Terminated	1+0	0	0	0
<i>India-France Income and Capital Tax Treaty, 1992</i>	In force	1+1	1	0	0
<i>India-Italy Income Tax Treaty, 1981</i>	Terminated	1+1	0	0	0
<i>India-Italy Income Tax Treaty, 1993</i>	In force	1+1	1	0	0
<i>India-United Kingdom Income Tax Treaty, 1981</i>	Terminated	1+1	0	0	0
<i>India-United Kingdom Income Tax Treaty, 1993</i>	In force	1+1	0	1	0

<i>India-Germany Income and Capital Tax Treaty, 1959</i>	Terminated	1+1	0	0	0
<i>India-Germany Income and Capital Tax Treaty, 1995</i>	In Force	1+1	1	0	0
<i>India-Canada Capital and Income Tax Treaty, 1985</i>	Terminated	1+1	1	0	0
<i>India-Canada Capital and Income Tax Treaty, 1996</i>	In force	1+1	1	1	1
<i>India-Australia Income Tax Treaty, 1991</i>	In force	1+0	0	1	0
<i>India-Austria Income Tax</i>	Terminated	1+0	0	0	0

<i>Treaty, 1963</i>					
<i>India-Austria Income Tax Treaty, 1999</i>	In force	1+1	0	1	0
<i>India-Belgium Income Tax Treaty, 1974</i>	Terminated	1+1	0	0	0
<i>India-Belgium Income Tax Treaty, 1993</i>	In force	1+1	1	0	0
<i>India-Czech Republic Income Tax Treaty, 1986</i>	Terminated	1+1	1	0	0
<i>India-Czech Republic Income Tax Treaty, 1998</i>	In force	1+0	0	0	0
<i>India-Denmark Income and Capital Tax Treaty, 1959</i>	Terminated	1+0	0	0	0
<i>India-Denmark Income and</i>	In force	1+1	1	1	0

<i>Capital Tax Treaty, 1989</i>					
<i>India-Estonia Income Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-Finland Income and Capital Tax Treaty, 1983</i>	Terminated	1+1	1	0	0
<i>India-Finland Income Tax Treaty, 2010</i>	In force	1+1	0	1	0
<i>India-Greece Income Tax Treaty, 1965</i>	In force	1+0	0	0	0
<i>India-Iceland Income Tax Treaty, 2007</i>	In force	1+1	0	1	0
<i>India-Ireland Income Tax Treaty, 2000</i>	In force	1+0	0	1	0
<i>India-Israel</i>	In force	1+0	0	1	0

<i>Income and Capital Tax Treaty, 1996</i>					
<i>India-Luxembourg Income and Capital Tax Treaty, 2008</i>	In force	1+1	0	1	0
<i>India-Netherlands Income and Capital Tax Treaty, 1988</i>	In force	1+1	0	1	0
<i>India-Norway Income Tax Treaty, 1959</i>	Terminated	1+0	0	0	0
<i>India-Norway Income and Capital Tax Treaty, 1986</i>	Terminated	1+1	1	0	0
<i>India-Norway Income and Capital Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-New</i>	In force	1+0	1	1	0

<i>Zealand Income Tax Treaty, 1986</i>					
<i>India-Portugal Income Tax Treaty, 1998</i>	In force	1+0	1	1	0
<i>India-Slovenia Income Tax Treaty, 2003</i>	In force	1+0	0	1	0
<i>India-Korea Income Tax Treaty, 1985</i>	In force	1+0	0	0	0
<i>India-Spain Income and Capital Tax Treaty, 1993</i>	In force	1+1	1	0	0
<i>India-Sweden Income Tax Treaty, 1958</i>	Terminated	1+0	0	1	0
<i>India-Sweden Income and Capital Tax Treaty, 1988</i>	Terminated	1+1	1	0	0

