

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

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# Taxation of Non-residents on Business Profits

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## 1. Introduction

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

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

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

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

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

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

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

This paper focuses on Articles 5 and 7 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries (“UN Model Convention”) and the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital (“OECD Model Convention”).<sup>4</sup> A thorough discussion of the taxation of services (including the services of artistes and sports persons) and investment income, which are important types of business profits, is covered under separate parts.<sup>5</sup> The taxation of other types of business

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

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

<sup>4</sup> Unless specified otherwise, any references to Articles in this paper are references to the Articles of the UN and OECD Model Conventions.

<sup>5</sup> See Ariane Pickering, Taxation of Non-resident Service Providers; and Jan de Goede, Taxation of Investment Income and Capital Gains, Parts 6-A and 7-A of this collection respectively.



Several considerations need to be taken into account in designing rules on requesting information.

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

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

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

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

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

### 2.2.2 Withholding agents

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

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

### 2.2.3 Other government agencies

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

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

<sup>11</sup> Couzin, *supra* note 6, at p.183.



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



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

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

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

Type of business profits	UN Model	Threshold for taxation in Source country	Taxable Amount
General	Art.7	PE	Net profit
Immovable property	Art.6	Situs of property	Net profit (gross-basis withholding on rent is allowed in some cases)
Transport	Art.8	N/A (taxable exclusively in the country in which the place of effective management is situated)	
Dividends, interest, and royalties	Art.10 Art.11 Art.12	- Residency of payer, or - PE or fixed base that bears the cost of the interest/ royalties	-Gross amount under Arts.10,11 and 12 -Net basis under Art.7 and Art.14

Independent personal services	Art.14	- fixed base, or - physical presence of 183 days or more in any 12-month period	Net basis
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the source country, not only business profits attributable to the PE are taxable in the source country, so are dividends, interest and royalties if the holding of the shares, debts or property is effectively connected with such PE.<sup>19</sup> The UN Model Convention further allows the source country to tax profits derived from sales in the source country of goods merchandise of the same or similar kind as those sold through that PE, or other business activities carried on in the source country of the same or similar kind as those effected through that PE. Treaties define the meaning of a PE in different ways, depending on the type of activities.<sup>20</sup>

#### 4.2 Fixed place of business without specific time requirement

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

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

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

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

<sup>19</sup> Articles 10(4), 11(4) and Article 12(4), respectively, of the UN Model Convention.

<sup>20</sup> For further discussion, see Brian J. Arnold, “Threshold Requirements for Taxing Business Profits under Tax Treaties,” in Arnold, Sasseville and Zolt, *supra* note 6, at p. 55-108.

<sup>21</sup> Paragraph 3 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 5.1 of the Commentary on Article 5 of the OECD Model Convention.

<sup>22</sup> Paragraph 3 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 6 of the Commentary on Article 5 of the OECD Model Convention.

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

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

#### 4.4 Physical presence

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

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

<sup>23</sup> The OECD Model Convention does not mention assembly and supervisory activities. For further discussion of the differences between the UN and OECD Model Conventions, see paragraph 7 of the Commentary on Article 5 of the UN Model Convention.

<sup>24</sup> Paragraph 11 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 18 of the Commentary on Article 5 of the OECD Model Convention.

<sup>25</sup> Paragraph 11 of the Commentary on Article 5 of the UN Model Convention, quoting paragraph 20 of the Commentary on Article 5 of the OECD Model Convention.

<sup>26</sup> For further discussion of Article 14, See Ariane Pickering, Taxation of Non-resident Service Providers, Paper 6-A of this collection.



#### 4.7 Subsidiary versus PE

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

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



## 5. Attribution of profits

### 5.1 Introduction

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

### 5.2 Force of attraction

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

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

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

#### 5.4 Deductibility of expenses

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

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

<sup>30</sup> Paragraph 15 of the Commentary on Article 7 of the UN Model Convention, quoting paragraph 14 of the Commentary on Article 7 of the 2005 OECD Model Convention.

<sup>31</sup> E.g., section 67 of the Canadian Income Tax Act limits the amount of deductible expense to the reasonable amount.

<sup>32</sup> Paragraph 18 of the Commentary on

## 5.5 Source rules

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

The above point is confirmed by the effectively connected principle underlying Articles 10, 11 and 12: dividends, interest, royalties and other income that is effectively connected with a PE are attributable to the PE and taxable under Article 7. However, the force of attraction rules under Article 7(1) (b) (c)



## 7. Conclusions

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

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