
International Economic Law Clinic

TAXING INCOME FROM SERVICES PROVIDED BY NON-RESIDENTS AND ATTRIBUTING INCOME TO PERMANENT ESTABLISHMENTS THROUGH “FRACTIONAL APPORTIONMENT”: A STUDY OF DOUBLE TAXATION TREATIES AND NATIONAL LAWS

10/01/2020, Geneva

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To:

BEPS Monitoring Group

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Acknowledgements

The authors would like to cordially thank the beneficiary of the present report, BMG Monitoring Group, and particularly Mr. Sol Picciotto. The authors would also like to acknowledge and thank for the valuable contribution of Prof. Joost Pauwelyn, Panagiotis Kyriakou and Vincent Beyer.

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INDEX OF ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
FA	Fractional Apportionment
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS
OECD	Organization for Economic Cooperation and Development
PE	Permanent Establishment

Executive Summary

This research paper addresses the issue of taxation of income from services provided by non-residents and examines double taxation treaties as well as national laws.

Digitalization of economy has sharpened the recent debates on efficiency of tax rules around the world, and the OECD is striving to reach international consensus on the matter. The current study is an attempt to contribute to the ongoing debates on tax reforms by studying two key concepts, namely services permanent establishment and fractional apportionment, which are provided for in Article 7.4 and Article 5.3.b of the UN Model Tax Convention, respectively. The notion of permanent establishment (PE), defined in many tax treaties, as well as in Article 5 of the OECD and UN Model Tax Conventions, is used to determine the right of a State to tax the profits of an enterprise of the other State. The UN Model Tax Convention includes a broader notion of PE by considering the furnishing of services as PE, should certain conditions be met. The UN Model Convention Treaty also includes a provision that allows the use of the method of fractional apportionment (FA) to determine the profits attributed to a PE.

This research examines, firstly, if and to what extent the provisions on PE and FA are included in double taxation treaties that are currently in force. Secondly, it analyzes the domestic laws of certain developing countries to shed light on different forms that PE and FA may take.

Our conclusions are based on analysis of 3181 double taxation treaties currently in force. To collect our data and draw the above conclusions, we relied on the IBFD Tax Research Platform. Regarding the provision on services PE, the research found that such provision is contained in 1131 double taxation treaties, that is in around $\frac{1}{3}$ of the overall number of the treaties analyzed. Further, we identified three main deviations from the text of Article 5.3.b of the UN Model Tax Convention and provided numbers on the tax treaties that include provisions with such deviations. Regarding the provision on FA, our results showed that the relevant provision is contained in 2166 tax treaties, that is in around $\frac{2}{3}$ of the 3181 tax treaties analyzed. Further, 1236 tax treaties contain provisions that follow the exact same wording of the UN Model Tax Convention, while 720 tax treaties

contain provisions with only insignificant grammatical deviations. Lastly, 205 treaties contain provisions that significantly deviate from the wording of the UN Model Tax Convention. The research also found that 904 tax treaties, which is around 28% of the 3181 tax treaties analyzed, contain both provisions on FA and services PE. Further, our analysis showed that the tax treaties of developing countries are more likely to follow the exact wording of the UN Model Tax Convention or to contain provisions with only insignificant deviations from the wording of the UN Tax Convention, while tax treaties of developed countries are more likely either not to follow the wording of the UN Model Convention or not to contain a FA provision at all. Another key finding of the research is that, after the revision of the OECD Model Tax Convention in 2010, when the FA provision was removed from its text, a higher percentage of tax treaties included provisions following the wording of the relevant articles of the UN Model Convention, either fully or with minor deviations.

Apart from the double taxation treaties, this research also examines how PE and FA are applied on a domestic level, namely in the jurisdictions of India and South Africa. Both countries attempt to capture more of profits made by digital economies under their legislation by providing for the concept of services PE. Additionally, both countries have accepted the potential application of the method of FA, yet in none of these jurisdictions it has been established whether FA is “customarily applied”.

I. Introduction

In a period of only five years (2016 – 2021), the level of the digitalization of companies is expected to rise between 42% and 74% in the Americas, between 31% and 67% in Asia-Pacific, and between 41% and 71% in Europe, the Middle East and Africa.¹ When thinking of digitalization of the economy and industries, it is common to refer to multinational digital giants, such as Facebook, Apple, Amazon, Netflix and Google., digitalization also affects traditional businesses as,

¹ PwC, *Industry 4.0: Building the digital enterprise (Global Industry 40 Survey 2016)*, available at www.pwc.com/gx/en/industries/industries-4.0/landing-page/industry-4.0-building-your-digital-enterprise-april-2016.pdf, last accessed 06.11.2019.

for example, in the construction and operation, transport, extractive, engineering, agriculture, and banking industries.² Cloud-based processes, the sharing economy and collaborative production are modern trends that also create additional value for the production of goods and the provision of services. The increase in internet-related economic activity, along with the development and sale of digital goods and services, requires re-evaluation of many traditional tax laws and principles.³ Holding on to traditional principles, it is argued, will in the long run lead to adverse outcomes for governments, including revenue losses resulting from the inability to effectively charge and collect taxes on digital economic activity.⁴ Under the current rules, tax authorities do not appear to have sufficient mechanisms by which to tax the business profits of companies that are derived from the value generated by the digitalization of the economy.

The core of the current debate surrounding the taxation of digital economy is the issue of allocating taxing rights among states in respect of digital business models. The problems to be brought into light in the current study are:

- the difficulty to establish a nexus with a particular taxing jurisdiction; and
- the problem of allocating profit once a nexus has been found.

Against this background, the OECD/G20 BEPS initiative issued a report on the digital economy in Action 1, which seeks to provide solutions to the issue of how taxing rights of income generated from cross-border activities in the digital economy are allocated among countries. The OECD focuses on taxing where value is created and on understanding the effect that digitalization may have had on business models and value creation. Due to a lack of consensus, the OECD has not come up with any recommendations on whether and to what extent changes to international tax rules for dividing profits between source and residence countries may be required. Instead, the OECD calls for further work to examine the existing international tax rules on nexus and on how to allocate profit

² Petruzzi R, Buriak S, International/OECD - Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules? Bulletin for International Taxation, 2018 (Volume 72).

³ *Ibid.*

⁴ Cockfield J A, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, Bulletin for International Fiscal Documentation, Vol. 56, p. 606, 2002, available at https://www.researchgate.net/publication/228261238_The_Law_and_Economics_of_Digital_Taxation_Challenges_to_Traditional_Tax_Laws_and_Principles, last accessed 06.11.2019.

on the basis of that nexus. The OECD is currently discussing avenues to tackle current issues of taxing the digital economy by reforming some of the core elements of allocation of rights between resident and source jurisdictions.⁵ The solutions imply either creating a new multilateral instrument or offering solutions still compatible with the existing bilateral and multilateral treaty networks. Reforming some core elements of taxation system might raise not only legal but also political issues, thus making it more difficult to offer a one-size-fits-all solution.⁶

Public outcry and political pressures force legislators to try to capture more of the income of resident and non-resident digital business by devising different solutions on a domestic and international level. Different jurisdictions take different approaches in their domestic laws in order to tackle changing realities in taxation. Many governments have attempted to deal with this situation by conducting investigations, as well as initiating proceedings against companies that provide services in their jurisdictions, either with or without physical presence. Currently, Italian authorities are under investigation of Netflix Inc., arguing that the latter has enough physical presence to qualify as a local business that can be taxed under the Italian domestic law. Similarly, separate investigations had recently initiated with regard to Amazon Inc. and Alphabet Inc.'s Google.⁷ In 2019, France introduced a Digital Services Tax affecting 30 large internet-based multinational businesses, including Google, Apple, Facebook, and Amazon. The authorities justified it as necessary because internet companies are paying well

⁵ See e.g. OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (2019) OECD/G20 Inclusive Framework on BEPS, available at www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm 'accessed 11/15/2019'; OECD, *Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One*, available at <http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> 'accessed 25/10/2019'.

⁶ Grinberg I, Pauwelyn J, *The Emergence of a New International Tax Regime* (2015) American Society of International Law Vol 19, available at <https://www.asil.org/insights/volume/19/issue/24/emergence-new-international-tax-regime-oecd%E2%80%99s-package-base-erosion-and> 'accessed 15/11/2019'.

⁷ Carraud S, Rosemain M, *Google to pay \$1 billion in France to settle fiscal fraud probe* (2019) Reuters Report, available at <https://www.reuters.com/article/us-france-tech-google-tax/google-agrees-to-550-million-fine-in-france-to-settle-fiscal-fraud-probe-idUSKCN1VX1SM> 'accessed 25/10/2019'.

below France's statutory 34 percent corporate income tax.⁸ The new tax is a 3 percent levy on the total French revenue of the companies with global revenues of at least 750 million euros (\$831 million) and revenues of at least 25 million euros in France alone.⁹ Thus, the tax is based on revenue rather than profits made in France, which opens the door to alternative ways to calculate corporate income tax.¹⁰ Thus, some jurisdictions reinforce domestic corporate income tax rules, provide for new rules to determine which businesses have a nexus to their jurisdiction, else they tax revenues instead of income or provide for revised indirect tax rules.