<i>India-Sweden Income and Capital Tax Treaty, 1997</i>	In force	1+0	0	1	0
<i>India-Switzerland Income Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>India-Hungary Income Tax Treaty, 1986</i>	Terminated	1+1	1	1	0
<i>India-Hungary Income Tax Treaty, 2003</i>	In force	1+0	0	1	0
<i>India-Poland Income Tax Treaty, 1989</i>	In force	1+1	1	1	0
<i>India-Mexico Income Tax Treaty, 2007</i>	In force	1+1	1	1	1
<i>India-Turkey Income Tax</i>	In force	1+0	1	1	0

<i>Treaty, 1995</i>					
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**Table 2**

**India's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>India-Saudi Arabia Income Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>India-Oman Income Tax Treaty, 1997</i>	In force	1+0	0	0	0
<i>India-Qatar</i>	In force	1+0	0	1	0

<i>Income Tax Treaty, 1999</i>					
<i>India-Kuwait Income Tax Treaty, 2006</i>	In force	1+1	1	1	0
<i>India-United Arab Emirates Income and Capital Tax Treaty, 1992</i>	In force	1+0	0	0	0
<i>India-Trinidad and Tobago Income Tax Treaty, 1999</i>	In force	1+0	0	1	0
<i>India-Cyprus Income and Capital Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>India-Malta Income Tax Treaty, 1994</i>	Terminated	1+1	0	1	0
<i>India-Malta Income Tax Treaty, 2013</i>	In force	1+0	0	1	0

<i>India-Singapore Income Tax Treaty, 1981</i>	Terminated	1+0	0	0	0
<i>India-Singapore Income Tax Treaty, 1994</i>	In force	1+0	0	0	0
<i>India-Taiwan Income Tax Agreement, 2011</i>	In force	1+1	1	1	0
<i>India-Russia Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Russia Income Tax Treaty, 1997</i>	In force	1+0	0	0	0

**Table 3**

**India's bilateral tax treaties with other developing countries**

<i>Treaty</i>	<b>Status</b>	<b>Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used</b>	<b>Force of attraction principle</b>	<b>Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)</b>	<b>Use of Article 9(3) of the UN Model</b>
<i>India-Brazil Income Tax Treaty, 1988</i>	In force	1+0	0	0	0
<i>India-China Income Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>India-Malaysia Income Tax Treaty, 1976</i>	Terminated	1+0	0	0	0
<i>India-Malaysia</i>	In force	1+1	0	1	0

<i>Income Tax Treaty, 2012</i>					
<i>India-Thailand Income Tax Treaty, 1985</i>	In force	1+0	1	0	0
<i>India-Vietnam Income Tax Treaty, 1994</i>	In force	1+0	0	0	0
<i>India-Philippines Income Tax Treaty, 1990</i>	In force	1+0	0	1	0
<i>India-Indonesia Income Tax Treaty, 1987</i>	In force	1+1	1	1	0
<i>India-Indonesia Income Tax Treaty, 2012</i>	Not yet effective	1+1	1	1	1
<i>India-Bulgaria Income and Capital Tax Treaty, 1994</i>	In force	1+1	1	0	0
<i>India-Nepal</i>	Terminated	1+1	0	0	0

<i>Income Tax Treaty, 1987</i>					
<i>India-Nepal Income Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-Bangladesh Income Tax Treaty, 1991</i>	In force	1+0	0	0	0
<i>India-Sri Lanka Income and Capital Tax Treaty, 1982</i>	Terminated	1+1	1	1	0
<i>India-Sri Lanka Income Tax Treaty, 2013</i>	In force	1+1	0	1	0
<i>India-Syria Income Tax Treaty, 1984</i>	Terminated	1+0	0	0	0
<i>India-Syria Income Tax Treaty, 2008</i>	In force	1+0	0	1	0
<i>India-Mongolia</i>	In force	1+0	1	0	0

