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2018-03-19

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Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
Client File: GAAR

Vern Krishna, Tax Chambers, discusses permanent establishment, and the problems of monitoring the taxation of multinational enterprises, as well as the OECD's plans to rectify these issues.

Tax Actions Beget Tax Reactions (Vern Krishna)
Date: March 19, 2018
Tax Actions Beget Tax Reactions

By Vern Krishna, CM, QC

As in Newtonian physics, actions in tax law attract reactions. As global trade expands, so do the problems of monitoring the taxation of multinational enterprises (MNEs). Countries are eager to claim taxing jurisdiction over foreign corporations that operate within their borders as provide revenues and cannot generate the political emotion that domestic persons muster.

Early on, the League of Nations recognized the propensity of governments to tax foreign corporations. Hence, they conceived the notion of the "permanent establishment" (PE) to restrain unwarranted taxation of foreign corporations. T. S. Adams (the US representative on the team of Technical Experts of the League of Nations) played a significant, even predominant, role in developing the notion of the PE to protect the business interests of American MNEs. His assistant, Mitchell Caroll, said:

> After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States firm [Sears Roebuck] on profits from advertising its wares and receiving mail orders from customers in its territory. In the early 1920's, the British Board of Inland Revenue sought to impose liability … [on] sales through a local commission agent … even if the non-resident and his British intermediary took pains to conclude the contract abroad.

The fundamental theory underlying the concept of PE in international tax treaties is to tax the business income of MNEs trading *in*, as opposed to trading *with*, a country. A PE provides a measure of the depth of an enterprise's presence in a country. The concept is intended to prevent governments from overreaching their power by taxing persons based on an insignificant presence in the source country.

To be taxable in the source country, the MNE's profits must be attributable to a notional "distinct and separate enterprise"—the PE—engaged in business in the country. This avoids tax obligations where an enterprise generates only minimal profits without a sufficient presence in the country.

A PE generally requires a fixed place of business in the country. However, the fixed place rule is subject to the agency rule, which enlarges the jurisdiction to tax even where an MNE does not have a fixed place in the country. Under the *OECD Model Treaty*, which Canada uses to negotiate most of its treaties, a MNE would have a PE in a country if a dependent agent acting on its behalf habitually exercised an authority to conclude contracts in its name in the country.

The basic concept underlying this rule is that an agent's presence and power may—despite the absence of any physical premises in the country—be akin to the principal's fixed place of business. In effect, the agency rule shifts the focus of the nexus for a PE from a geographic fixed place of business, to an economic presence test. Hence, a MNE may have a PE in a country even if it does not have a fixed place of business therein.

However, sophisticated tax lawyers soon figured out a way around the rule by structuring *commissionaire* arrangements, under which the agent would sell sells products in a country in its own name, but on behalf of a foreign MNE that actually owned the products. The MNE would not have a PE to which sales could be attributed for tax purposes and, hence, would avoid tax in the source country where the goods were sold. At the same time, the agent selling the products would not own them and, therefore, could not be taxed on the profits from the sale. In this way, neither the MNE nor the agent would be subject to tax in the country of sale. Alternatively, contracts substantially negotiated in a country would not be formally concluded in it because they would finalized abroad.

The OECD reacted to these arrangements of convenience and revised its 2017 Model Treaty. Under the new rule, an enterprise may have a PE in a country if an agent acting in the country on behalf of the enterprise has, and habitually exercises, in that country an authority to conclude contracts in the name of the enterprise, *or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*.

The phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" enlarges the concept of agency PE, and is intended to thwart tax avoidance. The change is prospective only and is not intended to affect the interpretation of former provisions of the OECD Model.

The OECD's reaction to international tax planning will no doubt have sophisticated tax lawyers working overtime to allow their MNE clients to work their way around the new rules. Unlike Newtonian physics, however, tax reactions attract legislative responses.

Professor Vern Krishna, CM, QC

Counsel, Tax Chambers LLP (Toronto)

vern.krishna@taxchambers.ca

www.vernkrishna.com

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