Domestic solutions, however, need to be compatible with the existing bilateral and multilateral treaty networks. The present research addresses discussions of possible reforms of tax rules on both a national and international level, regarding the nexus to tax non-resident companies and profit attribution. In particular, the research concerns two provisions in the existing bilateral and multilateral treaty networks, that is the provision on furnishing of services in the article on permanent establishment and the provision on apportionment in the article on business profits. As a preliminary matter, it must be stated that international tax treaties do not create rights to tax for states. Rather, they limit the inherent rights of states to tax, by restricting the right of each Contracting State to tax the income of residents of the other contracting state. Put it differently, most countries in their domestic laws tax income arising from business or trade in that country, even if these activities are conducted by a non-resident. Tax treaties restrict this in relation to residents of the treaty partners.

The survey aims to reveal whether the treaties in force list furnishing of services in the articles on PE. Also, it examines whether the articles on business profits in the treaties provide for attribution of profits to a PE by way of apportionment. In other words, the survey studies if and to what extent the relevant provisions in current tax treaties follow Article 5.3.b and Article 7.4 of the

⁸ Ferry J, Parks B, Dahal A, *An Alternate Solution for France's Digital Services Tax* (2019) Tax Analysts, available at <https://www.taxnotes.com/tax-notes-today-international/digital-economy/alternate-solution-frances-digital-services-tax/2019/10/30/2b0p3?highlight=netflix%20united%20kingdom> 'accessed 13/11/2019'.

⁹ *Ibid.*

¹⁰ *Ibid.*

UN Model Convention. The research aims to reveal the significant deviations of the provisions in the treaties compared to the text of Article 5.3.b and Article 7.4 of the UN Model Convention and to analyze some cases of deviations.

This paper consists of three chapters. Chapter I provides a general discussion on the concepts of permanent establishment and profit attribution. Chapter II details the methodology of the research, i.e. shows how the relevant data were obtained, processed and analyzed. Chapter III presents the outcomes of the research. Chapter IV offers insights into domestic laws of two jurisdictions, South Africa and India, in an attempt to discuss the actual or potential implementation of the relevant provisions in a domestic context. Chapter V concludes.

II. Basic notions

A. Permanent establishment

A permanent establishment (PE) is the existence of taxable presence in a particular jurisdiction. This term is used to define the threshold for taxation of business profits of a non-resident entrepreneur income of a resident of the other treaty partner only to the extent that it is attributable to a PE. This term is used in bilateral tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. The PE concept does not apply in a uniform manner in practice. Rather, what falls under the ambit of PE depends on the relevant provision included in each double taxation treaty, and on how the provision is interpreted.

Both the OECD and the UN Model Tax Convention include a PE provision. According to Article 5 OECD Model Tax Convention,

“1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

The very same provision is included in the UN Model Tax Convention. In the second paragraph of these provisions, an indicative list of what PE includes is provided. The UN Model Convention, broadens the scope of the PE definition by containing the following paragraph:

“(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned”.

B. Profits attributed to a permanent establishment

Once it is determined that there is a PE, the question that ensues is how to calculate the profits that are attributed to the PE. This issue is dealt with in Article 7 of both the OECD and the UN Model Convention. These provisions guide countries in devising such rules in their double taxation treaties as will help them determine when and to what extent they can tax profits of an enterprise resident in one country and operating in the other.

To illustrate, assume that there is an enterprise, ACo, which is resident in Country A, and this enterprise operates in Country B through a PE, e.g. an office, that is situated in Country B. Country A will typically have exclusive taxing rights over profits of ACo; however, since ACo carries out business activities through an office in Country B, the latter may also tax certain profits. In this simple scenario, the double tax treaty between Country A and Country B will contain rules helping both countries to allocate such rights. Profit attribution rules are thus a fundamental feature of the international tax system, yet there is much complexity surrounding those rules.

The present research focuses on the fractional apportionment method (FA), as provided for in the UN Model Convention. Particularly, Article 7.4 UN Model Convention provides as follows:

“4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an

apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

Under this approach, countries that customarily determine the profits of a PE by apportioning the total profits of the enterprise according to a formula (for example, on the basis of receipts, expenses or capital) can continue to do so, provided that the result of applying this method of apportionment is in accordance with the arm's length principle. The essential character of the apportionment method is that a proportionate part of the profits of the whole enterprise is allocated to a part of it. The key issue here is the varying criteria used to determine the correct proportion of the total profits.

The criteria commonly used can be grouped into three main categories, as referred to in the OECD Commentary, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The method to be used in computing the total profits of the enterprise vary depending on the laws of different countries.

III. Research Methodology

A. Building the database

The present survey uses data obtained from the IBFD-Tax Research Platform. The IBFD Platform contains over 14,000 tax, exchange of information and social security treaty documents, including protocols and amendments, supplementary agreements and exchanges of notes to these treaties. Importantly, it allows to apply filters to narrow the treaty results, to compare individual treaty articles and to export data to Excel for comparison.

Using the option of exporting data to Excel, we created our own database, which contains texts of articles on PE and business profits for 4726 treaties, 3181

of which were in force. This number of treaties is the result of applying several filters and data exporting functions offered by the IBFD database as will be explained below.

The initial number of entries for Treaties and Models section of IBFD is 14380. For the filter “Treaty Subject”, and the category “Income/Capital”, 9697 results are exported, either in force or not. To make it possible to manage the data in our Excel database using standardized formulas, and to avoid counting different language versions of the same article multiple times, we analyzed only those treaties available on IBFD in English. Therefore, we applied the “Language” filter in the IBFD database and chose “English” from the language catalogue. Applying these two filters (“Income/Capital” as the subject and “English” as the language), the IBFD database showed 5029 results. We then applied the filter “Document Type” and chose the category “Treaty”, that gave us 4878 results.

We exported these results to our Excel database, by applying the “Export” option available under “Actions” on the IBFD database. We exported two articles of each treaty, namely “Permanent Establishment” and “Business Profits” as they were the main *loci* of the provisions under concern for the research¹¹. We exported groups of 25 treaties, since this is the maximum number IBFD allows to export from the database at each time. We then combined all the Excel files containing the relevant articles for each group of 25 treaties and came up with one Excel file containing the relevant articles of 4726 treaties. The difference between this number and the one previously found (4878), i.e. 152 treaties less, might relate to technical problems connected with the IBFD database itself. For example, some treaties appear as a matching document in the IBFD database after applying the relevant language filter (English), whereas actually they do not have an English version and thus data on articles cannot be successfully exported to Excel. In addition, sometimes the IBFD database does not contain the text of the treaty but brings it as a matching document in the search results. In this case, the treaty either does not appear in the exported Excel document at all or it

¹¹ In some treaties, the notion of PE might be provided for in the article containing the general definitions, but our assessment is that such cases are exceptions and do not severely limit our findings. Consequently, we considered that this potential limitation did not overcome the benefits of using the option to export the two articles and creating our own database with them.

appears but with indication of “No article found on “Business profits” in this treaty” and “No article found on “Permanent Establishment” in this treaty”.

Our database has some limitations. Some treaties exported from IBFD following the previous steps, such as the Algeria – Libya Income Tax Treaty (1988) do not contain any provision on PE but had other articles (e.g. Article on “Place of Taxation”) found in the Excel file download from the database. This is also a malfunctioning of the IBFD database as we restricted the exported document to contain only “Permanent Establishment” or “Business Profits” articles. In other cases, the PE provision was not identified by the IBFD due to the fact that it contained no title and it was only numbered.¹².

In this regard, the Excel database we created for the purposes of this research allowed us to identify the main deviations in the wording of articles on permanent establishment and business profits in different treaties. In order to do so, we used Excel formulas to identify the treaties that have incorporated, fully or partially, the relevant provisions of the UN Model Convention. The following two sections explain how such formulas were applied to each of the two articles under concern.

As a common aspect for finding the results in both cases was the use of the treaties that were in force in the moment of the research (October 2019). By applying a first filter to spot such articles, we found that this was the case for 3181 out of the 4726 treaties ultimately included in our database. Therefore, all the percentage results presented in the result section regarding the incorporation or not of the UN Model Convention were calculated out of this sample containing 3181 treaties.

B. Data on provisions concerning PE

Our database was first used in the text analysis of PE to identify if the treaties containing this article included any provision related to the possibility of applying a services PE. In this regard, we defined the phrase “of services” as the

¹² This limitation is one potential explanation of why the Excel file exported from IBFD sometimes included treaties where both articles were labeled as “not found”. This was the case in around 3% of the articles in force included in our database.

minimum element to be incorporated in the treaty for it to be counted as containing such provision¹³.

Then, to identify the three main deviations related to services PE provisions (presented in Section III.1.b), we applied filters in our database to show only the articles containing the minimum requirement in treaties currently in force. Two of such deviations (“Kenya – Mauritius” type and the identification number of the paragraph in which the provision is included) required a manual analysis of these results¹⁴. In the deviation concerning the presence of the excerpt “for the same or a connected project”, however, we were able to apply another filter that showed whenever it was included in the text of the article¹⁵.

3. Data on provisions concerning profit attribution

When using our database for the analysis of the business profits article, we first followed a similar procedure to what was done in the permanent establishment one and established a minimum element to identify whether the articles provided for apportionment or not. In this case, we chose “apportion” or “proportional distribution”.

In addition to this “minimum requirement” about the presence of a fractional apportionment provision, the wording of this article allowed us to apply Excel text analysis tools to analyze the deviations from the UN Model Convention.

