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International Taxation, the BRICS, and the Brazilian Experience: Tracing Patterns and Drawing Comparisons on Taxation of Business Profits

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Declaration

I, Marcelo Pedroso Ilarraz, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

Abstract

The specialized literature identifies a number of factors that influence economic growth, usually centring its attention either on geography, on the integration between rich and poor countries when it comes to international trade, or on institutions. The institutional factor assumes a particular relevance when developing and developed countries face the challenges of taxing income from international transactions. In this context, the question about which jurisdiction would have the taxing right on such an income is the main friction point; then the question on the mechanisms to allocate profits to different taxpayers in different jurisdictions comes into play. In light of this, the thesis addresses the following research question: to what extent can the experience of the BRICS countries in the taxation of business profits provide a different framework for developing countries? It does so by applying a comparative methodology through a functional analysis of the legal systems of Brazil, India, and South Africa. Three research objectives, or sub-questions, guide this research endeavour: (i) to investigate the level of influence of the OECD MC on the compared countries' tax treaty networks with regards to taxation of business profits (and, as a result, the level of deviation from the OECD MC towards the UN MC); (ii) to analyse whether and to what extent the adoption by developing countries of a transfer pricing regulation that does not entirely mirror the OECD's one would be convenient for those jurisdictions; and (iii) to consider the building up of an alternative transfer pricing framework derived from the thesis's findings. The thesis is divided into five substantive chapters. It evolves from a general assessment of the income tax legislation and the tax treaty networks of the compared countries (Chapter 2) to a critical analysis of the provisions dealing with business taxation (Chapters 3 to 5) to, finally, presenting a transfer pricing proposal that could be more beneficial for developing countries (Chapter 6). The chapters dedicated to the analysis of the domestic law and of specific treaty articles (Articles 5 on the permanent establishment concept, Article 7 on attribution of profits to permanent establishments, and Article 9 on taxation of associated enterprises) are structured in a similar way, so that they offer a consistent and coherent comparative framework for the thesis purposes. The research findings show that, while those countries do not adopt a coordinated treaty policy, they deviate from the OECD MC in respect to various provisions, to different degrees. In many cases, conventions were signed with OECD member countries that provided for a treatment far more beneficial to the source country on taxation of business profits than

the one adopted by the OECD MC. Tax treaties that were patterned after either the UN MC and the OECD MC were signed between relevant FDI origin jurisdictions and the compared countries. Such findings then provide the answer to the question on whether the alignment with the OECD MC (mainly with respect to the attraction of FDI) is mandatory. The answer seems to be negative. Finally, drawing on the domestic regulation and tax treaty networks analysis, the thesis puts forward a proposal of a regulatory-based, pre-fixed profit margins transfer pricing framework aiming at providing developing countries with a regulatory system that is focused on the legal certainty needed for FDI attraction. It privileges transparency and the due scrutiny by the governments of the fiscal and regulatory outcomes as intended by developing countries when they enact the transfer pricing legislation.

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List of Acronyms

BEPS	OECD/G20 Base Erosion and Profit Shifting Project
BRICS	Brazil, Russia, India, and South Africa
CARF	Administrative Tax Appeal Tribunal
CIT	Commissioner of Income Tax
G20	Group of Twenty
GDP	Gross Domestic Product
IBFD	International Bureau of Fiscal Documentation
IMF	International Monetary Fund
ITAT	Income Tax Appellate Tribunal
LN	League of Nations
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing Power Parity
RFB	Brazilian Federal Revenue Service
SARS	South African Revenue Service
STF	Federal Supreme Court
STJ	Superior Court of Justice
TP	Transfer Pricing
TPO	Transfer Pricing Officer
TRF	Federal Court of Appeal
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
WB	World Bank
WEO	World Economic Outlook

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CHAPTER 1

Introduction

1.1 Research Purpose and Scope

To what extent can the experience of the BRICS[1] countries in international taxation provide a pathway that deviates from the OECD's framework and, at the same time, is more beneficial to developing countries[2] on taxation of business profits? The thesis seeks to address this question by investigating the legal framework adopted by Brazil, India, and South Africa regarding the taxation of corporates' income derived from international transactions. This is placed within an institutional context analysis. In this respect, the specialized literature identifies a number of factors that influence economic growth, usually centring its attention either on geography, on the integration between rich and poor countries when it comes to international trade, or on institutions.[3] Such factors matter when examining whether a specific country provides an adequate environment for the desired pace of growth. Among all three, the institutional factor is assumed to be the most relevant factor.[4]

As for the institutional context, the legal system plays a distinguished role. The legal framework settles the rules of the game under which countries will experience

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[1] The BRICS acronym stands for Brazil, Russia, India, China, and South Africa. Jim O'Neil coined its first version (BRIC) in 2001. See Jim O'Neill, *Building Better Global Economic BRICs* (Goldman Sachs 2001). Available at <http://www.content.gs.com/japan/ideas/brics/building-better-pdf.pdf> accessed 21 January 2015.

[2] In this thesis, the category developing countries is used interchangeably with the developing economies one. On the classification of countries, see 2.2.1.

[3] Dani Rodrik, Arvind Subramanian and Francesco Trebbi, 'Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development' (2004) 9 Journal of Economic Growth 131, p. 132. Also, for the importance of institutions when one assesses different economies' performance, see Douglas C North, 'Economic Performance Through Time' (1994) 84 American Economic Association 359.

[4] For institutions, the role of property rights and the rule of law receive special attention. There is evidence stressing that institutional quality notably exerts a positive influence on international trade. Rodrik, Subramanian and Trebbi (n 3). On tax matters, quite often the institutional factor is shown as the most valued one. See Helen Rogers and Lynne Oats, 'The Use of Advance Pricing Agreements in Transfer Pricing Management' [2013] B.T.R. 76.

economic growth, including both governments and entrepreneurs among its actors.[5] In the international tax law scenario,[6] those sets of rules provide for the taxing rights for either source or residence countries. When developing and developed countries face the challenges of taxing income from international transactions, the question about which jurisdiction would have the taxing right on such an income is the main friction point; then the question on the mechanisms to allocate profits to different taxpayers in different jurisdictions comes into play. In this context, the UN's and the OECD's works on international taxation take a prominent role. The model conventions they provide function as an instrument to remove barriers for investment (namely double taxation), being widely recognised as an instrument able to enhance economic development linked to foreign investment.[7]

The OECD Model Tax Convention on Income and on Capital (OECD MC) has been the most influential template followed by countries when entering into income tax agreements. Such a prominent role is the result of decades of the OECD acting as the most important forum in the international taxation field. To a great extent, this position was inherited from the work of the League of Nations carried out during the first half of the last century.[8] However, the role played by the OECD in the field as an institution representing mainly developed countries, and their stance on international tax matters, is not immune to criticism.[9]

By its part, the UN recognises the importance of the OECD MC as well as the need for consistency in the setting up of rules dealing with taxation of international transactions. However, it offers its own response. The United Nations Model Double Taxation Convention between Developed and Developed Countries (UN MC) focuses on a

[5] North (n 3) 361.

[6] This work follows the strand of thought that considers International Tax Law as part of International Law. On this matter, see Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press 2007).

[7] On the OECD stance on the issue, see the *2017 OECD MC* (OECD 2017), Introduction.

[8] On the historical background of the appearance of the OECD MC and the influence of the work carried out by League of Nations on international taxation, see *ibid.*, Introduction, 9ff.

[9] On the OECD being a 'rich club' and its influence in the development field, see Matthias Schmelzer, 'A Club of the Rich to Help the Poor? The OECD, "development", and the Hegemony of Donor Countries' in Marc Frey, Sönke Kunkel and Corinna R Unger, *International Organizations and Development, 1945-1990* (Palgrave Macmillan 2014).

template that favours developing countries when entering into income tax agreements.[10] Therefore, the UN MC is concerned with tax rules that provide for legal certainty and for an attractive investment climate, which, in the end, benefits the developing countries' economies.[11] It does so by encompassing several rules that, while deviating from the OECD MC approach, provide for taxing rights more beneficial to the source countries.[12] Within the UN MC, when it comes to the taxation of corporates, the provisions dealing with the presence of foreign enterprises in the host country, coupled with those ones allocating profits to permanent establishments and to associated enterprises, gain particular relevance.

In such a context, and considering the particularities of the BRICS countries under scrutiny in this thesis, key inquiries arise that need to be investigated with more attention within an international taxation research agenda. What is the tax system design adopted by Brazil, India, and South Africa when dealing with taxation of corporates regarding income derived from international transactions? Do they reflect the most accepted standards on international taxation? Is there integration between the international tax practice and the compared countries' practices? If so, does such integration have a positive outcome on the attraction of foreign investment, and ultimately on those countries' economic growth? What were the economic, and to some extent political, driving forces behind the building up of such frameworks?

In order to address the above, the thesis aims to examine the extent to which the compared countries' domestic legislation and treaty policy align with the framework adopted by the OECD on the taxation of corporates' business profits (the law and treaty policies in the thesis are up to date as at 31 December 2017). Thus, the thesis' research question is framed as follows: to what extent can the experience of the BRICS countries in the taxation of business profits provide a different framework for developing

[10] The works that lead to the UN MC had the OECD MC (namely the 1963 Draft Convention and the 1977 OECD MC) as their primary template when they approached the need for a model fit for negotiation between developing and developed nations. On the matter, see Philip Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and Capital* (Sweet & Maxwell 2001), Introductory Topics, A.10, A-6.

[11] On the desired legal certainty for the attraction of investment into the development countries' economies, see the *2011 UN MC* (United Nations 2011), Introduction, paragraphs 5ff.

[12] Such concern is recurrent also when the model convention approaches specific treaty provisions, as is the case of its stance on Article 5. See ibid, commentaries on Article 5 (b), paragraph 10.

countries? Three research objectives, or sub-questions, guide this research endeavour: (i) to investigate the level of influence of the OECD MC on the compared countries' tax treaty networks with regards to taxation of business profits (and, as a result, the level of deviation from the OECD MC towards the UN MC); (ii) to analyse whether and to what extent the adoption by developing countries of a transfer pricing regulation that does not entirely mirror the OECD's one would be convenient for those jurisdictions;[13] and (iii) to consider the building up of an alternative transfer pricing framework derived from the thesis's findings.

Comparative work on international taxation, by itself, is not a novelty within international tax law scholarship. There are relevant works on comparisons of the tax systems of different jurisdictions.[14] Specifically, concerns about the tax policy adopted by developing countries and by the BRICS have been the subject of relevant research and publications.[15] The same can be said with regard to the comparison between the OECD MC and the UN MC and their influence on the treaty policies followed throughout the globe.[16]

Nevertheless, this thesis may contribute to the development in the field. The thesis has the comparative analysis of specific countries' treaty policies as its starting point. It starts by examining the relevance and influence of the model conventions and then assesses the impact of deviations in the main investment origins. Therefore, the contribution of this thesis to international tax law research is twofold: it carries out an in-depth assessment of the level of alignment of the compared countries with the model conventions coupled with an evaluation of their impact on foreign investment and, considering the comparison's results, it puts forward a proposal for a transfer pricing

[13] It is worth mentioning that the UN Practical Manual on Transfer Pricing for Developing Countries follows, in general, the OECD's one. This issue is developed in detail in Chapter 5.

[14] For instance, Hugh J. Ault et al., *Comparative Income Taxation* (Third Edition, Wolters Kluwer 2010).

[15] That is the case, e.g. of Veronika Daurer, *Tax Treaties and Developing Countries* (Wolters Kluwer 2014) and Yariv Brauner and Pasquale Pistone (eds.), *BRICS and the Emergence of International Tax Coordination* (IBFD 2015).

[16] See Michael Lang et al., *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge 2012). Also, for recent works on the importance of the UN MC, see Michael Lang et al, *The UN Model Convention and Its Relevance for the Global Tax Treaty Network* (IBFD 2017). For a quantitative account on the influence of the UN MC, see Wim Wijnen and Jan de Goede, 'The UN Model in Practice 1997-2013' (2014) 68 Bull Intl Taxation 118.

framework that deviates from international practice (more specifically, from the OECD framework) that is thought to be beneficial for developing countries.