<i>Income and Capital Tax Treaty, 1994</i>					
<i>India-Belarus Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Belarus Income and Capital Tax Treaty, 1997</i>	In force	1+0	1	0	0
<i>India-Georgia Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Georgia Income and Capital Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-Kazakhstan Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Kazakhstan Income and Capital Tax Treaty, 1996</i>	In force	1+1	0	0	0
<i>India-Ukraine</i>	Terminated	1+0	0	0	0

<i>Income Tax Treaty, 1988</i>					
<i>India-Ukraine Income and Capital Tax Treaty, 1999</i>	In force	1+0	0	0	0
<i>India-Tajikistan Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Tajikistan Income Tax Treaty, 2008</i>	In force	1+0	0	1	0
<i>India-Armenia Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Armenia Income Tax Treaty, 2003</i>	In force	1+1	0	1	0
<i>India-Kyrgyzstan Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Kyrgyzstan Income Tax Treaty,</i>	In force	1+0	0	1	0

1999					
<i>India-Moldova Income Tax Treaty, 1988</i>	In force	1+0	0	0	0
<i>India-Azerbaijan Income Tax Treaty, 1988</i>	In force	1+0	0	0	0
<i>India-Turkmenistan Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Turkmenistan Income and Capital Tax Treaty, 1997</i>	In force	1+0	0	1	0
<i>India-Uzbekistan Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>India-Uzbekistan Income and Capital Tax Treaty, 1993</i>	In force	1+0	0	0	0
<i>India-Lithuania Income and Capital Tax Treaty, 2011</i>	In force	1+1	0	1	0

<i>India-Romania Income Tax Treaty, 1987</i>	Terminated	1+1	1	0	0
<i>India-Romania Income Tax Treaty, 2013</i>	In force	1+0	0	1	0
<i>India-Serbia and Montenegro Income and Capital Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>India-Serbia and Montenegro Income and Capital Tax Treaty, 2006</i>	Application of the treaty to Montenegro has to be confirmed by India.	1+1	0	1	0
<i>India-Myanmar Income Tax Treaty, 2008</i>	In force	1+1	0	1	0
<i>India-Jordan Income Tax Treaty, 1999</i>	In force	1+0	0	1	1

**Table 4**

**India's bilateral tax treaties with African countries**

<i>Treaty</i>	<b>Status</b>	<b>Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used</b>	<b>Force of attraction principle</b>	<b>Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)</b>	<b>Use of Article 9(3) of the UN Model</b>
<i>India-Mauritius Income Tax Treaty, 1982</i>	In force	1+0	0	0	0
<i>India-Morocco Income Tax Treaty, 1998</i>	In force	1+0	0	1	0
<i>India-Sudan Income Tax Treaty, 2003</i>	In force	1+0	0	1	0
<i>India-Egypt</i>	In force	1+0	0	1	0

<i>Income Tax Treaty, 1969</i>					
<i>India-Ethiopia Income Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-Zambia Income Tax Treaty, 1981</i>	In force	1+0	1	0	0
<i>India-South Africa Income Tax Treaty, 1996</i>	In force	1+0	0	1	0
<i>India-Botswana Income Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>India-Kenya Income Tax Treaty, 1985</i>	In force	1+0	1	1	0
<i>India-Namibia Income Tax Treaty, 1997</i>	In force	1+1	0	1	0
<i>India-Mozambique</i>	In force	1+1	0	1	0

<i>Income Tax Treaty, 2010</i>					
<i>India-Tanzania Income Tax Treaty, 1979</i>	Terminated	1+0	1	0	0
<i>India-Tanzania Income Tax Treaty, 2011</i>	In force	1+1	0	1	0
<i>India-Uganda Income Tax Treaty, 2004</i>	In force	1+0	0	1	0
<i>India-Libya Income Tax Treaty, 1981</i>	In force	1+0	0	0	0

Annexure VI

**Table 1**

**China's bilateral tax treaties with OECD countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used for specifying the deductions allowed in determining a PE's profits	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>China-United States Income Tax Treaty, 1984</i>	In force	1+1	0	1	0
<i>China-Japan Income Tax</i>	In force	1+1	0	0	0