Therefore, we created additional columns in our database: (1) the first one spotted the relevant articles that fully match with the relevant article of UN Model Convention; (2) the second column indicated insignificant deviations (e.g.

¹³ When establishing the categories to analyze this provision we opted not to include one related to insignificant grammatical deviations as we did when analyzing the FA provision (explained in section II.3). This choice was motivated by the fact that the time element of the services PE provision# was found to be written in many different manners. In this regard, the text analysis method used in our database would not be appropriate to differentiate all the possible combinations of writing from significant deviations.

¹⁴ In the case of the “Kenya - Mauritius type” of deviation, a manual analysis was needed because the key difference (the effect caused by the inclusion of the excerpt “engaged in the other Contracting States”) could be present by the addition of alternate excerpts with different writing. This was found to be the case in the Ecuador - Romania treaty, as discussed in Section III.1.b. The manual analysis was also needed to identify the deviation related to the number of the paragraph, because the treaties number their paragraphs in different and non-harmonized manners.

¹⁵ Different from the two previous deviations, in this case the fact that the deviation was characterized by a single and clearly defined excerpt made it possible to use an Excel text analysis formula.

different syntax, spelling, grammar); (3) the third one showed significant deviations (a residual category, with any element additional to or missing from the wording of the relevant UN Model article).

In particular, the “full match” category included the whole text of Article 7.4 of the UN Model.

The second “Insignificant deviation” category column for Article 7.4 identified whenever all of the following excerpts were present in the treaty:

1. "as it has been customary in", "to determine the profits to be attributed to a permanent establishment on the", "basis of an apportionment of the total profits of the enterprise to its various parts, nothing in", "shall preclude", "from determining the profits to be taxed by such", "an apportionment as may be customary", "the method of", "apportionment adopted shall, however, be such that the result shall be in accordance with".

The missing elements in this column are: “In so far”, “a Contracting State”, “paragraph 2”, “that Contracting State”, “the principles contained in this Article”. The reason for omitting these elements in this column is that the manual study of wording patterns in our database revealed that many treaties use “Insofar” instead of “In so far”, or provide for “nothing in this Article/in paragraph x (depending on numbering of that particular treaty) of this Article”. There are also different versions of the phrase “principles contained in this Article”, such as “principles laid down”, “principles embodied”, “general principles”, etc.

All other columns containing less elements of the full text were deemed to be significant deviations. For the avoidance of doubt, we also undertook manual analysis of the “Significant deviation” category for Article 7.4. We thus manually analyzed 381 provisions to see if the difference is merely grammatical, syntax, paragraph numbering, or is such that can potentially change a meaning. We have included in an annex the list of cases which turned out to be patterns of significant deviations, based on manual analysis of 381 cases of deviations.

The research identified 376 treaties whose provisions on apportionment in the article on business profits contained “potentially significant” deviations from the text of Article 7.4 of UN Model Convention. This category, therefore, included the treaties that did not match with the first and second columns of our database.

We conducted manual study of these treaties to see if these deviations are minor or they have the potential to change a meaning. Out of these 376, we

considered 205 treaties as “substantially significant”. The list of all 205 “substantially significant deviations” is presented in Annex II to this survey. The definition of what was considered as a “substantially significant deviation” was made by personal assessment of the authors. The following illustrated types of deviations that, after the manual study, we considered to be insignificant.

Deviating phrase in the relevant provision of the treaty	Corresponding phrase of Article 7.4 of UN Model
profits to be attributable to	to be attributed to
to the determine	to determine
from the determining	from determining
the method of apportionment adopted shall, however, be in accordance with the principles contained in this Article.	the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
Appointment	apportionment
such an apportionment	such apportionment
on the basis of any apportionment	on the basis of an apportionment
total profit	total profits
customary to a Contracting State	customary in a Contracting State
customary for a Contracting State	customary in a Contracting State
be such that the result will be in accordance	be such that the result shall be in accordance
principles laid down in this Article	principles contained in this Article

If it has been customary	Insofar as it has been customary
maybe customary	may be customary

IV. Results and remarks

This part of the research concerns to the results that were exported according to the abovementioned methodology. The presentation of such data has been divided in two parts, the first referring to PE and the second to FA. From the overall number of double tax treaties, 905 contain both a services PE and FA provision. The number of treaties that include a relevant provision on apportionment, the number of treaties that do not include such provision, as well as the number of treaties which include such provision but with significant deviations are provided below.

A. Services PE

1. Results

Regarding the Article on services PE, we identified the overall numbers of treaties that include such a provision. These numbers are presented in the table below:

Overall Number of treaties in force	Number of treaties including services PE	Number of treaties not including services PE
3181	1131 (35.6%)	2050 (64.4%)

As it can be seen in the table and as further illustrated in the pie chart below, the data show that a majority (around 2/3) of the treaties currently in force does not include a provision similar to Article 5.3.b of the UN Model Tax Convention.

The large number of variations in the wording of Article 5.3.b was an impediment to further quantitative results on the types of variations found. However, an overall assessment of the articles present in the database allowed the conclusion that deviations from Article 5.3.b of the UN Model Convention are, *inter alia*, related to the time period required to establish a permanent establishment, which may, for instance, be 90 days instead of 6 months.

In addition, in many cases the scope of the services PE provision is limited to only “the same or connected project” for which services are provided. This common deviation is due to the fact that previous versions of the UN Model Convention contained this characterization for the activities covered by the paragraph. However, the last version (2017) excluded this characterization in its wording in order to make clear that the paragraph would have a broader application.

2. Examples of provisions deviating from Article 5.3b UN Model Convention

As explained above, the large number of variations in the wording of Article 5.3.b prevented an overall to differentiation between insignificant and significant deviations. However, an assessment of the articles in the database allowed the conclusion that there are three main deviations from Article 5.3.b of the UN Model Convention. Below, the effects of these deviations in the practice and the number of treaties in which they were found are presented.

1st deviation: “by an enterprise of a Contracting State through employees or other personnel engaged in the other Contracting State”

One main difference, present, for instance, in Kenya-Mauritius treaty, is the wording “by an enterprise of a Contracting State through employees or other

personnel engaged in the other Contracting State” instead of “by an enterprise through employees or other personnel engaged by the enterprise for such purpose”. The key difference is the inclusion of the words “engaged in the other Contracting State”.

This difference in wording is very important. A common form of tax avoidance is to set up a company resident in a low-tax jurisdiction (A) to provide services to companies that are residents in the high-tax country (B), which may be an affiliate of the same corporate group. The fees for the services provided would be tax deductible, reducing the taxable profits of the entity in B. If there is a treaty, the income is taxable only in the country of residence (A), unless the service provider has a PE in B. The inclusion of a services PE provision in a tax treaty between the two countries would allow country B to tax the income from providing services. However, if it is limited to when the PE employs people locally, it would not do so. Indeed, it may employ very few people even in country A. This deviation is present in 22 treaties currently in force (and 5 others not in force)¹⁶ with the same wording as in the Kenya - Mauritius treaty¹⁷. A similar wording is also included in the Ecuador – Romania treaty¹⁸.

2nd deviation: “for the same or a connected project”

¹⁶ The treaties containing the Kenya - Mauritius wording for the services PE provision are: Bangladesh - Mauritius (2009, in force), Botswana - Mauritius (1995, in force), China - Croatia (1995, in force), China - Luxembourg (1994, in force), China - Mauritius (1994, in force), Cyprus - Mauritius (2000, in force), Egypt - Mauritius (2012, in force), Ghana - Mauritius (2017, in force), India - Namibia (1997, in force), Iran - Kenya (2012, in force), Kenya - United Arab Emirates (2011, in force), Lesotho - Mauritius (1997, in force), Malta - Mauritius (2014, in force), Mauritius - Nigeria (2012, not yet in force), Mauritius - Namibia (1995, in force), Mauritius - Mozambique (1997, in force), Mauritius - Swaziland (1994, in force), Mauritius - Uganda (2003, in force), Mauritius - Thailand (1997, in force), Mauritius - Sri Lanka (1996, in force), Mauritius - Seychelles (2005, in force), Mauritius - Rwanda (2001, terminated), Mauritius - Russia (1995, not yet in force), Mauritius - United Arab Emirates (2006, in force), Namibia - Russia (1998, in force), Netherlands - Uganda (2004, in force).

¹⁷ The services PE provision reads as follows in the Kenya - Mauritius treaty: “the furnishing of services including consultancy services by an enterprise of a Contracting State through employees or other personnel engaged in the other Contracting State, provided that such activities continue for the same or a connected project for a period or periods aggregating to more than 6 months within any 12-month period.”

¹⁸ The services PE provision reads as follows in the Ecuador - Romania treaty: “the rendering of services, including consulting services, by an enterprise of a Contracting State through its own personnel or through other personnel employed in the other Contracting State, provided that those activities relate to the same project or a project connected thereto for a period exceeding in total 12 months.”

The excerpt “for the same or a connected project” was part of the UN Model Convention until its last revision in 2017. As explained in the commentaries’ section of the Convention, this wording was removed as the “project” limitation was easy to manipulate and created difficult interpretive issues and factual determinations for tax authorities, which in particular for developing countries is an undesired administrative burden.¹⁹

This deviation was found to be present in 655 treaties in force, which amounts to a percentage of almost 58% of all the treaties containing services PE currently in force.²⁰ The high percentage of this deviation, especially when compared to the other two deviations identified, is probably explained by the fact that it is the only of them that has formerly part of the writing of the services PE provision suggested by the UN Model Convention. In fact, only 7 agreements in force signed after 2017 include this deviation.²¹ .