The chapters of the thesis are structured in order to offer a comparative scrutiny on the compared countries' domestic legislation and on the OECD MC's influence on particular treaty provisions instrumental to the taxation of business profits. After examining the way the compared countries built their tax treaty networks (Chapter 2), the thesis addresses the PE concept as put forward by Article 5 (Chapter 3) and the allocation of profits to PEs according to Article 7 (Chapter 4). Here, the purpose is to focus on the widening of the PE threshold and on the granting of taxing rights more beneficial to developing countries. In addition, when investigating the taxation of associated enterprises (Chapter 5), the thesis questions the alignment of the respective treaty provisions with the OECD's arm's length principle that underlies the transfer pricing issue. This casts light on the level of alignment of Brazil, India, and South Africa with the international transfer pricing practice, which also affects the way profits are allocated to PEs.[17]

1.2 Justifying the Choice of Jurisdictions: Why Brazil, India, and South Africa

One can say that the international tax[18] regime's rules, as we know today, were mainly influenced by the developed countries' economic interests.[19] Nevertheless, the analysis of the early stages of such a process reveals the relevance of the tax policy adopted by a few developing countries on the matter. In this sense, it is noteworthy that the works that culminated in the Carroll Report of 1933, which is referred to as the basis for the

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[17] There is no substantial divergence of positions between both model conventions on the importance of the arm's length principle for the allocation of profits to PEs. For the UN MC's endorsement of the OECD MC's approach on the matter, see *1980 UN MC* (United Nations 1980), commentaries to Article 7, A. General Considerations.

[18] On the influence exerted by European countries' treaty policies on the League of Nations' models, see John F Avery Jones and others, 'The Origins and Concepts and Expressions Used in the OECD Model and Their Adoption by States' [2006] B.T.R. 695.

[19] For an account on the early works concerned with the setting up of the principles guiding the international taxation, with a special attention to the separate entity and the arm's length principles, see Richard S. Collier and Joseph L. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (Oxford University Press 2017).

development of principles for the allocation of international transactions' business profits,[20] included the assessment of several tax systems of developing countries,[21] with South Africa's and British India's systems being some of them.[22] At the same time, developed countries' fiscal policy concerns occupied a prominent position from the outset of the establishment of the income tax models' provisions to guide the taxation of international transactions. The debate on the appropriateness of the rules dealing with the jurisdiction to tax (whether mostly relying on residence-based or on source-based provisions) in the 1920s is a remarkable example on the matter.[23] A later attempt to adopt a framework more beneficial to capital importing countries, as adopted by the 1943 Mexico Draft, therefore more beneficial to developing countries,[24] failed to influence the development of the international tax regime. It took almost 40 years for the developing countries' interests to gain ground again in the debate around the adoption of the 1980 UN MC.[25]

Recently, the OECD showed concerns about establishing a more inclusive forum for discussions on the rules governing the international tax regime. Since the early 1990s, several countries that are not members of the OECD (many of them developing ones)

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[20] See Jacques Sassevile and Richard Vann, 'Article 7: Business Profits' in IBFD, *Global Tax Treaty Commentaries* (IBFD 2017), 1.2.1.6.

[21] For the jurisdictions assessed, see Mitchell B. Carroll, 'Allocation of Business Income: The Draft Convention of the League of Nations' (1934) 34 Columbia Law Review 473. For a historical account on the works that culminated in the Carroll Report, see Collier and Andrus (n 19), mainly 26ff.

[22] The Carroll Report included the Union of South Africa and British India among the surveyed jurisdictions. For instance, its Volume IV, which highlights the methods of allocation of business profits, referred to the British India's legislation rules on allocation of business profits. See Mitchel B. Carroll, Taxation of Foreign and National Enterprises, Volume 4: Methods of Allocating Taxable Income, Geneva: League of Nations, 1933, Document No. C.425 (b).M.217 (b).II.A, Chapter II - Legal Principles for Allocating Business Profits, paragraph 35. Available at <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=cartaxa.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=2&division=div1> accessed 1 October 2016.

[23] See Michael J Graetz and Michael M O'Hear, 'The Original Intent of US International Taxation' (1996) 46 Duke LJ 1021, mainly 1066ff.

[24] The League of Nations even acknowledged that the 1943 Mexico draft was more appealing to Latin American Countries. See League of Nations Fiscal Committee London and Mexico Model Tax Conventions Commentary and Text. C.88.M.88.1946.II.A, Foreword, p. 6. Available at <http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-15.xml;chunk.id=item-15;toc.depth=1;toc.id=item-15;database=;collection=;brand=default> accessed 1 October 2016.

[25] On the participation of developing countries in the making of the 1980 UN MC, particularly on the role of the Brazil's and India's representatives in the UN's Group of Experts' Drafting Committee, see the *1980 UN MC* (n 17), Commentaries, Introduction, A.

collaborated with inputs on the OECD MC.[26] In doing so, the OECD's intention was to consider the outsiders' collaboration[27] on the evolution of the principles[28] guiding the international tax system.[29] In addition, and perhaps the most important OECD move in the last decades, the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project (BEPS Project) stressed the importance of the participation of developing countries in the international tax debate.[30] Not only were concerns with such jurisdictions' engagement in the BEPS Project pointed out as relevant but also the implementation of the outcomes through an inclusive framework were of utmost importance.[31] Finally, it is worth referring to The Platform for Collaboration on Tax as a joint initiative by the OECD, IMF, World Bank, and the UN that aims to support developing countries in the international tax field.[32] Again, the implementation of the BEPS Project measures has particular relevance.[33]

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[26] See *2017 OECD MC* (n 7), Introduction, paragraph 10.

[27] On the collaboration of non-member countries with regard to the development of the OECD MC, see Baker, *Double Taxation Conventions* (n 10), A.09, A-5.

[28] As pointed out by the OECD, 'It was felt that such outside contributions would assist the Committee on Fiscal Affairs in its continuing task of updating the Model Convention to conform with the evolution of international tax rules and principles'. ibid.

[29] On the relevance of the OECD MC's Commentaries for the interpretation of treaties signed by non-OECD member countries, see Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (Fourth Edition, Wolters Kluwer 2015), p. 48. This thesis returns to this issue in 6.4.3.

[30] For an account of the participation of developing countries in the BEPS project, see OECD, *Strategy for Deepening Developing Country Engagement' (2014).* Available at <http://www.oecd.org/ctp/strategy-deepening-developing-country-engagement.pdf> accessed 21 January 2015. The involvement of developing countries in the BEPS Project has been acknowledged by important international institutions. See, for instance, the position of the International Chamber of Commerce, *ICC Welcomes OECD's Plan to Include Developing Countries in Implementation of BEPS (2016).* Available at <https://iccwbo.org/media-wall/news-speeches/icc-welcomes-oecds-plan-to-include-developing-countries-in-implementation-of-beps/> accessed 1 August 2017. Chapter 6 elaborates on and addresses the issues involved in the BEPS Project with respect to the thesis's subject, notably on the transfer pricing issue.

[31] In this sense, the OECD, responding to a call from the G20 for a 'broad and consistent implementation of the BEPS package, set up the Inclusive Framework on BEPS', with the participation of more than 100 countries/jurisdictions, many of them developing ones. See OECD, *Inclusive Framework on BEPS: Progress Report July 2016 – June 2017.* Available at <www.oecd.org/ctp/beps-about.htm> accessed 1 December 2017.

[32] Such is the goal of the Platform for Collaboration on Tax: 'Amid the growing importance of taxation in the debate to achieve the UN Sustainable Development Goals (SDGs), a major aim of the Platform is to better frame technical advice to developing countries as they seek both more capacity support and greater influence in designing international rules'. See IMF, OECD, UN, and World Bank, *Platform for Collaboration on Tax.* Available at <http://www.worldbank.org/en/programs/platform-for-tax-collaboration> accessed 1 December 2017.

[33] See World Bank, *The Platform for Collaboration on Tax: Concept Note* (World Bank 2016), 7-8, E1 and E2.

It is against this backdrop that the thesis is framed. The selection of the tax systems of Brazil, India, and South Africa as the subject for comparison is supported by several factors. It is assumed that these countries share some common constraints when facing the goal of development. Moreover, they even face similar fiscal challenges regarding their potential growth,[34] which implies the necessity of designing their tax system in order to, on the one hand, have a more attractive investment environment and, on the other hand, keep their tax revenue[35] at a desirable level.[36]

It is worth noting that the compared countries express, to a certain extent, a coordinated view when dealing with international taxation and development issues. Since its inception, the BRICS group[37] has been committed to working together to tackle 'the pressing problems of development'.[38] Such concern has strengthened the BRICS countries' standing since they reinforce the need to exert their taxing powers when economic activity takes place in their territories.[39] Moreover, these countries have taken active participation in discussions on international tax issues, as is the case of the

[34] IMF, *Taxing Times.* (International Monetary Fund 2013), p.14.

[35] The International Monetary Fund considers the tax receipts and the tax ratio of a specific country, measured against its peers' data, as common approaches for comparison. See ibid. The present work considers both the amount (and relevance) of income tax receipts, and the tax-GDP ratio, as a starting point for the comparison proposed.

[36] Such a difficult balance is identified as a challenge to political leaders in developing countries. It is even assumed that the criticism they could face in case they fail to attract investment into their countries' economies would be higher than the disapproval for occasional reduction in tax collection. See Michael C. Durst, 'Self-Help and Altruism: Protecting Developing Countries' Tax Revenues' in Thomas Pogge and Krishen Mehta, *Global Tax Fairness* (Oxford University Press 2016), p. 329,

[37] The acronym stood as BRIC originally. See O'Neill (n 1). The BRICS acronym appeared when South Africa joined the group in 2011. See BRICS, *Third BRICS Summit: Sanya Declaration and Action Plan (2011)* <http://brics6.itamaraty.gov.br/category-english/21-documents/67-third-summit> accessed 21 January 2015. On South Africa's economic performance and additional data measured against its pairs by the time the country was invited to join the BRICS, see Ron Sandrey, 'South Africa's Way Ahead: Are We a BRIC?' in Ron Sandrey et al. (eds), *BRICS: South Africa's Way Ahead* (Trade Law Centre 2013), p. 33ff.

[38] BRIC, *BRIC's Foreign Ministers' Meeting, May 16, 2008 - Joint Communiqué*. Available at <http://brics6.itamaraty.gov.br/images/bric-ministerial-communique> accessed 21 January 2015.

[39] Point 17 of the *Sixth BRICS Summit: Fortaleza Declaration and Action Plan* (2014). Available at <http://brics6.itamaraty.gov.br/category-english/21-documents/223-sixth-summit-declaration-and-action-plan> accessed 21 January 2015.

OECD/G20 BEPS Project[40] and the work carried out by the UN's Committee of Experts on International Cooperation in Tax Matters (UN Committee of Experts).[41]

Finally, it is necessary to make it clear that this thesis deals only with Brazil, India, and South Africa also due to practical reasons. A comparison that includes all the BRICSs is out of the scope of this thesis for time and space constraints. Additionally, the lack of a substantial amount of academic literature in English on the Russian and Chinese tax systems was considered as a factor for the selection of the countries compared.

1.3 Methodology

The thesis examines the characteristics of each country's tax system regarding the taxation of international transactions applying a comparative methodology. The comparison is carried out through a functional analysis of the compared countries' legal systems, [42] which means that it identifies how certain tax rules function in each

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[40] See OECD (n 31)

[41] For documents on the BRICS countries' participation in the committee, see UN Department of Economic and Social Affairs, *FFD Follow-up.* Available at <http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html> accessed 21 January 2015. An interesting example is provided by the work developed by the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries. Available at <http://www.un.org/esa/ffd/wp-content/uploads/2015/01/BepsIssues.pdf> accessed 21 January 2015. It is also worth noting the recent financial support offered by India to the UN Tax Committee. See UN Sustainable Development GOALS. Available at <http://www.un.org/sustainabledevelopment/blog/2017/06/to-support-addis-ababa-action-agenda-india-makes-first-voluntary-contribution-to-un-tax-trust-fund/> accessed 1 August 2017.