<i>Treaty, 1983</i>					
<i>China-France Income Tax Treaty, 1984</i>	In force	1+1	0	0	0
<i>China-France Income Tax Treaty, 2013</i>	In force	1+0	0	1	0
<i>China-Germany Income and Capital Tax Treaty, 1985</i>	In force	1+1	0	0	0
<i>China-Germany Income and Capital Tax Treaty 2014</i>	Not yet in force	1+0	0	1	0
<i>China-Canada Income Tax Treaty, 1986</i>	In force	1+1	0	0	0
<i>China-Italy Income Tax Treaty, 1987</i>	In force	1+1	0	0	0

<i>China-United Kingdom Income Tax Treaty, 1984</i>	Terminated	1+1	0	0	0
<i>China-United Kingdom Income Tax Treaty, 2011</i>	In force	1+0	0	1	0
<i>China-Australia Income Tax Treaty, 1988</i>	In force	1+1	0	1	0
<i>China-Austria Income and Capital Tax Treaty, 1991</i>	In force	1+1	0	0	0
<i>China-Belgium Income Tax Treaty, 1985</i>	Terminated	1+1	0	0	0
<i>China-Belgium Income Tax Treaty, 2009</i>	In force	1+0	0	1	0
<i>China-Czech Republic Income Tax Treaty, 1987</i>	Terminated	1+1	0	1	0

<i>China-Czech Republic Income Tax Treaty, 2009</i>	In force	1+0	0	1	1
<i>China-Denmark Income Tax Treaty, 1986</i>	Terminated	1+1	0	1	0
<i>China-Denmark Income Tax Treaty, 2012</i>	In force	1+0	0	1	0
<i>China Estonia Income Tax Treaty, 1998</i>	In force	1+0	0	1	0
<i>China-Finland Income Tax Treaty, 1986</i>	Terminated	1+1	0	1	0
<i>China-Finland Income Tax Treaty, 2010</i>	In force	1+0	0	1	0
<i>China-Greece Income Tax Treaty, 2002</i>	In force	1+0	0	1	0
<i>China-Iceland</i>	In force	1+0	0	1	0

<i>Income Tax Treaty, 1996</i>					
<i>China-Hungary Income tax Treaty, 1992</i>	In force	1+1	0	0	0
<i>China-Ireland Income Tax Treaty, 2000</i>	In force	1+0	0	1	0
<i>China-Israel Income and Capital Tax Treaty, 1995</i>	In force	1+0	0	1	0
<i>China-Luxembourg Income and Capital Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>China-Netherlands Income Tax Treaty, 1987</i>	Terminated	1+1	0	1	0

<i>China-Netherlands Tax Treaty, 2013</i>	In force	1+0	0	1	0
<i>China-Norway Income and Capital Tax Treaty, 1986</i>	In force	1+1	0	0	0
<i>China-New Zealand Income Tax Treaty, 1986</i>	In force	1+0	0	1	0
<i>China-Portugal Income Tax Treaty, 1998</i>	In force	1+0	0	1	0
<i>China-Slovenia Income and Capital Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>China-Slovenia Income Tax Treaty, 1995</i>	In force	1+0	0	0	0

<i>China-Slovak Republic Income Tax Treaty, 1987</i>	In force	1+1	0	1	0
<i>China-Korea Income Tax Treaty, 1994</i>	In force	1+0	0	0	0
<i>China-Spain Income and Capital Tax Treaty, 1990</i>	In force	1+1	0	0	0
<i>China-Sweden Income Tax Treaty, 1986</i>	In force	1+1	0	1	0
<i>China-Switzerland Income and Capital Tax Treaty, 1990</i>	Terminated	1+0	0	0	0
<i>China-Switzerland Income and Capital Tax Treaty, 2013</i>	In force	1+0	0	1	0