3rd deviation: the services PE provision is not included in paragraph 3 of Article 5 UN Model Tax Convention

A manual study of the 1131 tax treaties currently in force and that contain the minimum to be considered related to services (“of services”) showed that 225 treaties currently in force have the services PE provision in a paragraph other than the 3rd one in the PE chapter. In such cases, the services PE provision is most commonly included in paragraph 2, as an additional element to the existing list or in paragraph 4.

Such a difference may be of essence with regard to the interpretation and application of the services PE provision. For the illustration of this statement, the AB LLC and BD Holdings LLC case is notable. In that case, the relevant double taxation treaty, the services PE provision was found in paragraph 2(k), the appellant argued that paragraph 2 cannot be interpreted independently from paragraph 1, which refers to a “fixed place of business”.²² The Supreme Court of

¹⁹ Commentary on the UN Model Convention, 161.

²⁰ This deviation is also present in other 95 treaties not in force.

²¹ Namely: Cambodia - Vietnam (2018), Croatia - Vietnam (2018), Cyprus - Saudi Arabia (2018), Egypt - Uzbekistan (2018), Georgia - Saudi Arabia (2018), Kosovo - Malta (2019), Qatar - Ukraine (2018).

²² South Africa v AB LLC and BD Holdings LLC, Case No 13276 (2015) (Tax Court of South Africa) para 32.

Africa eventually interpreted the services PE provision as not having to occur within a “fixed place of business”. It held that Article 5 paragraph 2(k) is “specific and very different” from subparagraphs (a)-(f) of the same paragraph, i.e. that the services PE provision is not subject to paragraph 1.²³ Yet this case illustrates that the services PE provision being in different paragraph may result in differences as to its interpretation. Should the Court have agreed with the applicant that paragraph 2(k) is subject to paragraph 1, i.e. that a fixed place of business is required, the notion of services PE would be substantially different from both the interpretation given by the Court in the present case and the one enshrined in the UN Model Tax Convention, since it would require it to occur within a “fixed place of business”.

B. Fractional Apportionment

1. Results

As explained in the Research Methodology section, the analysis of the article containing the relevant provision on fractional apportionment (normally called “Business Profits”) made possible the unveiling of the same overall information found for the article on permanent establishment, but also additional information. In this case, the limited number of variations in the wording made possible that analysis using text analysis formulas and manual coding revealed the substantially significant and insignificant deviations of the article under concern. The general results are presented in the table below.

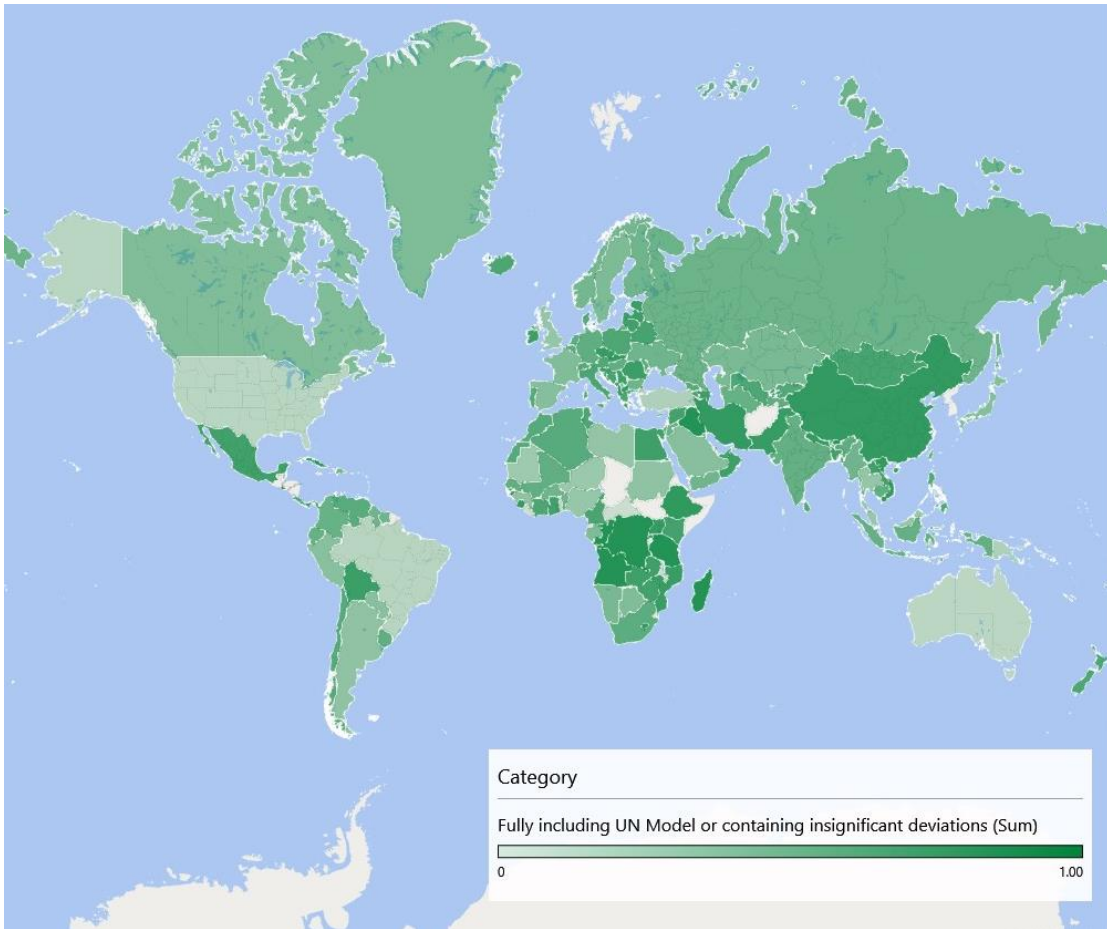
²³ *ibid.*, para 26.

Overall number of treaties in force available in English		
3181		
Number of treaties including FA		Number of treaties not including FA
2166		1020
No Deviation	Insignificant Deviation	Substantially Significant Deviation
1236	720	205

As it is indicated in the table, around $\frac{2}{3}$ of treaties permits the application of fractional apportionment method in calculating business profits that are attributed to a permanent establishment, as long as this method is customarily applied in the country in question. Annex I shows our results for all the countries in the world, in an alphabetical order. Annex I presents the three categories in absolute terms based on the number of treaties in force, as well as the categories as percentages of the total number of treaties signed by the country.

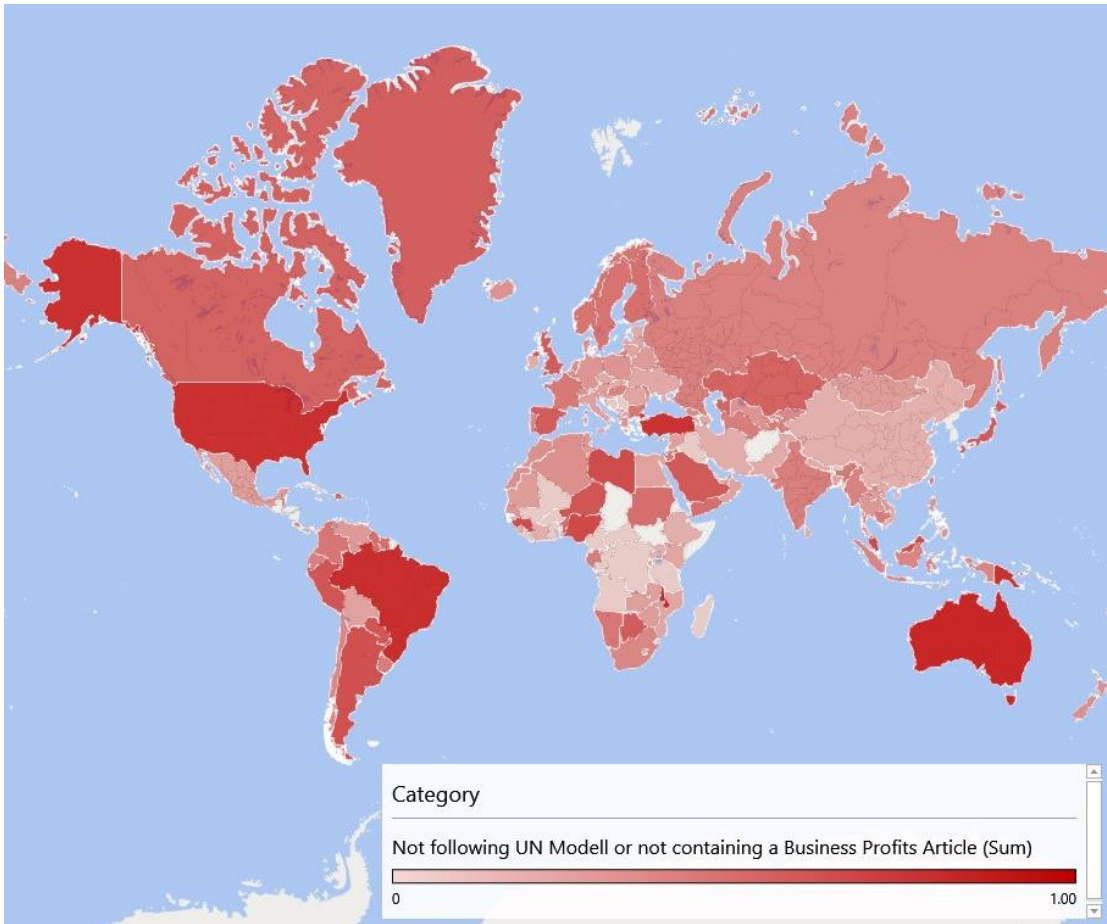
The maps below summarize two of the main categories presented in Annex I. The first map presents the percentage of treaties of each country that either fully include UN Model for 7.4 or contain insignificant deviations from the Model.