[42] Zweigert and Kötz consider the functional method as 'the basic methodological principle of all comparative law'. See Konrad Zweigert, Hein Kötz and Tony Weir, *An Introduction to Comparative Law* (Third Edition, Clarendon Press 1998), p. 34. Here it is worth noting the explanation put forward by Örücü on the questions addressed by comparatists when they compare using the functionalist method: 'The functional-institutional approach answers the question, 'Which institution in system B performs an equivalent function to the one under survey in system A?'' A Esin Örücü, 'Methodology of comparative law' in JM Smits (ed), *Elgar Encyclopedia of Comparative Law* (2nd ed, Edward Elgar 2012), p. 561-562. Considering Örücü's and other's positions on the functionalist method, see Geoffrey Samuel, *An Introduction to Comparative Law Theory and Method* (Hart 2014). Also, on the critical and different concepts of functionalism, see Ralf Michaels, 'The Functional Method of Comparative Law' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford University Press 2008). Also, mainly on a critical analysis of functionalism, see Michele Graziadei, 'The functionalist heritage' in Pierre Legrand and RJC Munday (eds), *Comparative Legal Studies: Traditions and Transitions* (Cambridge University Press 2003), p. 100.

jurisdiction[43] when dealing with similar problems all compared countries share.[44] The problems subject to analysis are:[45] (i) the setting up of the jurisdiction to tax framework; (ii) how to tax business profits; (iii) and the transfer pricing issue.[46] Based on this comparison, the work then identifies the commonalities and differences present in each jurisdiction's solutions to the shared problems.

Such comparative process, to be carried out on the substantive chapters of the thesis (see Section 1.4 below), can be formalized through the following series *[a a1 B1]*, where 'a' represents a particular problem, 'a1' represents a particular legal system, and 'B1' represents a particular solution.[47] Thus, the identification of a particular tax problem shared by all compared countries (*a*), and the analysis of each of the compared countries' legal systems (*a1, a2*, and *a3* for Brazil, India, and South Africa, respectively), will allow this work to identify each of the compared countries' solution to the problem (*B1*, *B2*, and *B3* for the Brazilian, the Indian, and the South African solutions, respectively). This process allows the thesis to put forward, when appropriate, recommendations for better solutions[48] to the challenges faced by developing countries regarding the taxation of business profits.

This research is carried out through desktop research, consisting of literature review on international taxation. In addition, the thesis analyses economic data, reports, guidelines, and other materials related to international taxation. Furthermore,

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[43] It is worth referring to Thuronyi's approach on the matter: 'Comparative law involves the study of basic structures, country differences, and the influence of systems on each other. It identifies underlying patterns and analyses how different rules function in different countries to resolve similar problems.' See Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International 2003), p. 3.

[44] A specific socio-economic problem as a starting point for analysis is considered as the core element of a functional comparative law. See Mathias M Siems, *Comparative Law* (Cambridge University Press 2014), p. 26.

[45] For each of those items, see 1.5 (Outline of the Thesis).

[46] In general, it could be said that the problem the compared countries face relates to the balance between, on the one hand, the attraction of FDI and, on the other hand, the maintenance of an appropriate level (according to their assumptions on their taxing rights as source countries) of taxation on international transactions. See *2001 UN MC* (United Nations 2001). This thesis bears in mind such problem when it addresses its research question and its research objectives.

[47] On the benefits of the adoption of such kind of a series, see Reimann and Zimmermann (n 42).

[48] On the comparative tax approach as a tool for propositions of solutions for common policy issues, see Carlo Garbarino, 'Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of General Anti-Avoidance Rules' (2010) 11 Theoretical Inquiries in Law 765.

legislation, case law, international agreements, and official documents related to international taxation and to tax policy of the compared countries take part of the analysis. Specifically on the tax treaty networks, the thesis analyses all the income tax treaties signed by Brazil, India, and South Africa (approximately three hundred agreements) and related documents, such as protocols to the treaties and exchange of notes between the treaty parties. In doing so, a specific set of treaty provisions dealing with taxation of business profits are scrutinised and compared against the various editions of the UN MC and the OECD MC.

Although within a limited scope, the thesis also looks at case law with the purpose of considering the main challenges presented to the compared countries' courts with regard to taxation of business profits of international transactions. It draws on comprehensive academic literature (articles and books) and case law reports when selecting the relevant cases to highlight the main court discussions on the matter.[49] A quantitative approach to examining case law is out of the thesis' scope owing to the large number of decisions on the taxation of business profits one can find when searching the sources consulted.[50] Nevertheless, the case law chosen offers a proxy for the main problems faced by both the tax administrations and the taxpayers on the application of the domestic law as restricted by the treaty provisions (following either the OECD MC or the UN MC), which also influences the choice of an efficient regulatory design on the topic.

Finally, the thesis pursues a qualitative research through a purposive sampling of data related to international taxation and to economic indicators that are, to some extent, related to the capital flow between different jurisdictions.[51] The main sources of data

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[49] Among others, Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes – A Global Analysis* (Cambridge 2012); Anuschka Bakker and Marc M. Levey, *Transfer Pricing and Dispute Resolution – Aligning Strategy and Execution* (IBFD 2011); Eduardo Baistrocchi (ed), *A Global Analysis of Tax Treaty Disputes* (Cambridge 2017); IFA's *Cahiers de Droit Fiscal International* (CDFI) (IFA); *International Tax Law Reports* (ITLR) (Lexis Nexis); IBFD's *Tax Research Platform, Tax Treaty Case Law* (IBFD).

[50] For example, the IBFD's Tax Research Platform shows 267 decisions by Indian courts dealing with Article 7 of the OECD MC. The number is even larger (1,105 decisions) with regard to Article 9. See *Tax Research Platform, Tax Treaty Case Law,* topics 'country, OECD Article 7(1)/9, document type'. Available at <www.ibfd.org> accessed 2 September 2018.

[51] On qualitative research and on purposive sampling, see Alan Bryman, *Social Research Methods* (Oxford University Press 2001).

are the compared countries' government archives and a series of data sets available through many international organizations (printed and available online). Among such international institutions, it is worth mentioning the United Nations, International Monetary Fund, World Bank and the OECD.

1.4 Outline of the Thesis

The thesis is divided into five substantive chapters, evolving from a general assessment of the income tax legislation and the tax treaty networks of the compared countries (Chapter 2) to a critical analysis of the provisions dealing with business taxation (Chapters 3 to 5) to, finally, presenting a transfer pricing proposal that could be more beneficial for developing countries (Chapter 6). The chapters dedicated to the analysis of the domestic law and of specific treaty articles (Chapters 3 to 5) are structured in a similar way, so that they offer a consistent and coherent comparative framework for the thesis purposes.

Chapter 2 (Evolution of the Income Tax and the Tax Treaty Network in Brazil, India, and South Africa) investigates the building up process of the compared countries' tax treaty networks. The aim is to provide the following chapters with a background for the investigation on the variations of the treaty articles dealing with taxation of business profits. This chapter starts by examining the economic background of such jurisdictions, with special attention to the level of economic development and to the importance of FDI attraction. Then, it analyses the historic evolution of the income tax in Brazil, India, and South Africa. Finally, the chapter focuses on understanding the key drivers for the countries entering into income tax treaties. Special attention is paid to the diverse periods of time and to the treaties counterparts' position as UN countries or OECD member countries. The level of investment into their economies with regards to tax conventions with countries where the FDI is originated from is also analysed.

Chapter 3 (Article 5: The PE Threshold) carries out an analysis of the domestic rules dealing with the PE concept and of Article 5 of the tax treaty networks, with particular attention to the widening of the permanent establishment threshold. Although Article 5 does not deal with the allocation of profits to PEs through the application of the arm's

length principle, its examination helps to identify the path the compared countries follow when dealing with the MNEs' presence in their jurisdictions. The chapter scrutinises relevant provisions present in Article 5, such as the service PE in Paragraph (3) (b) and the agency PE in Paragraph (5) (b) rules. It also presents a series of comparative tables, with a final comparative section identifying the tax policy adopted throughout Article 5 of the tax treaty networks. Finally, it presents a comparison of the policy choices considering economic data on the FDI origin jurisdictions.

Chapter 4 (Article 7: Allocation of Profits to PEs) focuses on provisions that allocate profits to permanent establishments according to the compared countries' legislation and to Article 7. This article, coupled with Article 9, plays a crucial role on the application of the arm's length principle as currently adopted by the OECD. First, the chapter examines the countries' domestic rules on the issue. Then, it questions whether the compared countries' treaty networks follow the Authorised OECD Approach (AOA) as adopted by the OECD MC from its 2010 edition. The following sections analyse provisions which present a mismatch between the model conventions. Next, it highlights the treaty policy adopted throughout Article 7 by following the same comparative framework as adopted in Chapter 3. Finally, Chapter 4 inaugurates the case law analysis, aiming at identifying key challenges presented before Brazil's, India's, and South Africa's courts on taxation of PEs. Due to the close relationship between Article 5 and Article 7, decisions on both articles are included.

The analysis carried out in Chapter 5 (Article 9: Transfer Pricing Frameworks) is based on the OECD's position on the arm's length standard as the underlying principle for transfer pricing regulation. First, it focuses on how Article 9 has evolved in the context of both the OECD MC and UN MC. Then, it examines the inclusion of the transfer pricing provisions into the countries' tax treaty networks, stressing the influence received from international tax practice. A comparative table highlighting the mismatches between the treaty networks and Article 9's wording is provided. The treaties counterparties and the FDI origin jurisdictions are equally considered. Then, the chapter scrutinises the legal transplant of provisions dealing with transfer pricing into the countries' domestic legislation, highlighting the functional equivalence of each set of rules in comparison with both the UN's and OECD's approaches. Such analysis is of particular relevance to the thesis since domestic regulation on transfer pricing,

coupled with the treaty provisions on taxation of business profits, orientates the allocation of profits to both associated enterprises and permanent establishments. The final part of Chapter 5 deals with key case law on the issue.

Chapter 6 (A Transfer Pricing Framework for Developing Countries: A Regulatory-Based, Pre-Fixed Profit Margins System) discusses whether a transfer pricing framework that does not align with the OECD's one (as it is specially the case of the regulatory design adopted by Brazil) could be more beneficial to developing countries. To do so, the pros and cons of the Brazilian transfer pricing system are weighed against a proposal for a regulation framed by the highly needed legal certainty and practicability in the international taxation arena. Therefore, the chapter puts forward a regulatory-based, pre-fixed profit margins framework for taxation of transactions between associated enterprises. The application of this set of rules to the allocation of profits to PEs is equally considered. In addition, Chapter 6 weighs such proposal against the outcomes of the OECD/G20 BEPS project.

Finally, Chapter 7 (Conclusion) gives a critical appraisal of each chapter's conclusions, aiming at highlighting the contribution of the thesis to the research agenda on business profits taxation with a particular focus on developing countries. As the concluding chapter, it also puts forward future research avenues to be pursued with regards to specific topics in the international tax arena.

Table 1.1 – Chapter-by-chapter thesis structure

	Chapter 1	Chapter 2	Chapter 3	Chapter 4	Chapter 5	Chapter 6	Chapter 7
Subject	Introduction	Evolution of the tax treaty networks	Article 5 – The PE Threshold	Article 7 – Allocation of Profits to PEs	Article 9 – Transfer Pricing Frameworks	A Transfer Pricing Framework for Developing Countries: A Regulatory-Based, Pre-Fixed Profit Margins System	Conclusion
Scope	- Problem - Methodology - Outline of chapters	- Analysis of the compared countries' income tax evolution - Analysis of the building up process of the tax treaty networks	- Analysis of the domestic law on the PE concept - Analysis of the treaties' provisions on the PE concept	- Analysis of the domestic law on attribution of profits to PEs - Analysis of the treaties' provisions on the attribution of profits to permanent establishments	- Analysis of the domestic law on taxation of associated enterprises - Analysis of the treaties' provisions on taxation of associated enterprises	- Putting forward a TP framework that could be more beneficial to developing countries and could comply with the current ALP at the same time	- Summary of the previous chapters and the thesis' conclusions - Further research challenges
Functional approach: problem and possible solution	----	- Need for an attractive legal environment for FDI inflow - Setting up a broad tax treaty network	- Need for a PE concept more beneficial to the host country - Possible alignment with the UN MC	- Need for taxing rights more beneficial to the host country - Possible alignment with the UN MC	- Need for a transfer pricing framework beneficial to developing countries - Possibilities: only alignment with the UN MC; a framework deviating from the OECD standard	- A proposal that does not cause disruption to the international tax regime and is beneficial to developing countries at same time - A proposal based on a regulatory approach that could also serve as an entry level system for developing countries	----
Proxy for challenges	----	----	----	- Case law analysis	- Case law analysis	----	----
Proposal	----	----	----	----	----	- A resettable pre-fixed profit margins system	----

CHAPTER 2

Evolution of the Income Tax and the Tax Treaty Network in Brazil, India, and South Africa

2.1 Introduction

This chapter draws upon the income tax evolution in Brazil, India, and South Africa. While providing an analysis of how the taxation on income evolved in these three countries, it shows how the tax treaty network of each of the chosen countries evolved. In addition, the chapter findings indicate that, to some extent, the economic outcomes experienced by the treaty policy adopted by the countries are not convergent.