<i>China-Poland Income Tax Treaty, 1988</i>	In force	1+1	0	0	0
<i>China-Turkey Income Tax Treaty, 1995</i>	In force	1+0	0	1	0
<i>China-Mexico Income Tax Treaty, 2005</i>	In force	1+1	0	1	0

**Table 2**

**China's bilateral tax treaties with high-income non-OECD countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
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<i>China-Saudi Arabia Income Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>China-Bahrain Income Tax Treaty, 2002</i>	In force	1+1	0	1	0
<i>China-Oman Income Tax Treaty, 2002</i>	In force	1+1	0	1	0
<i>China-Qatar Income Tax Treaty, 2001</i>	In force	1+0	0	1	0
<i>China-Kuwait Income Tax Treaty, 1989</i>	In force	1+1	0	1	0
<i>China-United Arab Emirates Income Tax Treaty, 1993</i>	In force	1+0	0	1	0
<i>China-Brunei Income Tax Treaty, 2004</i>	In force	1+0	0	1	0

<i>China-Trinidad and Tobago Income Tax Treaty, 2003</i>	In force	1+0	0	1	0
<i>China-Barbados Income Tax Treaty, 2000</i>	In force	1+0	0	1	0
<i>China-Cyprus Income Tax Treaty, 1990</i>	In force	1+1	0	1	0
<i>China-Malta Income Tax Treaty, 1993</i>	Terminated	1+0	0	1	0
<i>China-Malta Income Tax Treaty, 2010</i>	In force	1+0	0	1	0
<i>China-Singapore Income Tax Treaty, 1986</i>	Terminated	1+1	0	0	0
<i>China-Singapore Income Tax Treaty, 2007</i>	In force	1+0	0	1	0

<i>China-Croatia Income Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>China-Croatia Income Tax Treaty, 1995</i>	In force	1+0	0	1	0
<i>China-Latvia Income and Capital Tax Treaty, 1996</i>	In force	1+0	0	0	0
<i>China-Hong Kong Income Tax Treaty, 1998</i>	Terminated	1+1	0	0	0
<i>China-Hong Kong Income Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>China-Macau Income Tax Agreement, 2003</i>	In force	1+1	0	1	0
<i>China-Russia Income Tax Treaty, 1994</i>	In force	1+0	0	0	0

<i>China-Russia Income Tax Treaty, 2014</i>	Not yet in force	1+0	0	1	0
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**Table 3**

**China's bilateral tax treaties with other developing countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>China-Brazil Income Tax Treaty, 1991</i>	In force	1+0	0	0	0
<i>China-India Income Tax Treaty, 1994</i>	In force	1+0	1	1	0

<i>China-Malaysia Income Tax Treaty, 1985</i>	In force	1+1	0	0	0
<i>China-Thailand Income Tax Treaty, 1986</i>	In force	1+0	0	0	0
<i>China-Vietnam Income Tax Treaty, 1995</i>	In force	1+1	0	1	0
<i>China-Philippines Income Tax Treaty, 1999</i>	In force	1+0	0	1	0
<i>China-Indonesia Income Tax Treaty, 2001</i>	In force	1+0	1	1	0
<i>China-Bulgaria Income and Capital Tax Treaty, 1989</i>	In force	1+0	0	1	0
<i>China-Pakistan Income Tax Treaty, 1989</i>	In force	1+1	1	1	0
<i>China-Nepal</i>	In force	1+1	0	1	0

<i>Income Tax Treaty, 2001</i>					
<i>China-Bangladesh Income Tax Treaty, 1996</i>	In force	1+0	0	1	0
<i>China-Sri Lanka Income Tax Treaty, 2003</i>	In force	1+1	0	1	0
<i>China-Syrian Arab Republic Income Tax Treaty, 2010</i>	In force	1+0	0	1	0
<i>China-Iran Income Tax Treaty, 2002</i>	In force	1+0	0	1	0
<i>China-Venezuela Income and Capital Tax Treaty, 2001</i>	In force	1+1	0	1	1
<i>China-Cuba Income Tax Treaty, 2001</i>	In force	1+0	0	1	0
<i>China-Jamaica Income Tax Treaty,</i>	In force	1+1	0	1	0