Figure 1. Presence of articles including the UN Model writing for Article 7.4 or insignificant grammar deviations (percentage variation out of the total number of treaties by country)



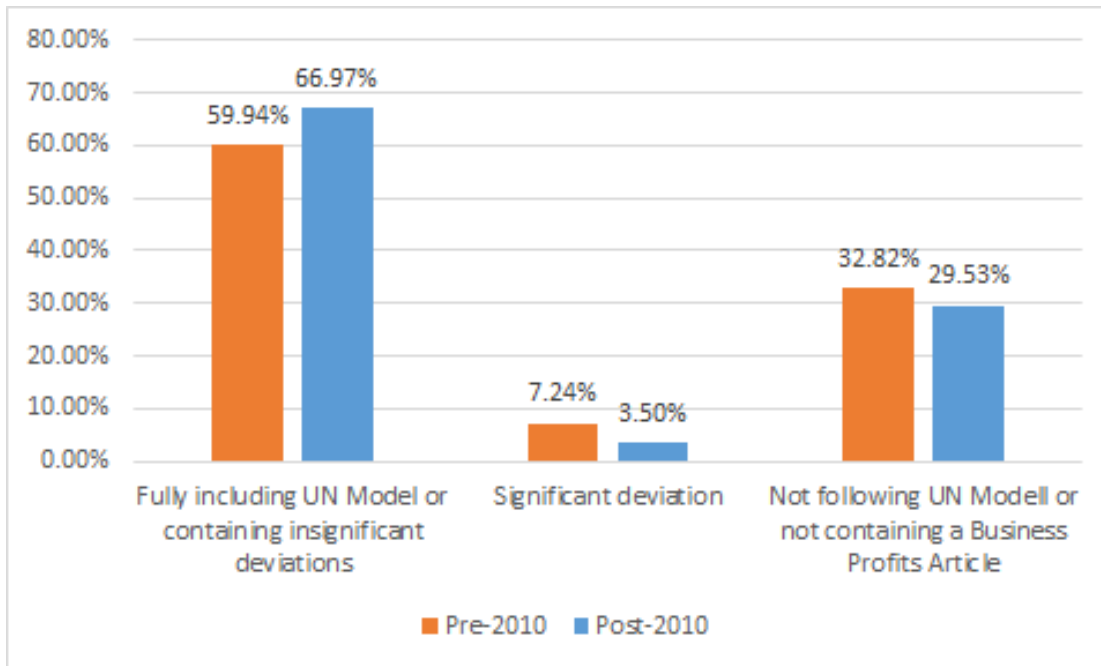
The second map shows the opposite pole, what is the percentage of treaties neither following UN Model nor containing a Business Profits Article.

Figure 2. Presence of articles not following the UN Model writing for Article 7.4 or not containing a Business Profits Article (percentage variation out of the total number of treaties by country)



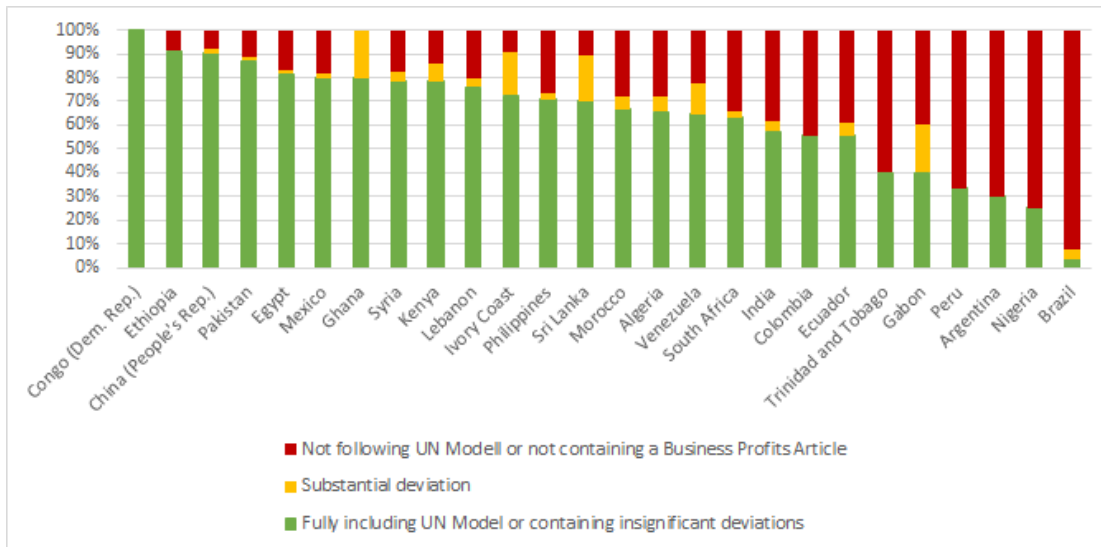
In addition to this regional illustration, we used our data to make a temporal analysis of the presence of each category in the treaties analyzed. We establish 2010 as our reference period due to the fact that in the month of September of that year the OECD decided to delete this provision from its model. In this regard, our results, presented in the table and in the graph below, are unexpected. They show that the treaties signed after 2010 incorporated a higher percentage of treaties fully including the UN Model or containing insignificant deviations of this Model when compared to the pre-2010 period.

Graph 1. Categories of Articles on Business Profits pre- and post-2010



In addition to presenting the worldwide scenario in both regional and time frames, we made a more in-depth analysis of the members of the G24. The graph below presents an extract from Annex III containing only the countries who are members of this group, ordered based on the percentage of higher compliance with the wording present in the UN Model. It makes clear how the percentage of treaties in each of the categories varies substantially among the countries of the G24. China, for example, has more than 90% of its 103 treaties fully matching the wording in the UN Model Convention, while Brazil has almost all of its treaties neither following the UN Model Convention in its minimum aspects or containing a Business Profits Article.

Graph 2. Article on Business Profits in G24 Members (percentage in each category per country)



Despite these internal disparities, we compared the general results of the countries of the G24 with the rest of the world in percentage terms. The results are presented in the table below and show that members of the G24 have incorporated articles that are classified as either fully including UN Model or containing insignificant deviations in a higher percentage than the rest of the world.

Table 1. Categories of Article on Business Profits in treaties signed by G24 countries and by the rest of the world (average of the percentage of countries in each category)

Group of countries	Fully including UN Model or containing insignificant deviations	Significant deviation	Not following UN Model or not containing a Business Profits Article
G24	63.76%	5.47%	30.76%
Rest of the world	55.65%	8.12%	36.23%

In addition to comparisons focused on the G24, we expanded the comparison to include other developing countries. We first made a more detailed

comparison that brings the results for the four levels of income defined by the World Bank. The table below shows that lower-middle income countries are the ones that signed the higher percentage of treaties fully incorporating the 7.4 provision of the UN Model Convention or this provision with only grammatical insignificant deviations.

Table 2. Categories of Article on Business Profits in treaties depending on the income level, World Bank categories (average of the percentage of countries in each category)

Group	Fully including UN Model or containing insignificant deviations	Substantial deviation	Not following UN Model or not containing a Business Profits Article
Low-Income Economies	59.93%	17.82%	22.26%
Lower-Middle Income Economies	67.89%	6.77%	25.34%
Upper-Middle-Income Economies	51.10%	6.15%	42.75%
High-Income Economies	54.14%	6.39%	39.48%

We also did a broader comparison, which merges low income countries, lower-middle income ones and upper-middle income ones in a same category called “developing countries” and considers high-income countries as “developing

countries”. In this comparison, presented in the table below, we can see that developing countries have been incorporating the full provision as in the UN Model Convention or such provision with only insignificant grammatical deviations in a higher percentage that developed countries.

Table 3. Categories of Article on Business Profits in treaties depending on the income level, developing and developed countries (average of the percentage of countries in each category)

Group	Fully including UN Model or containing insignificant deviations	Significant deviation	Not following UN Model or not containing a Business Profits Article
Developing countries	58.51%	8.75%	32.74%
Developed countries	54.14%	6.39%	39.48%

2. Examples of provisions deviating from Article 7.4 UN Model Convention

The 205 deviations that we considered “substantially significant” can be broken down into several categories.

2 treaties providing for apportionment of the total profits of the project instead of total profits of the enterprise.