To this end, Section 2.2 highlights relevant economic characteristics of the compared countries, such as GDP, growth rate, and tax-to-GDP ratios. Section 2.3 gives an overview of the evolution of income taxation, briefly presenting the background for the implementation of the income tax legislation in each jurisdiction; the subsequent amendments in the respective domestic legislation, when relevant, are dealt with similarly. Finally, Section 2.4 sheds light on the importance of the tax treaty network of Brazil, India, and South Africa. The literature shows that there is a dispute over the role played by bilateral tax treaties in attracting FDI. Some scholars advocate the positive effect of a tax treaty network on the FDI flow into developing countries' economies, while others reach a different conclusion when stressing that tax treaties do not necessarily have a positive effect on the FDI inflow. Having this in mind, together with the diverse evolution of the tax treaty network of the compared countries, Section 2.4 then highlights the amount of foreign investment in the last decades from the US, the UK, and Germany into the Brazilian economy. The data analysed, to some extent, suggest the tax treaty policy adopted by Brazil causes some distortions considering the FDI inflow from those jurisdictions.

The relevance of this chapter is in presenting the background for the analysis this thesis carries out further. The following chapters draw upon the understanding of the evolution of the income tax legislation and the developments of the tax treaty networks when comparing specific international tax issues.

2.2 Setting the scene

2.2.1 Level of development and the BRICS's standing on international taxation

When classifying the jurisdictions according to their economic development, this work follows the IMF classification. According to the IMF's methodology, the country classification is divided into two groups: *advanced economies and emerging market and developing economies*. All the compared countries are part of the latter category. This thesis also refers to that category, in general, as developing countries. The IMF goes further in the classification, sub-grouping the emerging market and developing economies into *Commonwealth of Independent States* (CIS), *emerging and developing Asia*, *emerging and developing Europe*, *Latin America and the Caribbean (LAC)*, the *Middle East, North Africa, Afghanistan, and Pakistan* (MENAP), and *sub-Saharan Africa (SSA)*.[52]

Although they are situated on different continents, it should be stressed that the countries have common interest in some geopolitical features. Brazil, India, and South Africa, as part of the BRICSs, have shared common positions when dealing with issues related to international taxation.[53] Moreover, as part of the G20 group, concerns about the improvement of the international tax system have been systematically put forward

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[52] World Economic Outlook, October 2017 (IMF 2017), Statistical Appendix, 220ff. Other classifications equally identify these countries as emerging/developing countries when analysing their economic development. Although the United Nations follows its own criteria, this is the case with the UN classification. See United Nations, 'World Economic Situation and Prospects 2013'. Available at <www.un.org/en/development/desa/policy/wesp/wesp_current/wesp2013.pdf> accessed 10 January 2015. On the importance and history of development taxonomy, see Lynge Nielsen, 'How to Classify Countries Based on Their Level of Development' (2013) 114 (3) Social Indicators Research 1087.

[53] See 1.2.

as part of the core priorities for the coming years.[54] In so doing, these countries intend to strengthen the developing countries' perspective on the matter.[55]

2.2.2 Population, GDP, per capita income, and tax-to-GDP ratios data[56]

Although adopting similar positions when stressing the importance of developing countries in the international arena, Brazil, India, and South Africa present clear diversity with regard to population and economic factors (Table 2.1). It is remarkable that India's population density is more than six times that of Brazil, and more than twenty times that of South Africa. The predominance does not shift regarding the GDP of such countries. India has the higher GDP, placing Brazil in the second position, and South Africa in third.[57] The gross national income per capita (GNI) of Brazil and South Africa are quite similar, with that of Brazil around 20% higher. However, India's GNI falls remarkably behind that of its peers, reaching about 40% of the Brazilian GNI, and slightly above 47% of the South African GNI.

Table 2.1: Population, GDP, and per capita income[58]

	Population	GDP[59]	GNI[60]
Brazil	204,470,000	1,801.482	15,280
India	1,282,918,000	2,089.867	6,060
South Africa	54,750,000	317.568	12,840

[54] For the international tax improvements and G20 agenda for 2015, see G20, 'Turkish G20 Presidency Priorities for 2015'. Available at <https://g20.org/wp-content/uploads/2014/12/2015-TURKEY-G-20-PRESIDENCY-FINAL.pdf> accessed 10 January 2015.

[55] Also on the matter, see G20 Germany 2017, 'G20 Leaders' Declaration: Shaping an Interconnected World', point 20, 7. Available at <https://www.g20germany.de/Content/EN/_Anlagen/G20/G20-leaders-declaration.pdf?__blob=publicationFile&v=11> Accessed 10 December 2017.

[56] The acronyms read as follows: GDP: Gross Domestic Product; % GDP: GDP Annual Growth Rate; % GDP 2008-2013: GDP Annual Average Growth Rate; GNI: Gross National Income per capita, PPP.

[57] Brazil has experienced a decrease in its GDP in the last years due to economic recession. For instance, for 2013, the Brazilian GDP figure is 2,190.218 (billions/US Dollars), while the Indian one is 1,758.216 (billions/US Dollars). See IMF, 'World Economic Outlook Database: 2013' (2014). Available at <http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx> accessed 10 January 2015.

[58] The figures are for 2015.

[59] Current prices, in billions/US Dollars.

[60] PPP (purchasing-power-parity) in current $.

Sources: IMF, World Bank[61]

On the other hand, economic data indicate that India is experiencing a rather accelerated growth in comparison with its peers (Table 2.2). If the 2013 figures alone are analysed the economic growth rate of India is more than twice that of Brazil and South Africa. The gap is even more prominent for the following years: in 2015 and in 2016, the Indian figures are above seven percent, while Brazil's economic activity shows a negative figure; South Africa did not experience a relevant economic growth in the same period. In addition, it is worth noting that this impressive pace of growth has been the reality in India for the last decade or so. Since 2004, the rate of India's economic growth has peaked to near 10% on several occasions, reaching a remarkable figure of 10.3% in 2010. The economic scenarios of Brazil and South Africa have not matched this.[62]

Table 2.2: Countries' Annual Average Growth Rate (%GDP)

	Brazil	India	South Africa
2006	4.0	9.3	5.6
2007	6.1	9.8	5.4
2008	5.1	3.9	3.2
2009	-0.1	8.5	-1.5
2010	7.5	10.3	3.0
2011	4.0	6.6	3.3
2012	1.9	5.5	2.2
2013	3.0	6.4	2.5
2014	0.5	7.5	1.7
2015	-3.8	8.0	1.3
2016	-3.6	7.1	0.3

Source: UNCTAD[63]

When comparing the countries' tax-to-GDP ratio, and the income tax share in the total tax revenue collection, all three show different positions. Amongst them, Brazil has the

[61] IMF 'World Economic Outlook Database, October 2017'. Available at <https://www.imf.org/external/pubs/ft/weo/2017/02/weodata/index.aspx> accessed 10 December 2017; World Bank. Available at <https://data.worldbank.org/country> accessed 10 December 2017.

[62] Between 1980 and 2000, the Indian GDP growth rate average was the highest among the three countries (5.67%). In the same period, the Brazilian GDP growth rate average was 2.33%, and the South African one was 1.42%. From 1970 to 1980, the Brazilian GDP growth rate average was the highest among the three (8.26%), while the Indian one was 3.33%. The South African economy grew at an average rate of 3.05% in the same period. UNCTAD Statistics. Available at <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx> accessed 10 December 2017.

[63] ibid.

highest tax-to-GDP ratio, followed by South Africa and India.[64] The positions change regarding the income tax to total tax revenue ratio; in this case, South Africa is the jurisdictions that most relies on income tax for its tax revenue.

Table 2.3: Tax-to-GDP ratios and Income Tax (%)[65]

	Brazil	India	South Africa
Tax-to-GDP	36.27	17.22	25.30
Income Tax to Tax Revenue	20.42	20.50	53.80

Source: OECD[66], BRICS Joint Statistical Publication[67], Indian Public Finance Statistics[68], IMF[69], Brazilian Federal Revenue[70]

Finally, it is relevant to point out that, amongst the countries compared, only South Africa has relied more on direct than on indirect taxation, and this has been the reality for the last years.[71] The contrary has occurred in the other two countries. India has relied

[64] The analysis of the tax-to-GDP and of the income tax to tax revenue ratios was carried out during the building up process of the thesis. An assessment considering a more recent data, in general, confirms those policies though. For instance, the Brazilian tax-to-GDP ratio is 32.11% and 32.38% for 2015 and 2016 respectively, while the figure for South Africa is 26.1% (2016-2017) and for India is 17.15% (2015-2016). See Brazilian Federal Revenue, 'Brazilian Tax Load 2016' (2016). Available at <http://idg.receita.fazenda.gov.br/dados/receitadata/estudos-e-tributarios-e-aduaneiros/estudos-e-estatisticas/carga-tributaria-no-brasil/carga-tributaria-2016.pdf > accessed 10 December 2017; SARS, 'Annual Report South African Revenue Service 2015-2016'. Available at <http://www.sars.gov.za/AllDocs/SARSEntDoclib/AnnualReports/SARS-AR-22%20-%20Annual%20Report%202016-2017.pdf > accessed 10 December 2017; Government of India, Ministry of Finance, 'Indian Public Finance Statistics 2015-2016'. Available <https://dea.gov.in/sites/default/files/IPFS%20English%202015-16.pdf> accessed 10 December 2017.

[65] The data refer to the 2012 fiscal year (2012-13 for India and South Africa).

[66] OECD, 'OECD.Stat'. Available at <http://stats.oecd.org/index.aspx> accessed 23 January 2015.

[67] BRICS, 'Joint Statistical Publication 2014' (2014). Available at <http://www.brics.ibge.gov.br/downloads/BRICS_Joint_Statistical_Publication_2014.pdf> accessed 23 January 2015.

[68] Government of India, Ministry of Finance, 'Indian Public Finance Statistics 2013-2014' (2014). Available at <http://finmin.nic.in/reports/IPFStat201314.pdf> accessed 2 February 2015.

[69] IMF, 'World Economic Outlook Database: 2014' (2014). Available at <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx> accessed 5 February 2015.

[70] The Brazilian Social Contribution on Net Profit is considered in this thesis as integrating the Corporate Tax burden. See Receita Federal do Brasil, 'Carga Tributária no Brasil 2013' (2014). Available at <http://idg.receita.fazenda.gov.br/dados/receitadata/estudos-e-tributarios-e-aduaneiros/estudos-e-estatisticas/carga-tributaria-no-brasil/carga-tributaria-2013.pdf> accessed 5 February 2015.

[71] As was the case for the 2008-09 fiscal year, when income tax collection alone constituted 58.1% of the total tax revenue. National Treasury (South Africa) and South African Revenue Service, *2013 Tax Statistics: A Joint Publication between National Treasury and South African Revenue Service* (National Treasury and South African Revenue Service 2013).

more on indirect than on direct taxation. However, this trend has experienced a relevant shift from the 1990s onwards. By the early 1990s, indirect taxation was the source of more than 80% of total tax revenue in India. After the tax reforms that took place from 1991,[72] the country's direct to indirect taxation proportion changed to 28.1:71.9 in 2004-05, reaching 33.28:66.72 in the 2012-13 fiscal year.[73] As for Brazil, it has relied more on indirect taxation for the latest periods.[74]

2.2.3 The industries of each country

The GDP-by-industry factor also assumes special relevance in this work.[75] At present, the available data show that Brazil and South Africa share similar realities. The agricultural sector in neither country accounts for an impressive share of GDP, whereas in India agriculture represents around 18% of its GDP-by-industry.[76] On the other hand, all three countries share a similar position on the relevance exerted by the industrial sector, the service sector having less importance in India than in Brazil and South Africa. Then, as the upward tendency of tax revenue growth is usually linked to growth in the corporate sector, it is not surprising that the tax-to-GDP ratio in India has fallen far below its peers.[77]

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[72] See MM Sury, *Fiscal Policy Developments in India, 1947 to 2007* (Indian Tax Foundation in association with New Century Publications 2007), p. 123.