<i>1996</i>					
<i>China-Papua New Guinea Income Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>China-Mongolia Income Tax Treaty, 1991</i>	In force	1+0	0	1	0
<i>China-Albania Income and Capital Tax Treaty, 2004</i>	In force	1+0	0	1	0
<i>China-Belarus Income and Capital Tax Treaty, 1995</i>	In force	1+0	0	1	0
<i>China-Georgia Income and Capital Tax Treaty, 2005</i>	In force	1+0	0	1	0
<i>China-Kazakhstan Income Tax Treaty, 2001</i>	In force	1+1	0	1	0
<i>China-Ukraine Income and</i>	In force	1+1	0	1	0

<i>Capital Tax Treaty, 1995</i>					
<i>China-Tajikistan Income and Capital Tax Treaty, 2008</i>	In force	1+0	0	1	0
<i>China-Armenia Income and Capital Tax Treaty, 1996</i>	In force	1+1	0	1	0
<i>China-Kyrgyzstan Income Tax Treaty, 2002</i>	In force	1+1	0	1	0
<i>China-Moldova Income Tax Treaty, 2000</i>	In force	1+1	0	1	0
<i>China-Azerbaijan Income Tax Treaty, 2005</i>	In force	1+0	0	1	0
<i>China-Turkmenistan Income Tax Treaty, 2009</i>	In force	1+0	0	1	0
<i>China-Uzbekistan</i>	In force	1+1	0	1	0

<i>Income Tax Treaty, 1996</i>					
<i>China-Lithuania Income and Capital Tax Treaty, 1996</i>	In force	1+0	0	1	0
<i>China-Romania Income Tax Treaty, 1991</i>	In force	1+1	0	0	0
<i>China-Macedonia Income and Capital Tax Treaty, 1988</i>	Terminated	1+0	0	0	0
<i>China-Macedonia Income and Capital Tax Treaty, 1997</i>	In force	1+0	0	1	0
<i>China-Laos Income Tax Treaty, 1999</i>	In force	1+0	0	1	0

**Table 4**

**China's bilateral tax treaties with African countries**

<i>Treaty</i>	Status	Provision for attribution of profits to PEs based on pre-2010 Article 7 of the OECD Model or Article 7 of the UN Model + Language of Article 7(3) of the UN Model used	Force of attraction principle	Correlative adjustment (use of Article 9 (2) of the OECD Model and the UN Model)	Use of Article 9(3) of the UN Model
<i>China-Mauritius Income Tax Treaty, 1994</i>	In force	1+0	0	1	0
<i>China-Morocco Income Tax Treaty, 2002</i>	In force	1+1	0	1	0
<i>China-Sudan Income Tax Treaty, 1997</i>	In force	1+0	0	1	0

<i>China-Egypt Income Tax Treaty, 1997</i>	In force	1+0	0	1	0
<i>China-Seychelles Income Tax Treaty, 1999</i>	In force	1+0	0	1	0
<i>China-Algeria Income and Capital Tax Treaty, 2006</i>	In force	1+1	0	1	0
<i>China-Ethiopia Income Tax Treaty, 2009</i>	In force	1+0	0	1	0
<i>China-Zambia Income Tax Treaty, 2010</i>	In force	1+0	0	1	0
<i>China-South Africa Income Tax Treaty, 2000</i>	In force	1+0	1	1	0
<i>China-Nigeria Income Tax Treaty, 2002</i>	In force	1+1	0	1	0

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<i>China-Tunisia Income Tax Treaty, 2002</i>	In force	1+1	0	1	0
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