1.	Algeria – Qatar Income Tax Treaty (2008)
2.	Qatar – Sudan Income Tax Treaty (1998)

6 treaties provide for apportionment following the whole of the text of Article 7.4 of the UN Model Convention except for the last part, which is “the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

1.	Algeria – Russia Income and Capital Tax Treaty (2006)
2.	Armenia – Indonesia Income and Capital Tax Treaty (2005)
3.	Armenia – Moldova Income and Capital Tax Treaty (2002)
4.	Armenia – Syria Income Tax Treaty (2005)
5.	Armenia – Turkmenistan Income and Capital Tax Treaty (1997)
6.	Belarus – Russia Income and Capital Tax Treaty (1995)

12 treaties provide for apportionment of business profits of the enterprise.

1.	Austria – Bulgaria Income and Capital Tax Treaty (2010)
2.	Barbados - United States Income Tax Treaty (1984)
3.	Canada – Estonia Income and Capital Tax Treaty (1995)
4.	Canada – Latvia Income and Capital Tax Treaty (1995)
5.	Canada – Lithuania Income and Capital Tax Treaty (1996)
6.	Canada - South Africa Income Tax Treaty (1995)

7.	Denmark – Jamaica Income Tax Treaty (1990)
8.	Israel – Jamaica Income Tax Treaty (1984)
9.	Jamaica – Sweden Income Tax Treaty (1985)
10.	Jamaica – Spain Income Tax Treaty (2008)

Most of treaties with Serbia and Montenegro, Montenegro, Serbia, Kosovo, Bosnia and Herzegovina, Croatia, and one treaty with Romania contain slightly different versions of the following wording:

“4. The profits to be attributed to a permanent establishment shall be determined on the basis of separate business books kept by the permanent establishment. If such books do not constitute an adequate basis for the purposes of determining the profits of the permanent establishment, then such profits may be determined on the basis of an apportionment of the total profits of the enterprise to its various parts. The method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles embodied in this Article. If necessary, the competent authorities of the Contracting States shall endeavor to agree on the method for apportioning the profits of the enterprise.”

Many treaties concluded with France and certain African countries refer to apportioning the total earnings between the two states in proportion to the turnover realized in each state. An example would be Article 10.4 of Cameroon – France Income, Inheritance, Registration and Stamp Tax Treaty (1976), which reads as follows:

“4. Where taxpayers with business in both Contracting States are not obliged in accordance with the domestic laws of those States, to keep regular accounts showing separately and exactly the profits accruing to the permanent establishments situated in each State, the amount of profits taxable by each State may be determined by apportioning the total

earnings in proportion to the turnover realized in their respective territories.”

The following is the list of treaties with similar wording:

1.	Burkina Faso – France Income, Inheritance, Registration and Stamp Tax Treaty (1965)
2.	Cameroon – France Income, Inheritance, Registration and Stamp Tax Treaty (1976)
3.	Central African Republic – France Income, Inheritance, Registration and Stamp Tax Treaty (1969)
4.	France – India Income and Capital Tax Treaty (1992)
5.	France - Ivory Coast Income, Capital, Inheritance, Registration and Stamp Tax Treaty (1966)
6.	France – Mali Income, Inheritance, Registration and Stamp Tax Treaty (1972)
7.	France – Mauritania Income, Inheritance, Registration and Stamp Tax Treaty (1967)
8.	France – Morocco Income Tax Treaty (1970)
9.	France – Morocco Income Tax Treaty (1970)
10.	France – Niger Income, Inheritance, Registration and Stamp Tax Treaty (1965)
11.	France – Senegal Income, Inheritance, Registration, Stamp and Gift Tax Treaty (1974)
12.	France – Togo Income, Inheritance, Registration and Stamp Tax Treaty (1971)
13.	Mauritania – Senegal Income Tax Treaty (1971)
14.	Senegal – Tunisia Income Tax Treaty (1984)

Sweden – Switzerland Income and Capital Tax Treaty (1965) prescribes that:

“Nothing in paragraph 2 shall preclude a Contracting State from determining the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts after a previous allocation of not more than 10% to the seat of the enterprise; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this Article.”

30 treaties allow for applying apportionment if its application in the country is customary under its laws. Most of such treaties are concluded with Ukraine (17), United Kingdom (8), and Moldova (4). These treaties are as follows:

1.	Armenia – Moldova Income and Capital Tax Treaty (2002)
2.	Armenia – Turkmenistan Income and Capital Tax Treaty (1997)
3.	Austria - Hong Kong Income and Capital Tax Agreement (2010)
4.	Austria - United Kingdom Income Tax Treaty (1969)
5.	Azerbaijan – Moldova Income and Capital Tax Treaty (1997)
6.	Brazil – Venezuela Income Tax Treaty (2005)
7.	China (People's Rep.) - Hong Kong Income Tax Agreement (2006)
8.	Denmark – Ukraine Income and Capital Tax Treaty (1996)
9.	Egypt – Ukraine Income and Capital Tax Treaty (1997)
10.	Falkland Islands - United Kingdom Income Tax Treaty (1997)

11.	Georgia – Ukraine Income and Capital Tax Treaty (1997)
12.	Hungary – Ukraine Income and Capital Tax Treaty (1995)
13.	Greece – Ukraine Income and Capital Tax Treaty (2000)
14.	Germany – Ukraine Income and Capital Tax Treaty (1995)
15.	Italy – Ukraine Income and Capital Tax Treaty (1997)
16.	Jordan – Ukraine Income and Capital Tax Treaty (2005)
17.	Malta – Ukraine Income Tax Treaty (2013)
18.	Moldova – Poland Income and Capital Tax Treaty (1994)
19.	Mexico - United Kingdom Income Tax Treaty (1994)
20.	Moldova - United Kingdom Income and Capital Tax Treaty (2007)
21.	Morocco – Ukraine Income Tax Treaty (2007)
22.	Norway – Ukraine Income and Capital Tax Treaty (1996)
23.	Serbia and Montenegro – Ukraine Income and Capital Tax Treaty (2001)
24.	Serbia – Ukraine Income and Capital Tax Treaty (2001)
25.	Slovenia – Ukraine Income and Capital Tax Treaty (2003)
26.	South Africa – Ukraine Income Tax Treaty (2003)
27.	Sudan - United Kingdom Income and Capital Tax Treaty (1975)
28.	Sri Lanka - United Kingdom Income Tax Treaty (1979)

29.	Turkey – Ukraine Income and Capital Tax Treaty (1996)
30.	Ukraine - United Kingdom Income Tax Treaty (1993)

20 treaties concluded with Hong Kong provide for apportionment or another method as may be prescribed by the laws of the country concerned.

Lastly, 31 double taxation treaties with Thailand refer to certain or reasonable percentage of the gross receipts of the enterprise. Hence, Thailand’s double taxation treaties deviate from the UN Model Convention in that they additionally include the following phrase “or, in the case of a person who does not claim taxation on the basis of the actual net profits of the permanent establishment, on the basis of certain reasonable percentage of the gross receipts of the permanent establishment”. Under this approach, the “profits of the enterprise” are interpreted as the “enterprise’s total gross profit”.²⁴

This means that the income that is attributed to a PE cannot exceed the total gross profits of the enterprise of which it is part.²⁵ This approach is certainly not adopted by the language of Article 7 UN Model Convention, since it has been criticized for “not achieving a result consistent with sound tax policy.”²⁶

V. Domestic Law

A. General remarks

²⁴ OECD, Report on the Attribution of Profits to Permanent Establishments: Update on Status and Release on New Versions of Parts I, II, III (2006) 28, available at <https://www.oecd.org/ctp/treaties/37861293.pdf>; OECD Model: Commentary (2017) para 158.

²⁵ OECD, Report on the Attribution of Profits to Permanent Establishments: Update on Status and Release on New Versions of Parts I, II, III (2006) 28, available at <https://www.oecd.org/ctp/treaties/37861293.pdf>; OECD Model: Commentary (2017) para 158.

²⁶ *Ibid.*

This chapter focuses on the domestic law of certain G-24 countries. This first part aims at shedding light on the different legal forms that taxation of income of non-resident service providers may take. Typically, countries legislate their own PE standard, which is not always the same as the OECD or UN concept. The effect of the double taxation treaties in domestic law is that these treaties establish ceiling based on which countries may tax non-residents. Put it differently, double taxation treaties put limits on countries' taxing rights. In this context, it is also examined if and to what extent there is room for digital companies to form a PE in these countries albeit non-physically present.

The second part of this chapter concerns the domestic law provisions dealing with the calculation of an enterprise's profits for taxation purposes. This part is necessary on the following grounds; the application of apportionment of profits as set forth in double taxation treaties applies "as long as it is customary" for Contracting States to determine the profits to be attributed to a PE on the basis of an apportionment.²⁷ Therefore, it must be examined whether the domestic law leaves room for applying apportionment internally and, if yes, internationally. The domestic law of the countries that are examined here does not explicitly refer to the method of apportionment for the calculation of profits that are attributed to a PE. Thus, it must be examined whether the interpretation of the relevant provisions would allow for apportionment. In this regard, the opinion of national committees, as well as national court's judgements are analyzed.

For the purposes of this analysis, the domestic laws of South Africa and India have been chosen. The domestic law of South Africa follows the approach reflected in Article 5 OECD Model Tax Treaty. Yet, a number of double taxation treaties where South Africa is Contracting State expand this definition by including Article 7.4 UN Model Tax Treaty. India, on the other hand, has come under the spotlight of international tax system with its participation in the OECD/20 BEPS project, as well as the recent proposal of certain amendments to its domestic law. These proposals were made by a Committee formed by the Central Board of Direct Taxes, which is part of Department of Revenue in the Indian Ministry of Finance. Both the existing provisions of Indian domestic law and the proposals concerning PE and FA are hereby examined.