[73] Estimates based on the total, direct and indirect tax revenues data as provided by the Government of India. Government of India, Ministry of Finance (n 64).

[74] Brazilian Federal Revenue (n 64).

[75] See Chapter 6.

[76] For an overview of the compared countries' national accounts, see BRICS, 'Joint Statistical Publication 2017' (2017), p. 47ff. Available at <http://www.brics2018.org.za/sites/default/files/documents/Statistics/BRICS%20Joint_Statistics%20Publication%202017.pdf> accessed 10 April 2018.

[77] In India, the States have the power to impose tax on agricultural income. However, the proceeds from the Agricultural Income Tax have been historically insignificant. Mahesh C Purohit and Vishnu Kanta Purohit, *Handbook of Tax System in India: An Analysis of Tax Policy and Governance* (OUP India 2014), p. 41.

Table 2.4: Each industry's share of GDP [78]

	Agriculture	Industry	Services
Brazil	5.5	21.2	73.3
India	17.4	28.8	53.8
South Africa	2.4	28.9	68.6

Source: World Bank[79]

2.3 Evolution of income tax in the compared countries[80]

2.3.1 First wave – 1860 to 1922: From colonial legal transplants to a republican income tax – enactment of the first income tax legislation

Brazil temporarily adopted, in the first half of the nineteenth century, a tax imposition on receipts from the government. Such levy was both a progressive and a withholding tax. It lasted only from 1843 to 1845.[81] A similar form of taxation took place in 1867, this time because of increasing war expenditure.[82] Again, the main feature was a kind of withholding tax mechanism similar to the tax imposed in 1843. In addition, a levy on real estate rentals was imposed. These attempts, however, are not considered as the first Brazilian general income tax, which was enacted more than half a century later.[83] South Africa did not experience this kind of levy during the ninetieth century.[84]

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[78] The figures refer to 2016. Data analysis of previous years also shows similar figures for the agricultural sector in India, as is the case for 2012 (18.2%) and for 2013 (18.6%).

[79] World Bank, 'World Development Indicators 2017'. Available at <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators> accessed 10 April 2018.

[80] This chapter does not intend to carry out a detailed investigation of the income tax legislation of the compared countries. When relevant, the next chapters will approach the main issues related to such provisions. See Chapter 1, outline of chapters.

[81] Law 317 of 21 October 1843.

[82] Law 1,507 of 26 September 1867. The exceptional expenditures were related to the war waged against Paraguay.

[83] Henry J Gumpel and Rubens Gomes de Sousa (eds), *Taxation in Brazil* (Little, Brown 1957), p. 46.

[84] This thesis refers to South Africa in this chapter in a general manner. When a more specific reference is necessary, the author refers to the colonies (before 1910), to the Union of South Africa (from 1910 to 1961), and to the Republic of South Africa (from 1961 onwards).

British colonial rule in India was, in reality, responsible for the introduction of the first general income tax legislation among the compared countries. In fact, more than merely innovating with the Indian legal system, it is said that the transplant[85] of the British income tax to India held special relevance in the very establishment of modern India.[86]

The new tax followed the shift of power from the East India Company to the British Crown,[87] which was consolidated through the Government of India Act of 1858.[88] Facing the challenges posed by increasing expenditure,[89] the Indian government enacted the Income Tax Act 1860, which was basically a mirror of its British counterpart.[90] In what is relevant to this work, it is worth mentioning some of the features of the 1860 Indian legislation: the taxation was based on both residence and source principles, depending on the schedule by which the tax should be enforced; the provision for tax relief in case of payment of tax abroad; and taxation at the company level of dividends distributed to the companies' shareholders.[91] All these features of the first Indian income tax, along with other provisions of the Act, to some extent reflected the British government's concerns with the local reality.[92]

The first income tax in India had, however, a short life. It did not raise the expected revenue: this was due to administrative and evasion constraints. Such results influenced

[85] This thesis uses the term *transplant* when a country's legal system borrows a specific set of legal regulations from a foreign one. See Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd ed, University of Georgia Press 1993), 21. As for the first Brazilian income tax legislation, as it was not subject of a clear transplant from a specific country/legal system, this thesis opted for the term *influence*. On the legal transplant terminology, see Michele Graziadei, 'Comparative Law as the Study of Transplants and Receptions' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford University Press 2008).

[86] CL Jenkins, '1860: India's First Income Tax' [2012] B. T. R. 87.

[87] For a historical account of the shift of power in India from the Company to the Crown, see Ira Klein, 'Materialism, Mutiny and Modernization in British India' (2000) 34 Modern Asian Studies 545. This article equally elucidates the English-inspired new tax policy role in Indian economic modernization and development. ibid, p. 567.

[88] The power to raise revenue in Indian territory was passed to the Crown through Section II of the Government of India Act 1858.

[89] It was estimated that it was necessary to collect £3,000,000 of new revenue. See Jenkins (n 35), p. 89.

[90] The enactment of the Income Tax Act 1860 took place during a period of intense legislative transplantation. For an account of the legal transplants in India, including transplants during the Raj, see Jean-Louis Halpérin, 'Western Legal Transplants and India' (2010) 2 Jindal Global Law Review 14.

[91] See Jenkins (n 86).

[92] On the British colonies social realities and imposition of income tax, see G Eichelgrun, 'Income Tax in British Colonies' (1948) 58 The Economic Journal 128.

the abolition of the income tax five years after its imposition. Notwithstanding such meagre outcomes, a new direct tax was imposed in 1867 in order to face the government's financial needs, under the name of the Licence Tax, renamed the Certificate Tax in 1868. In 1869, the Income Tax Act II came out, only to be abolished again in 1873 due to uncertainty and inefficiency issues. Then a new Licence Tax was imposed four years later, followed by new income tax legislation – the Income Tax Act of 1886.[93]

This first period of direct taxation witnessed such varied attempts to meet the Indian government's needs in facing increasing expenditure. Moreover, such experiences provided for the widening of the income tax base. Then, when the 1886 income tax legislation was put in place, the Indian people had assimilated the introduction of direct taxation, to some extent.[94]

South Africa was the next of the compared countries to introduce taxation on income. The legal transplant of such tax provisions took place in the legal systems of two out of the four colonies that later formed the Union of South Africa in 1910.[95] The Cape Additional Taxation Act 36 was enacted in 1904,[96] and was mainly based on the provisions of the New South Wales Act of 1895.[97] The Cape legislation was followed

[93] S Ambirajan, *The Taxation of Corporate Income in India* (Asia Publishing House 1964).

[94] ibid, p. 121-122.

[95] The Union of South Africa was created through the South Africa Act 1909 passed by the British Parliament: this is considered as the first South African Constitution. See Heinz Klug, *The Constitution of South Africa: A Contextual Analysis* (Hart 2010), 17. A Royal Proclamation set 31 May 1910 as the date for the establishment of the Union. According to Section 4 of the South Africa Act 1909, the four colonies that formed the Union of South Africa were the colonies of the Cape of Good Hope, Natal, the Transvaal, and the Orange River Colony.

[96] Cape Colony had already experienced a poll tax at the beginning of the nineteenth century by occasion of the Dutch ruling, which was adopted and reformed under the British rule. See Peter Harris, *Income Tax in Common Law Jurisdictions : From the Origins to 1820* (Cambridge University Press 2006), 448-449.

[97] David Meyerowitz, *Meyerowitz on Income Tax* (1998-1999 ed., The Taxpayer CC, 1999). Minnis highlights the partial influence of continental Europe's experience on income taxation as well. SE Minnis, 'The Income Taxes of the Self-Governing Dominions' [1916] Journal of the Society of Comparative Legislation 30. Such influence was on the adoption of a mechanism of direct assessment and collection from the actual person receiving the income, as opposed to the English characteristic of collection at source. ibid, p. 30.

by a Natal income tax imposed through Act 38 of 1908, which was later repealed by Act 35 of 1910.[98]

These colonial legislative measures laid down the foundations for the levy on income in the unified South Africa. After the enactment of the South Africa Act of 1909, the Union Parliament passed the Income Tax Act 28 of 1914; this Act was the inaugural legislation dealing with a general system[99] of income taxation in the country.[100] The following years experienced a series of amendments to the 1914 provisions, which were consolidated through the Income Tax Act 41 of 1917. Act 41 of 1917 to some extent departed from – and went further than – the 1914 legislation, since it introduced the taxation on income, instead of on profits and gains,[101] and imposed a dividend tax and an excess profits duty. Subsequent legislation abolished the dividend tax and the excess profits duty eight years later.[102]

While South Africa was in its income taxation infancy, India was replacing its 1886 legislation with The Income Tax Act of 1918. In addition, other innovative provisions were put forward by the Indian government, such as the Super-Tax Acts (1917 and 1920). Super tax was originally created as a wartime tax.[103] The super tax was then included in the income tax legislation by the enactment of the Income Tax Act of 1922,[104] which was aimed at consolidating the previous legislation.[105] It is worth noting that the 1922 legislation took the first move towards centralization of the income

[98] Charles James Ingram, *The Law of Income Tax in South Africa. A Commentary on the Income Tax Acts of South Africa, Together with the Acts Relating to Surtax* (Juta & Co 1933).

[99] ibid.

[100] As was the case with the Cape Act, this first legislation took place through the colonial approach of legal transplants, the Income Tax Act 28 of 1914 being directly influenced by the New South Wales Act of 1895. See Meyerowitz (n 46), 2-1.

[101] Ingram (n 98). On the shift from taxation on 'profits and gains' to taxation on 'income', see as well EB Broomberg, 'The Basis of Income Taxation in South Africa' (1972) 89 S. African LJ 179.

[102] It took place through the Income Tax Act 40 of 1925. Meyerowitz (n 97), 2-1.

[103] Ambirajan (n 93). Equally as a tool to raise revenue collection during the First World War, a graduated scale for the income tax incidence was created in 1916. ibid, p.123.

[104] G L Phophale, *A Quarter Century of Direct Taxation in India 1939-1964* (Bombay: Economic Research and Training Foundation 1965), p. 10.

[105] ibid, p. 15.

tax administration, as the Indian Central Government was in charge of income tax administration issues thereafter.[106]

Simultaneously with this legislative evolution in India, the 1920s mark the inauguration of income taxation in Brazil. [107] Following previous legislative debates on the desirability of the adoption of a general tax on income, [108] Law 4,625 imposed the first Brazilian income tax in 1922.[109] The tax was confined to only one article that provided for the general features of such a levy. Due to the complexity of the income tax, more comprehensive regulation took place in the following years.[110]

2.3.2 Second wave – 1922 to 1961: Departing from the colonial influence

In the period from 1860 to 1947 in India, the taxation of income mainly focused on the financial needs of the British India Government. From India's independence

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[106] The Act provided for such centralization to take place from 1922. ibid, p. 15.

[107] Interestingly enough, there was no legal transplant of income tax legislation, as a general tax, into the Brazilian legal system. The Portuguese income tax, as a general tax on individuals' and companies' income, was enacted only in 1988 through Decree-Law n. 442-A and Decree-Law n. 442-B, respectively. They entered into force in 1989. Previously, the Portuguese legislation provided for a variety of taxes on individuals and on corporations. On the latter, the tax on capital gains and tax on immovable property could be cited. On the subject, see Francisco de Sousa da Câmara, Nuno de Oliveira Garcia, and José Almeida Fernandes, 'Chapter 27: Portugal' in Daniel Gutmann (ed) *Corporate Income Tax Subjects – EATLP Annual Congress Lisbon* (IBFD 2016), p. 411ff.