²⁷ UN Model Convention, Article 7.4.

Additionally, the application of fractional apportionment has been accepted in both countries under examination. Despite this fact, however, the notion of the term “customary” that is referred to in Article 7.4 UN Model Tax Treaty is left undefined. Therefore, the mere acceptance of fractional apportionment by a country may not suffice to trigger the application of the relevant provision that is included in double taxation agreements.

B. Permanent Establishment

1. India

As previously mentioned, India recently made certain proposals in its domestic tax law. To this end, the Central Board of Direct Taxes formed a Committee submitted a report for public consultation on 18 April 2019, aiming at dealing with the consequences that the new OECD proposal may bring for developing countries.²⁸ Before analyzing with proposal, the existing PE provisions in Indian domestic law are examined.

The issue of PE in India is regulated by the Indian Tax Act.²⁹ The Indian legislation prescribes that for a PE to exist, no physical presence is necessarily required. As such, India’s right to tax can be extended to also digital companies that are not physically established in its territory. In 2018, specifically, India introduced the concept of a nexus rule, the so-called “significant economic presence”.³⁰ This rule aims at expanding India’s taxation rights over business profits of both digital and non-digital multinational firms.³¹ According to the 2018 Financial Act, “significant economic presence” comprises of any:

²⁸ Government of India Ministry of Finance Department of Revenue, Central Board of Direct Taxes, Public Consultation on the Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment, F. No 500/3/2017-FTD.I (2019).

²⁹ Government of India Indian Ministry of Finance, Income Tax Act of 1961.

³⁰ Government of India Indian Ministry of Finance, Finance Bill, 2018, Chapter 3 (Direct Taxes), Clause 4 (Amendment of Section 9) Explanation 2A 7.

³¹ Nagappan M, Unnikrishnan A, *India developing “significant economic presence” test to increase taxation of multinational firms* (2018) Multinational Group Tax & Transfer Pricing News, available

- (i) “transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed” or
- (ii) any “systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.”³²

Hence, according to the “significant economic presence” test, digital transactions or activities may give rise to business connection and thus to India’s taxation rights, based on two alternative threshold factors: (i) the number of users and (ii) the amount of revenue generated in India.³³ Activities that exceed the threshold of either (i) or (ii) are taxable by a digital tax regardless of whether physical presence exists.³⁴

The Committee’s new proposal on significant economic presence involves more factors based on which economic presence may be established in a market jurisdiction. An indicative list of such factors is hereby provided:

- the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- the maintenance of a website in a local language
- sustained marketing and sales promotion activities, either online or otherwise.³⁵

2. South Africa

at <https://mnetax.com/india-developing-significant-economic-presence-test-to-increase-taxation-of-multinational-firms-28569> ‘accessed 15/11/2019’.

³² (n 2).

³³ Narayanan L, *Taxing Digital Transnational Corporations: Indian Policy Initiatives* (2019) International Center for Tax and Development, available at <https://www.ictd.ac/blog/taxing-digital-transnational-corporations-indian-policy-initiatives/> ‘accessed 14/11/2019’.

³⁴ Deloitte, *Finance Act 2018 Enacted* (2019) <https://www.taxathand.com/article/9431/India/2018/Finance-Act-2018-enacted> ‘accessed 14/11/2019’.

³⁵ (n 2); Falcao T, *The OECD’s Digital Economy Taxing Rights Allocation Mash-Up* (2019) Tax Notes, available at <https://www.taxnotes.com/tax-notes-international/digital-economy/oecd-digital-economy-taxing-rights-allocation-mash/2019/08/05/29smr> ‘accessed 14/11/2019’.

According to South African domestic law that is currently in force, the notion of PE is defined by reference to the definition of the OECD Model Tax Convention. According to the traditional OECD approach, the existence of PE requires a physical presence,³⁶ which does not encompass the provision of services by digital companies. Recently, however, the National Treasury released proposal on modifying the Income Tax Act.³⁷ It is particularly suggested that the UN Model Convention definition of PE should be used instead of the OECD one. The PE under the UN definition “allows the source country a wider scope to impose tax on the non-resident. It also enables our treaty negotiators to be in a position to negotiate concessions with other countries or allows them to offer some benefits to residents of countries which have concluded treaties with South Africa.” In other words, the PE as established in the UN Model Convention broadens the scope for the source taxation of business income in South Africa. Specifically, under the UN Model Convention’s definition, a service PE can be established by a mere – rather than necessarily physical - presence in a country for 183 days in a twelve-month period.³⁸

The definition of PE under the South African domestic law can be aptly illustrated by *AB LLC and BD Holdings LLC* case, where the South African Tax Court had to determine whether a PE had been created.³⁹ The case involved two US incorporated enterprises, engaged in consulting services to airlines and providing certain strategic and financial advisory services to a company based and operating in South Africa, from February 2007 to May 2008. The project was mainly provided by three employees that used to go over South Africa, on a rotational basis, for three-weeks at a time. During 2007, the employees continued their activities in South Africa for more than 183 days. In addition, the South African customer provided accommodation for the employees.

³⁶ Committee of Experts on International, Tax consequences of the digitalized economy E/C.18/2017/CRP.22 Cooperation in Tax Matters Fifteenth session (2017); OECD, Interpretation and Application of Article 5 (Permanent Establishment) of the Model Tax Convention (2012), available at: <https://www.oecd.org/tax/treaties/48836726.pdf>.

³⁷ 2019 draft Taxation Laws Amendment Bill.

³⁸ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy; Avi-Yonah (2016); European Parliament, Impact of Digitalization on International Tax Matters: Challenges and remedies

³⁹ South Africa v AB LLC and BD Holdings LLC, Case No 13276 (2015) (Tax Court of South Africa).

The Court interpreted and applied the US – South Africa double taxation treaty, and specifically Articles 7(1), 5(1) and 5(2). Article 7(1) stipulates that the profits of a US enterprise shall be taxable only in the US, unless that enterprise conducts business in South Africa through a permanent establishment located in South Africa. Furthermore, it provides that where business is carried on through a permanent establishment, the profits of the enterprise may be taxed in South Africa, but only to the extent that they are attributable to that permanent establishment. In turn, Article 5(1) provides as follows:

“For the purpose of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

In addition, Article 5(2)(k) of the double taxation treaty provides that the term “permanent establishment” includes especially:

“The furnishing of services, including consultancy services, within a contracting state by an enterprise through which employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or connected project) within that state for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the taxable year concerned”.

The taxpayer claimed that Article 5(2)(k) of the US – South Africa double taxation treaty, which refers to the provision of services, is subject to Article 5(1). Thus, it claimed that a PE is created first under Article 5(1), and only in such a case is Article 5(2)(k) considered. The South African Revenue Service (“SARS”), on the other hand, argued that should the elements of Article 5(2)(k) be fulfilled, a PE exists even without the requirements of Article 5(1) being met.

In interpreting the US – South Africa double taxation treaty, the Court referred to the general principles of interpretation and emphasized the need that “the term must be given a meaning that is congruent with the language of the DTA having regard to its object and purpose”. It essentially examined the word “include” as referred to in the *chapeau* of Article 5(2), starting from its ordinary meaning. Based on this interpretation, it found that the factors mentioned in Article 5(2)(k) are part of the definition referred to in 5(1).

However, such a conclusion cannot be drawn by the Commentary of the OECD Model Convention. Since Article 5(1)(k) is not contained in the OECD but

in the UN Model Convention, the Commentary could not provide answer in that regard. Even though it refers to an existing link between Articles 5(1) and 5(2), subparagraph (k) of 5(2) is different from subparagraphs (a) – (f) that are included in the OECD Model Convention.

This conclusion is reinforced by the Technical Explanation, an official guide to the Convention that reflects the understanding with respect to its application and interpretation. According to the Court, the Technical Explanation makes it clear that in considering the furnishing of services by an enterprise under 5(2)(k), the interpretation accorded to the place of work set out in Articles 5(2) (a) to 5(2)(f) is not relevant. Quite to the contrary, it indicates that the furnishing of services does not have to occur within a fixed place of business. Thus, once the requirements of Article 5(2)(k) are met, there is no need for further examination of whether the conditions of 5(1) are also met. Rather, Article 5(2)(k) is self-standing, and instead of referring to a place of work, it refers to a form of work. For this reason, the non-resident party (the claimant in this case), is not required to carry out all its business from the “fixed place of business” so established. On the basis of this analysis, the enterprises’ activities fall within the ambit of article 5(2)(k), and thus the enterprises are liable for taxation in the non-resident country. What is notable here is that the US attaches another interpretation of the same provision of this treaty. In the Canadian case of *Haas Estate v The Queen*, the Court stated as follows:

“There is no international tradition or procedure for an exchange of subsequently bargained documents as determinative of treaty interpretation. The Technical Explanation is a domestic American document. True, it is stated to have the endorsement of the Canadian Minister of Finance, but in order to bind Canada it would have to amount to another convention, which it does not. From the Canadian viewpoint, it has about the same status as a Revenue Canada interpretation bulletin, of interest to a Court but not necessarily decisive of an issue”.⁴⁰

This statement of the Canadian Court is an example of how the meaning given by each domestic law to international can vary.