[108] Mainly from the 1870s, there were several legislative discussions on the possible introduction of a general income tax in the country. It should be highlighted that some bills in this matter were even drafted and presented before the National Parliament, as happened in 1879 and 1883. See Augusto Olympio Viveiros de Castro, *Tratado dos Impostos - Estudo Theorico e Pratico* (2nd edn, Imprensa Nacional 1910). Besides being supported by the study of foreign academic literature, such debates were surrounded by a rather thorough analysis of the tax imposition and revenue collection in European countries. On the matter, see Rui Barbosa, *Relatório Do Ministro Da Fazenda* (Imprensa Nacional 1891); João Pedro da Veiga Filho, *Manual da Sciencia das Finanças n* (4th edn, Off Graph Monteiro Lobato & C 1928); Agenor de Roure*, A Constituinte Republicana, vol 1* (Imprensa Nacional 1920); Benedito Ferreira*, A História da Tributação no Brasil - Causas e Efeitos* (Senado Federal 1986); Fernando José Amed and Plínio José Labriola de Negreiros, *História dos Tributos no Brasil* (Edições SINAFRESP 2000).

[109] It is worth pointing out that the Brazilian Constitution of 1891, then in force, did not grant exclusive taxing power to the Brazilian Central government over income taxation. It kept the subject under the Central and State governments' concurrent legislation instead. In spite of this, no State enacted income tax legislation at that time, as the Union did in 1922. See Gumpel and Sousa (n 83).

[110] The first comprehensive regulation took place in 1924 through Decree 16,581.

onwards,[111] the building up of the new direct taxation framework was influenced by the new needs of the country, mainly focusing on the expenditure of the Welfare State. In addition, income taxation took a relevant part in India's efforts towards economic development,[112] quite often reflecting the series of Five Year Plans that were inaugurated in 1951.[113] With these concerns in mind, a series of committees and commissions were established by the Indian government to investigate the challenges and to propose legislative improvements related to the income tax.[114]

Further to enactment of the Income Tax Act of 1922, the most notable amendments to the legislation were those occurring in the 1939-59 period. Direct taxation experienced expansion through the creation of the Excess Profits Tax;[115] the Business Profits Tax; the Wealth Tax; and, more importantly, the Capital Gains Tax. Inspired by the US experience, capital gains taxation emerged through the inclusion of capital gains into the income tax base in 1947, only to be abolished two years later. Apart from its insignificant yield, the negative effect of the capital gains tax on the free movement of stocks and shares has been referred to as a reason for its abolition.[116] Taxation on capital gains was reintroduced in 1956.[117]

In South Africa, the Income Tax Act 40 of 1925[118] consolidated previous legislation. It stood in force, as amended, for almost twenty more years until the enactment of the

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[111] Independent India came into being in 1947 when the British Parliament passed the Indian Independence Act 1947.

[112] Phophale (n 104).

[113] The Indian development policy considered several tax mechanisms to push the economy from the beginning of the Plans' implementation, such as tax incentives through income tax concessions. See Walter W Brudno, Charles K Cobb and N A Palkhivala (eds), *Taxation in India* (Little, Brown 1960), p. 25.

[114] Phophale (n 104). The author provides a comprehensive approach to the committees' and commissions' goals ranging from 1935 (The Expert's Committee) to 1958 (Direct Taxes Administration Enquiry Committee).

[115] The Excess Profits Tax was created in 1940 to address extra expenditure caused by the Second World War. The same logic applies to the Business Profits Tax that replaced it in 1947 and was withdrawn in 1950. Ambirajan (n 93), p. 169 and 173.

[116] ibid, p. 175.

[117] ibid, p. 176.

[118] Apart from being based, through earlier legislation, on the New South Wales legislation, this act received some direct influence from the English legislation itself. See Ingram (n 47).

Income Tax Act 31 of 1941. Subsequent legislation,[119] among other features and apart from the taxing rights granted to the Union, empowered the provinces to impose income tax on individuals and companies. [120] Such provincial taxation was eventually abolished.[121] Additionally, it is worth pointing out that, in the 1940s, the Union of South Africa legislation provided for a series of distinct levies, although all of them came under the income tax legislation umbrella.[122] All the normal tax, super tax, non-resident shareholders' tax, and undistributed profits tax were considered as part of the income tax. Future amendments abolished some of these features, as was the case of the non-resident shareholder's tax and the undistributed profits tax.[123]

Finally, after imposing income tax in 1922, the Brazilian legislation evolved through a series of decrees for approximately thirty more years,[124] when Law 2,862 of 1956 and Decree 39,995 of 1956 were enacted. In addition, it is necessary to highlight the existence of a Brazilian Excess Profits Tax that lasted for three years from 1944.[125] Despite its abolition in 1947, the Brazilian central government imposed a similar income tax in 1956, applied to business profits. Its period of incidence was limited from 1957 to 1960.[126]

2.3.3 Third wave: 1961 up to the present

In India, a new Income Tax Act came out in 1961,[127] which was directly influenced by the challenges posed by the recent independence of the country. Hand in hand with the

[119] Financial Relations Consolidation and Amendment Act, Act 38 of 1945.

[120] Basil Edward John Blann, *Principles of South African Income Tax* (Butterworth & Co Africa 1955), p. 277.

[121] This took place through legislation enacted in 1971. See Meyerowitz (n 97).

[122] See Walter J Barnes, *Income Tax Handbook* (5th edn, Butterworth & Co 1944), especially its 1945 supplement.

[123] Both taxes were abolished during the 1990s under amendments of the new tax regime that took place after 1962. See Meyerowitz (n 97) and Robert C Williams, *Income Tax in South Africa: Cases & Materials* (3rd edn, LexisNexis 2009), p. 9.

[124] Decree 21,554 consolidated the first series of regulatory legislation in 1932. Other legislation followed, being consolidated in 1947 through Decree 24,239.

[125] Decree-law 6,224 created this tax in January 1944.

[126] Gumpel and Sousa (n 83), p. 270.

[127] The Act came into force on 1 April 1962.

increase in public expenditure, economic development issues formed the background for its design. Consequently, the form of the income tax was mainly influenced by official documents that addressed such fiscal and developmental constraints. In the main, the Law Commission's Twelfth Report of 1958, along with the Direct Taxes Administration Enquiry Committee's Report of 1959,[128] acted as the most influential works on the topic.

Despite being subject to a series of amendments since its enactment, the Income Tax Act of 1961 is still currently in force and has, to some extent, mirrored the economic and political changes experienced in India.[129] As occurred during the process of the enactment of the first income tax following Indian independence, the later Five Year Plans have more than somewhat influenced Indian income tax design since the 1960s. As is the case in the majority of countries nowadays, India also has a worldwide taxation and taxes capital gains through its income tax legislation.[130]

On the other hand, while India was putting forward a planned economic project, Brazil was setting up a comprehensive set of constitutional provisions dealing with tax issues.[131] Constitutional Amendment 18 of 1965[132] introduced a national tax system based on a series of constitutional provisions that, amongst other issues, provided for the taxing rights and revenue collection share of the three levels of government.[133] To

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[128] J B Kanga and Dinesh Vyas (eds), *The Law and Practice of Income Tax* (9th edn, LexisNexis 2004).

[129] The Indian legislation in force follows the Indian Constitution. Article 246 of the Constitution of India grants taxing power on income taxation to the Union and to the States according to its paragraphs 1 and 3, respectively. List I of the Seventh Schedule grants taxing power to the Union on taxes on income other than agriculture income (Entry 82) and on corporation tax (Entry 85). States can charge taxes on agricultural income according to List II of the Seventh Schedule (Entry 46).

[130] On the matter, see Purohit and Purohit (n 77), p. 67 and p. 88.

[131] Development-driven tax incentives were not absent from Brazilian fiscal policy, as is the case of the income tax incentives provided for by Law 4,357 of 1964. However, mainly from the 1970s, Brazil more closely pursued economic development based on policies laid down by periodic economic plans. This significantly affected its international tax policy. Section 2.4 approaches this matter.

[132] Constitutional Amendment 18 of 1965 was based on a report produced by the Ministry of Finance's Commission for Constitutional Tax Reform. On the circumstances for the constitutional amendment, see José de Castro Meira, 'O Sistema Tributário na Constituição de 1988 - Os Princípios Gerais' (1989) 26 Rev Inf Leg Brasília 104.

[133] Brazil is a federation divided into the Union, States, and Municipalities. On the importance of Brazilian federalism on the development of the Brazilian National Tax System, see Ives Gandra da Silva Martins, 'A Evolução Do Sistema Tributário No Brasil' (1994) 2 Caderno de Direito Tributário e Finanças Públicas.

some extent, such constitutional amendment was innovative, as it aimed to inaugurate a national tax system compatible with the Brazilian fiscal and economic realities. Based on such a background, the Brazilian Federal Constitution of 1988, currently in force, provides for a comprehensive regulation of the three levels of government taxing rights.[134]

Following this constitutional framework, the present Brazilian income tax is mainly based on 1990s legislation: Law 9,249 of 1995 and Law 9,430 of 1996.[135] The Brazilian legislation taxes capital gains as part of the income tax base. Law 9,249, besides laying down the basic framework of the taxation on income,[136] dramatically changed Brazilian income taxation in shifting income taxation from territorial to worldwide taxation.

As for South Africa, after the Income Tax Act 31 of 1941, the next consolidation of the income tax provisions took place through the Income Tax Act 58 of 1962, which was subject to a series of amendments until the present time.[137] Such a set of provisions is the legislation now in force in South Africa. The South African Income Tax Act imposes normal tax, dividends tax and donations tax.[138]

The 1962 legislation was passed by South Africa's legislature just one year after the second Constitution of South Africa was enacted,[139] which substituted a republic for British monarchic rule.[140] Since then, the country has experienced three other

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[134] The first constitutional provision that granted exclusive taxing powers to the Union was the Brazilian Constitution of 1934 (Art 6). Subsequent constitutional provisions were made in the Brazilian Constitution of 1967 (Art 22) and the present Brazilian Constitution of 1988 (Art 153).

[135] In the explanatory memorandum sent to the legislature in support of Law 9,430 of 1996, the executive made clear that the provisions contained in both Law 9,249 of 1995 and Law 9,430 of 1996 were intended to modernise income tax imposition. Together with the residence-based approach, the transfer pricing provisions can be regarded as a move to align the Brazilian legislation further with international practice. See Explanatory Memorandum n. 470 of 15 October 1996.

[136] The Brazilian National Tax Code (Law 5,172 of 1966) provides for basic concepts to be observed by the infra-constitutional provisions, as is the case of the concept of income (Article 43).

[137] On the amendments until 1999, see Meyerowitz (n 97), 2-2.

[138] Alwyn de Koker, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa* (Memorial edn, Butterworth 1995), 1-2. Dividend tax was the former secondary tax on companies. ibid.

[139] Constitution of the Republic of South Africa, Act 32 of 1961.

[140] The enactment of the 1961 Constitution followed a move that had begun a few decades before with the enactment of the Statute of Westminster of 1931, when the British parliament ceased to have

constitutional periods; [141] the current income tax is imposed under the umbrella of the Constitution of the Republic of South Africa of 1996.[142] In addition, note should be taken of the importance of the Interim Constitution of 1993. This constitution established a Financial and Fiscal Commission that carried out analysis of a possible equalisation of the revenue and expenditure between the South African provinces.[143]

Finally, it is worth referring to the jurisdiction to tax regime and to capital gains taxation in South Africa. Since its inception, the South African income tax legislation confined the tax imposition to income from a South African source only,[144] thus taxing income irrespective of the residence of its recipient.[145] This framework was abolished from 2001 onwards, shifting the jurisdiction to tax from source-based to residence-based taxation.[146] The South African government put forward the necessity of alignment with international practice, along with economic concerns, as the main reasons for such a shift.[147] As for capital gains taxation, the first legislative provisions did not tax receipts of a capital nature. [148] However, although this is not a separate tax,[149] provisions now levy income tax on capital gains through the addition of such amounts to taxable income.[150]

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legislative authority over the Union of South Africa. See IM Rautenbach, *Constitutional Law* (4th edn, LexisNexis Butterworths 2004), p. 15.

[141] South Africa has had five different constitutions since the creation of the Union of South Africa: the 1910 Constitution; the 1961 Constitution; the 1983 Constitution; the 1993 Constitution (the Interim Constitution); and the 1996 Constitution. See Heinz Klug (n 95).