⁴⁰ *Haas Estate v Canada*, DTC 5001 (2001) (Federal Court of Appeal).

Furthermore, the South African Court had also to consider the “183-day requirement” that is mentioned in US – South African treaty. It was common cause that the appellant satisfied the 183-day requirement for the 2007 and 2008 years. Yet, concerning the 2009 tax year, the appellant contended that if an entity spends less than 183 days in any twelve-month period in a country, it cannot be said to have set up a PE in that country. The Court held that:

“The fact that the duration spanned over two fiscal years does not mean that the 183 day period has to be separately calculated for each fiscal year for, as stated in the Commentary on the OECD Model, if the presence in each fiscal year was only 51/2 months, then the entity would avoid paying tax to the country in which the income was earned (or profits made) despite the fact that its presence in that country was for longer than 183 days. This interpretation, which is the one we are enjoined by the appellant to adopt, defeats the object of the [double taxation agreement], is contrary to the intention of the parties and stands in stark contrast to the interpretation proffered in the OECD Commentary.”

In sum, the requirements of article 5(2)(k) were met and therefore the appellant was liable for taxation in South Africa, since its operations fell within the meaning of PE as used in the double taxation agreement.

As the above case also indicates, the definition of the PE concept in South African domestic law requires a physical presence,⁴¹ which does not encompass the provision of services by digital companies. To deal with this issue and respond to the challenges in applying the PE concept to e-commerce, the Davis Tax Committee released its first interim report detailing the South African perspective on BEPS. By referring to an example of companies like Google, the Committee emphasized the need of making amendments by taking guidance from the OECD’s reform measures. A good starting point would be to recognize a foreign enterprise’s digital presence by applying a “virtual PE” criterion and expanding the conventional physical presence concept.⁴²

⁴¹ Committee of Experts on International, Tax consequences of the digitalized economy E/C.18/2017/CRP.22 Cooperation in Tax Matters Fifteenth session (2017); OECD, Interpretation and Application of Article 5 (Permanent Establishment) of the Model Tax Convention (2012), available at: <https://www.oecd.org/tax/treaties/48836726.pdf>.

⁴² Hongler, P. and Pistone, P. Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, Working Paper, IBFD 20 January 2015.

C. Attribution of profits to a PE

1. India

Indian current and proposed legislation with regard to FA is also of interest. The Indian Income-Tax Rules that are currently in force provide for the determination of income in the case of non-residents in Rule 10 as follows:

“In any case in which the [Assessing Officer] is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India or through or from any property in India or through or from any asset or source of income in India or through or from any money lent at interest and brought into India in cash or in kind cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax [...] may be calculated.

(i) at such percentage of the turnover so accruing or arising as the [Assessing Officer] may consider to be reasonable, or

(ii) on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or

(iii) in such other manner as the [Assessing Officer] may deem suitable.”⁴³

Based on this provision, the Assessing Officer is provided with wide discretion to determine the income of a non-resident; one of the ways based on which this income will be determined is formulary apportionment.⁴⁴

The Committee does not find the existing formulary apportionment method appropriate due to practical difficulties in obtaining information regarding revenue

⁴³ Income Tax Rules 1961, Rule 10.

⁴⁴ KPMG, *Report on proposed amendments of rules for profit attribution to permanent establishment in India open for public consultation* (2019), available at <https://home.kpmg/content/dam/kpmg/in/pdf/2019/04/KPMG-Flash-News-PE-Attribution-Committee-Report.pdf> 'accessed 14/11/2019' 'accessed 6/11/2019'.

and assets of multinational companies that are established outside India. Based on these concerns, the new proposal provides for amendments of Rule 10 by including a FA method instead of formulary. What the Committee particularly recommends is that business profits be allocated partly to the country where the consumers are located and partly to the country where activities are conducted.⁴⁵ Such a method would permit India to derive profit from applying the overall profitability of a multinational company, even if the latter's separate accounts do not reflect its branch activities in a clear manner.⁴⁶

In view of these considerations, the Committee makes the following recommendations:

First, that the determination of business profits will be based on equally weighted three factors; sales, employees, including manpower and wages, and assets. Second, in cases where "significant economic presence" is established, business profits will be determined on the basis of four factors; sales, employees, assets and users. Third, that multinational companies must be relieved from double taxation according to international double taxation agreements and the principles underlined by the Supreme Court of India in *Morgan Stanley*.⁴⁷ For this to be achieved, no further profits will be attributable to the operation of an enterprise in India, where the enterprise does not receive any payments on accounts of sales or services from any person who is resident in India and the activities of associated enterprise have been fully remunerated by an arm's length price".

By seeking to base profits attribution on a FA method, the Committee partially rejects the OECD's approach regarding PE profit attribution. The reason of this choice of India is that an approach reflected in article 7 of the OECD Model Convention can have significant adverse consequences for developing countries, especially for those that mostly import capital and technology services.⁴⁸ The Committee essentially underlines that this view "has been communicated and shared with other countries consistently and on a regular basis."

⁴⁵ Income Tax Rules 1961, Rule 10.

⁴⁶ (n 9).

⁴⁷ See general *DIT v Morgan Stanley* (2007) 292 ITR 416 (Supreme Court of India).

⁴⁸ (n 9); Govel A, *The Future of 'Significant Economic Presence' in India* (2018) Global Tax Governance in International Tax Law Making, available at <https://globtaxgov.weblog.leidenuniv.nl/2018/09/10/the-future-of-significant-economic-presence-in-india/> 'accessed 6/11/2019'.

India provides for FA method in numerous international tax treaties in accordance with Article 7.4 UN Model Convention. Particularly, from the 96 double taxation treaties in force to which India is a party, FA is included in 58 treaties. The majority of the treaties including FA (29 out of 58) do not deviate from the UN Model Convention text. 20 of them contain non-significant deviations, and only 9 treaties significantly deviate from the UN Model Convention text. The ratification of the MLI by India in October 2019 had impact on certain double taxation treaties where India is Contracting State with regard to, *inter alia*, PE, such as the India-France tax treaty, which has also adopted a broader agency PE rule.⁴⁹ By contrast, this rule is not applicable with regard to India's double taxation agreements with the UK, Netherlands and Singapore that have made a respective reservation.

2. South Africa

The apportionment of business profits has been held allowable in South Africa. Practical difference is, however, found in allocating profits to different sources.⁵⁰ This may result in the rule of dominant or real source being applied. In *ITC 1491*, for instance, the Supreme Court of South Africa found that profit received by a taxpayer based in South Africa could be calculated by apportioning certain profits from a source within South Africa.⁵¹ The potential applicability of an apportionment of profits in South African law may also arise by the fact that the South African company law does not regard a branch as a legal entity separate from its foreign head office.⁵²

However, it is important to note that contrary to international tax treaties that most often refer to the attribution of "profits" to a PE, the South African Income

⁴⁹ Deloitte, Multilateral Instrument (MLI) Ratification: Impact on Indian tax treaties (2019), available at <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-multilateral-instrument-ratification-noexp.pdf> 'accessed 6/12/2019'.

⁵⁰ Groenewald B H, A Critical Analysis of the Principle of Permanent Establishment and Related Tax Rules in Establishing Taxing Rights with Reference to E-commerce (2016) para 3.4.2.2.

⁵¹ *The Commissioner for the South African Revenue Services v MEGS Investments (PTY) LTD SNKH Investments (PTY) LTD* (2004) (Supreme Court of Appeal of South Africa).

⁵² Ogottu A W, *The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective* (2009) 21 SA Merc LJ 773, 788.

Tax does not refer to the taxation of profits but rather it refers to the notion of “taxable income”. Thus, it could be argued that the concept of “attributing profits” within the meaning of double tax treaties does not accord with the South African Income Tax. Apart from that, the South African Income Tax does not contain specific rules on attributing profits to a PE. Section 5(2) of the Income Tax simply states that a non-resident company doing business in South Africa through a branch or agency is taxed on a source basis at a rate of 34 per cent. Based on that, it is assumed that the same rate is applicable to PEs.

VI. Conclusion

Our research showed that out of 3181 tax treaties in force, 2050 treaties do not include a provision on furnishing of services in the article on business profits in the double taxation treaties.

A previous survey carried out by survey by Reuven Avi-Yonah and Zachee Pougá Tinhaga in 2014 showed that many developing country double taxation treaties have included a “fractional apportionment” provision. Further, a 2014 study argued that most developing countries are not bound by the authorized OECD approach to Article 7. Our research mainly supports this finding by showing that 58.51% of double taxation treaties of developing countries include a provision on apportionment similar to the text of Article 7.4 of the UN Model Convention. 8.75% of developing country double taxation treaties include a provision on apportionment with substantially significant deviations from the text of Article 7.4 of the UN Model Convention.

We also found that out of 3181 treaties in force, only 2166 treaties include a provision on apportionment. Out of these agreements that contain the provision, around 90% have no or insignificant deviations from the text of Article 7.4 of the UN Model Convention, and around 10% include a provision on apportionment with substantially significant deviations. However, it is worth noting that around $\frac{1}{3}$ of developing country double taxation treaties do not include a provision on apportionment, and this number might be taken into account in the discussions on feasibility of adopting unitary taxation principles within the context of the existing treaty network.

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