[142] Both the imposition of the income tax, and its administration, are subject to constitutional provisions. See de Koker (n 138), 1-2.

[143] Since 1986, the national public service has been integrated, leaving provincial autonomy in the past. See Job Mokgoro, 'Interprovincial fiscal equalization: the role of the financial and fiscal commission' in B de Villiers (ed), *Birth of a Constitution* (Juta & Co 1994), p. 282.

[144] Ingram (n 98).

[145] Blann (n 120), p.199; David Shrand, *Income Tax in South Africa* (Juta & Co 1951).

[146] The implementation of the residence-based system was announced in February 2000 through the Minister of Finance's budget review. See Williams (n 123), p. 10.

[147] ibid.

[148] Shrand (n 94).

[149] Robert C Williams, *Income Tax in South Africa: Law and Practice* (2nd edn, Butterworth 1995), p. 27.

[150] Koker (n 138). Taxation of capital gains is regulated through Section 26A of the Income Tax Act 58 of 1962.

Table 2.5: Income Tax Features

	Brazil	India	South Africa
Colonial legal transplant	No	Yes	Yes
Taxing powers	Union	Union/State (on agriculture)	Union
Jurisdiction to tax	Worldwide	Worldwide	Worldwide
Capital Gains Tax	IT legislation	IT legislation	IT legislation

2.4 Taxation of Income and Income Tax Treaties

The argument in favour of a tax treaty network[151] as an important tool for attracting foreign direct investment (FDI) is not new. However, such an assumption is not shared by all the literature dealing with this matter.[152] Actually, one can say that even the assumption of the benefits of a bilateral tax treaty network is not immune to controversy.[153] With such a scenario as a starting point, this section intends to shed light on the path followed by the selected countries regarding the building up of their tax treaty network. In doing so, this section organises their tax agreements according to distinct periods of time, highlighting the particular circumstances underlying each period. Based on this description, and through analysis of FDI inflows data, the last part of this section stresses the singular policy adopted by Brazil with regard to its lack of tax treaties with important partners, which contrasts with the Indian and South African positions.

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[151] This work refers to the definition of tax treaty(ies) in general meaning the conventions on income taxation.

[152] See Fabian Barthel et al., 'The Relationship between Double Taxation Treaties and Foreign Direct Investment' in Michael Lang and others (eds), *Tax Treaties: Building Bridges between Law and Economics* (IBFD 2010). The selection of diverse methods could lead to equally dissimilar conclusions. Barthel elucidates that investigations based on bilateral FDI data usually do not support the assumption in favor of a positive effect of bilateral tax treaties in the matter. Conversely, investigations that are based on aggregate FDI data – studies that have as a starting point the improvement (or not) of the total number of a country's tax treaties and the consequent variation of FDI inflow – show just the opposite. ibid, p. 7. Considering the absence of positive effect of tax treaties on FDI flows, see Paul L Baker, 'An Analysis of Double Taxation Treaties and Their Effect on Foreign Direct Investment' (2014) 21 International Journal of the Economics of Business 341, among others. For the effect of tax treaties on bilateral stocks of outward FDI, see Peter Egger et al, 'The Impact of Endogenous Tax Treaties on Foreign Direct Investment: Theory and Evidence' (2006) 39 Canadian Journal of Economics 902.

[153] See Tsilly Dagan, 'The Tax Treaties Myth' (1999) 32 NYUJ Int'l L. & Pol. 939.

2.4.1 Building up a Tax Treaty Network

The first wave – from the late 1930s to the end of the 1970s[154]

The compared countries' processes of building up their tax treaty networks had different starting points. Among the three, South Africa took the lead. South Africa signed an income tax treaty with Southern Rhodesia in 1939. During the 1940s, South Africa entered into tax treaties with the UK and with the US (both in 1946). In the following decade, it entered into few more tax treaties, as was the case of the income tax treaty with Sweden (1955). In the 1950s, the country's tax treaty policy was clearly influenced by the work developed by the Fiscal Committee of the League of Nations, which was considered as a standard to be followed.[155] Other tax agreements followed suit through the 1960s, as was the case of the extension to other territories of the treaty signed with the UK in 1946.[156] In the 1970s South Africa entered into a few other tax treaties, which did not massively contribute to its tax treaty network.

India was the next country to enter into a comprehensive tax treaty. The first Indian tax treaty was signed with Pakistan in 1947. The then-newly independent country's policy was clear about the importance of tax treaties as tools to attract foreign investment.[157] It is worth noting that since the beginning the Indian government was aware of the challenges posed by international practice when developing countries intended to enter into tax treaties. Notwithstanding the broad acceptance of the League of Nations model at the time, it was clear that the country's treaty network should be developed to protect

[154] Annex I provides a comparative table containing all the income tax treaties signed by Brazil, India, and South Africa.

[155] See Blann (n 120). The author also refers to a similar tax treaty South Africa had entered into with Italy in 1933, which was not ratified at the time.

[156] According to Art XV (1) of The Treaty of 1946 between the Union of South Africa and the UK, the 1946 treaty provisions could be extended to the contracting states colonies, overseas territories, protectorates, or territories. As a consequence, the treaty was extended to the following UK territories: Cyprus, Gambia, Grenada, Mauritius, Seychelles, Sierra Leone, and Trinidad and Tobago. The date of 6 August of 1960 is considered as the conclusion date of such agreements, with effective dates back to 1948 and 1951.

[157] See D P Sengupta, 'Chapter 6 - India' in Brauner and Pistone (eds) (n 15).

the source country's taxing rights, [158] which to some extent conflicted with the interests of the country's partners.[159] The next two decades did not see a large number of Indian tax treaties.[160]

In the latter half of the 1960s Brazil entered into its first bilateral income tax treaty. In fact, the country already had some history regarding income tax conventions since it had signed tax agreements regarding income from shipping and airline activities before.[161] However, the first comprehensive income tax treaty to be considered as such was the agreement signed with Sweden in 1965; this convention did not enter into force though.[162] The treaty the country entered into with Japan in 1967 was the first one to enter into force.[163] Other income tax conventions were signed by Brazil within the next decade or so, representing almost one third of the total bilateral tax treaties concluded by Brazil that are still in force.[164]

This first wave of agreements concluded by Brazil followed the country's policy in attracting foreign investment.[165] It could even be said that such a policy targeted the attraction of FDI from countries that historically had not massively invested in Brazil.[166] Nevertheless, in spite of not representing significant amounts of investment

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[158] Considering the countries' different levels of development, it seemed to the Taxation Enquiry Commission of 1953-54 that some deviations from the League of Nations model were necessary in case India intended to enter into asymmetric tax treaties. Such a policy seems to be present throughout Indian international tax treaty history since the country's independence. ibid, p. 120.

[159] A specific example of conflict of interest between India and its partners is the negotiation of a tax treaty with the US in the 1950s. After a debate on the feasibility of a tax sparing clause, which in the end would benefit India, the treaty ended up without ratification. Eventually India entered into a tax treaty with the US (1989). ibid, p.160. On the US Senate debates involving the tax sparing clause effects, see United States (ed), *Legislative History of United States Tax Conventions* (US Govt Print Off 1962).

[160] See Annex I.

[161] See Gumpel and Sousa (n 83), p. 212. As an example, the agreement between Brazil and the US for the avoidance of double taxation of income from shipping enterprises can be cited. ibid.

[162] Sergio André Rocha, 'Brazil's Treaty Policy' (2017) 71 Bull Intl Taxation 1. The convention signed with Sweden in 1975 is the one that is in force. See Annex I.

[163] See Annex I.

[164] ibid.

[165] The Brazilian government was clear on it, considering FDI as an important tool for the economic development of the country. See Jose Daniel Diniz, 'Acordos para evitar a dupla tributação de renda: a posição do Brasil' (1975) 2 Projeção 8.

[166] Except for Japan, none of the contracting states of the first wave of the income tax conventions was responsible for a remarkable investment in Brazil in comparison with the total foreign investment in the country. As a comparison, FDI inflow from the US, the UK, Germany (Federal Republic of), and Japan

back then, FDI from these countries was increasing during this period.[167] The policy was mainly based on the Brazilian Second National Development Plan, which intended to pair the economy of the country with the global economic reality present in the 1970s.[168]

Finally, the literature puts forward some reasons why Brazil has entered into only a few agreements during this period. It seems that the jurisdiction to tax framework adopted by Brazil was considered a deterrent to the adoption of a broad range of income tax treaties. Accordingly, since the country followed a territorial approach, it would not be convenient to give up tax collection on income from business carried out in the country since overseas income was not taxed at all.[169] Regardless of the accuracy of such reasoning, it seems that the shift from a territorial-based taxation to a global-based one in 1995 did not influence the country's policy towards an increase in the number of tax treaties.[170]

Second wave – the 1980s and the 1990s

The second period of tax treaty network evolution partially coincides with the liberalisation of the economies of several developing countries during the late 1980s and 1990s, which cleared the way for more capital inflow into those countries. The literature shows that openness is an important factor when a country decides to pursue economic growth and to enter into income tax agreements.[171] However, the importance

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altogether accounted for more than 60% of the total invested in Brazil at the time. See Francisco Dorneles, 'Acordos para eliminar a dupla tributação da renda' (1978) 3 RDT 251.

[167] This was the case of FDI inflow from Austria. In the period immediately before the treaty signature, FDI inflow from Austria had experienced a significant increase. See the press release issued by the Brazilian Federal Revenue Office regarding the signature of the income tax treaty with Austria in 1975. Available at <www.ibdt.com.br> accessed 25 March 2015.

[168] On the Brazilian Second National Development Plan, and the country's international policy, see Jose Daniel Diniz, 'Acordos para evitar a dupla tributacao de renda: a posicao do Brasil' (1975) 2 Projecao 8; Jorge Chami Batista, 'A Estrategia de Ajustamento Externo do Segundo Plano Nacional de Desenvolvimento', (1987) 7 Revista de Economia Politica 66.

[169] See Luís Eduardo Schoueri, 'Chapter 4 - Brazil' in Brauner and Pistone (eds) (n 15).

[170] See Annex I.

[171] Panagiotis G Liargovas and Konstantinos S Skandalis, 'Foreign Direct Investment and Trade Openness: The Case of Developing Economies' (2012) 106 Social Indicators Research 323. On a growth focused approach, see A Cuadros, V Orts and MT Alguacil, 'Openness and Growth: Re-Examining

could vary depending on one's analysis of symmetric and asymmetric double tax treaties.[172]

India began its liberalisation policy during the 1980s[173] and enhanced its market-oriented policy by the early 1990s.[174] This scenario is reflected in the number of income tax treaties signed by the country as well. The period between 1980 and 2000 represents by far the most productive period in terms of negotiating income tax treaties in India.[175]

As for Brazil, the country also opened its economy at the beginning of the 1990s. This occurred because the country adopted a policy aligned with the *Washington Consensus*,[176] whose framework included a more market-friendly policy toward trade

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Foreign Direct Investment, Trade and Output Linkages in Latin America' [2001] Centre for Research in Economic Development and International Trade 167.

[172] Here it is assumed that developing countries have interest in entering into both symmetric and asymmetric agreements. Actually, it is possible even to observe a certain degree of asymmetry when the BRICS enter into tax treaty with certain developing countries. Braun and Zagler show that increase in the openness degree positively affects the tax treaty network amongst developing countries. See Julia Braun and Martin Zagler, 'An Economic Perspective on Double Tax Treaties with(in) Developing Countries' (2014) 6 WTJ 242.

[173] Te Velde highlights the move towards liberalisation in some Asian countries (India included) and Latin American countries that favoured FDI inflow potential from the 1980s onwards. See Dirk Willem te Velde, 'Foreign Direct Investment and Development: An Historical Perspective' [2006] UNCTAD, Overseas Development Institute. On the effects of the liberalisation of the Indian economy on the country's economic growth, see Artur Radziwill, Paul Conway and Sean Dougherty, 'Long-Term Growth and Policy Challenges in the Large Emerging Economies' (2010) OECD Economics Department Working Papers 755.

[174] Michael Hutchison, G Pasricha and Nirvikar Singh, 'Some Market Measures of Capital Account Liberalization in India' [2010] Financial Integration in Asia. Sengupta points to the country's 'more or less closed economy' till the mid-1990s and the few number of tax treaties in India. See Sengupta (n 157).

[175] See Annex I.

[176] Luiz Fernando De Paula, *Financial Liberalization and Economic Performance: Brazil at the Crossroads*, vol 85 (Routledge 2011). The *Washington Consensus* expression was coined based on the proposals put forward by John Williamson. According to the author, the points addressed by him synthetize policy measures that would help Latin American countries in dealing with their debt crisis. Those measures, according to the author, represented what economist from institutions like the World Bank and the International Monetary Fund considered as adequate policy for those countries. See John Williamson, 'What Washington Means by Policy Reform' in John Williamson (ed), *Latin American Adjustment: How Much Has Happened?* (Institute for International Economics 1990). For an account of the 1990s reforms based on such policies, see Roberto Zagha and International Bank for Reconstruction and Development (eds), *Economic Growth in the 1990s: Learning from a Decade of Reform* (World Bank 2005); Dani Rodrik, 'Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform' (2006) 44 Journal of Economic literature 973.

liberalisation and incentives to FDI inflows.[177] Notwithstanding, the liberalisation of the Brazilian economy during the 1990s did not have a massive influence on the number of income tax treaties signed by the country.

When one analyses such a scenario on its own, one can conclude that Brazil strengthened its integration with the international community through the tax treaties signed during the 1980s and 1990s. However, in comparison with India, Brazil improved its tax treaty network only slightly, which can be seen in the astonishing difference between the size of the Indian and the Brazilian tax treaty networks. Finally, it is also important to highlight that, during the 1980s, the Brazilian tax treaty policy began to expand the country's tax treaty network towards developing countries.[178] In this case, some treaties' provisions were patterned in order to reflect the new treaty reality since the focus now was more on symmetric than on asymmetric tax treaties.[179]

In comparison with its peers, South Africa experienced a different scenario. It was not just the liberalisation of the economy that played a crucial role in the economic shift in the country, but also the democratic transition in South Africa. In general, the country did not take an ideological position against FDI even during the Apartheid era, since it adopted a growth-orientated economic policy instead. Actually, it was foreign investor reactions against specific policies that deterred the flow of FDI into the South African economy prior to the 1990s.[180] Therefore, FDI in South Africa experienced a positive trend in the decade immediately following the democratic transition,[181] in contrast to the negative capital flow in the 1980s and early 1990s.[182] In this new economic climate

[177] Such features were present in Brazil from the early 1990s. The implementation of the investment liberalisation policy was more drastic from 1995. See Edmund Amann and Werner Baer, 'Neoliberalism and Its Consequences in Brazil' (2002) 34 Journal of Latin American Studies 945, 946.

[178] Apart from an agreement with Norway (1980), this was the case of the treaties with Argentina (1980), Canada (1984), Czech Republic (1986), Ecuador (1983), Hungary (1986), India (1988), Korea (Rep. – 1989), Philippines (1983), and Slovakia (1986).

[179] Schoueri stresses the shift from a policy focused on tax sparing and matching credit, as was the case of previous treaties signed with developed countries. See Schoueri, 'Chapter 4 – Brazil' (n 169).

[180] Clark and Bogran highlight the extensive state intervention in the economy, the apartheid regime, and the country's monetary policy as part of such policies. See Hunter R Clark and Amy Bogran, 'Foreign Direct Investment in South Africa' (1998) 27 Denv. J. Int'l L. & Pol'y 337, 340.

[181] S Du Plessis and B Smit, 'South Africa's Growth Revival After 1994' (2007) 16 Journal of African Economies 668, p. 674.

[182] Indeed, the literature shows that the net capital flows in the country experienced a high volatility from the mid-1970s onwards due the political scenario in the country. On the matter, see Nicolaas Johannes

and political dispensation, South Africa concluded the majority of its tax treaties.[183]

Third wave – from 2000 to date

Although not actively seeking to conclude an impressive number of tax treaties, Brazil has increased its treaty network in the last decade or so. Since 2000, Brazil has entered into eleven more income tax agreements that are already in force.[184] Considering the increase in the international presence of Brazilian multinational corporations (MNCs), the policy of signing tax treaties with countries that are not traditional investors in Brazil makes sense.[185] Some features of these new tax agreements are considered as indicative of a new Brazilian approach to the issue. This is the case of the counterparties to such agreements and the design of some of their clauses, as is the case of the absence of tax sparing and matching credit provision.[186] In comparison with Brazil, India and South Africa have greatly improved their tax treaty networks with developing and developed countries alike;[187] since 2000, India has signed 43 tax treaties, while South Africa has entered into 35 additional ones.[188]

2.4.2 The Tax Treaty Network and FDI Flow

The differences between the paths chosen by these countries, with regard to the development of their tax treaty networks, are clear. Despite their similarities as emerging economies that aim at attracting FDI, only India and South Africa followed the assumption of the benefits of a broad tax treaty network. Nevertheless, one can

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Schoeman et al, ‘Foreign Direct Investment Flows and Fiscal Discipline in South Africa’ (2000) 3 South African Journal of Economic and Management Sciences 235.

[183] See Annex I.

[184] ibid.

[185] In reality, some of these countries have already received investment from Brazil. This is the case of Israel, South Africa, and Peru. See UNCTAD Bilateral FDI Statistics. Available at < http://unctad.org/Sections/dite_fdistat/docs/webdiaeia2014d3_BRA.pdf> accessed 07 April 2015.

[186] See Schoueri, ‘Chapter 4 – Brazil’ (n 169), p. 46.

[187] Those figures consider only tax conventions that are in force. See Annex I.

[188] See Annex I. Sengupta points to the fact that India does not include a tax sparing clause into its recent treaties as well. See Sengupta (n 174). The same happens with South Africa since presently the country does not request the inclusion of such clause. See Johann Hattingh, ‘Chapter 8 - South Africa’ in Brauner and Pistone (eds) (n 15), p. 259.

identify important dissimilarities even between the Indian and the South African treaty networks. Only India has followed a consistent policy in entering into income tax agreements since its independence from the UK, with the most emphasis on such a policy made from the 1980s onwards. On the other hand, despite the impressive total number of its tax treaties, South Africa has only just accelerated the process of building up its tax treaty network at the end of the Apartheid regime in the mid-1990s. On their similarities, it should be noted that both India and South Africa have treaties with the majority of the OECD member[189] countries.[190]

Brazil is clearly lagging behind the tendency of building up a broad tax treaty network, a policy which some consider controversial since it does not aid the expansion of Brazilian MNCs' business abroad.[191] As for FDI attraction, the Brazilian treaty policy was aimed from the outset primarily at attracting FDI from developed countries,[192] a policy that was put into place mainly during the first and second treaty waves. The Brazilian government, however, did not follow suit with this trend from the 1990s onwards. As a result, only 11 out of the 35 OECD members have entered into income tax agreements with Brazil. However, when one investigates the volume and origins of FDI flow into the Brazilian economy, such a disparity, to some extent, does not seem to have produced a dramatic negative outcome. One can draw such an assumption from the analysis of FDI flow into the Brazilian economy in the last decades from three

[189] For a list of the OECD member countries, see OECD, 'List of OECD Member countries – Ratification of the Convention on the OECD'. Available at <http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm> accessed 11 January 2018.

[190] South Africa has income tax treaties in force with all OECD member countries except Estonia, Iceland, and Slovenia. As for India, it has tax treaties in force with all OECD member countries but Chile (under negotiation). See Annex I.

[191] Brazilian FDI outflow has increased steadily in the last years. This new reality, according to some scholars, claim for a broader tax treaty network since Brazil is becoming an important capital export country. See Schoueri, 'Chapter 4 – Brazil' (n 169), p. 47. Thus, litigation on the Brazilian CFC rules has increased in the last years. About recent changes in the Brazilian CFC legislation, see Paola Violin, 'The Brazilian CFC Regime: Update on Recent Developments' (2014) 68 (9) Bulletin for International Taxation 508. On recent Brazilian tribunals' decisions on CFC rules, see Paulo Rosenblatt, 'Brazil: CFC Rules Update' (2012) 40 Intertax 279.

[192] As the policy adopted by the country mainly during the 1970s. See, e.g., the tax treaty negotiation with Austria.

different jurisdictions Brazil does not have tax treaties with:[193] the US, the UK, and Germany.[194]

During the 1990s

Brazil and the United States signed an income tax treaty during the 1970s, which failed to pass through the US Senate.[195] Nonetheless, in the absence of a tax agreement, the US has historically been one of the major investment partners with Brazil.[196] During the 1990s, the US occupied a prominent position among the original countries for FDI inflow into the Brazilian economy. Investment from US MNCs accounted for 26.03% of the total FDI stock in the Brazilian economy in 1995. In 1996, investment from US companies was responsible for 25.77% of FDI inflow in Brazil, peaking at 29.33% of the total invested in 1999.[197]

Considering the same period, a similar assumption is drawn from the analysis of FDI inflow originating from investors situated in the UK. Though not as prominent as

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[193] Brazil entered into an income tax treaty with Germany in 1975. This treaty was terminated in 2005, (termination date 1 January 2006). See IBFD Tax Research Platform. Available at <www.ibfd.org> accessed 31 March 2015.

[194] Both India and South Africa have income tax agreements with these three countries. India concluded its income tax agreements with the US in 1989, with the UK in 2000, and with Germany in 1995. In 2013, FDI flow into the Indian economy from the US and the UK represented 32% of the total (16% for each country). As for South Africa, the country entered into tax treaties with the US in 1995, with the UK in 1980, and with Germany in 1997. In 2013, FDI flow into the South African economy from the UK, the US, and from Germany represented 48%, 6%, and 5% of the total, respectively. Data available from the IMF, 'Coordinated Direct Investment Survey (CDIS)'. Available at < http://data.imf.org/?sk=D732FC6E-D8C3-44D1-BFEB-F70BA9E13211> accessed 07 April 2015.

[195] Such failure occurred because of the inclusion of a tax sparing provision into the tax agreement. See Schoueri, 'Chapter 4 – Brazil' (n 169). See also Yariv Brauner, 'Por que os Estados Unidos firmam Tratados Tributários? E por que não têm Tratado Tributário com o Brasil?' (2011) 26 Revista Direito Tributário Atual 109, p. 121. Despite such record, other attempts at discussing a tax agreement took place during the early 1990s, without success because of the Brazilian position on the tax sparing provision. See Jason R Connery et al., 'Current Status of U.S. Tax Treaties and International Tax Agreements' [2014] Tax Management International Journal 633.

[196] More recently, the support from the US side in favor of an income tax agreement has gained momentum. See the 2011 US Senate Resolution 108 'Expressing the Sense of the Senate on the Importance of Strengthening Investment Relations Between the United States and Brazil'. Such resolution, issued by occasion of President Obama's visit to Brazil, stressed the position of the US as the main direct investor in the Brazilian economy and the necessity for a bilateral tax treaty between the countries. Available at <https://www.congress.gov> accessed 07 April 2015.

[197] Central Bank of Brazil, 'Tabela Investimento Estrangeiro por País no Brasil'. Available at <www.bcb.gov.br> accessed 07 April 2015.

investment from the US, FDI inflow from the UK is notable considering the total amount invested during the 1990s. The investment stock from the UK accounted for 4.47% in 1995, 1.19% of FDI inflow in Brazil in 1996 and peaked at 4.60% in 1999.[198]

Finally, with regard to Germany, the country occupies second place when it comes to foreign investment stock in 1995, being responsible for 13.98% of the total FDI stock. In 1996, FDI from German investors amounted to 2.77% of the total, decreasing to 1.74% in 1999.[199]

From 2000 onwards

Most recently, investment from German investors has been rather representative. In 2001, FDI inflow from Germany amounted to $551 million USD, reaching a total of $958 million USD in 2005, the year Germany revoked its tax treaty with Brazil.[200] One would expect that, since the Germany treaty was not in force anymore, FDI inflow from Germany would experience a downward trend. However, this did not happen: FDI inflow from German peaked at $2,365 million USD in 2009, and was still as high as $1,171 million USD in 2012.[201] In 2013, Germany was responsible for 2.12% of FDI stock in the Brazilian economy.[202]

The case for the UK did not follow a different path. In 2001 FDI inflow from the UK amounted to $353 million USD, $816 million of USD in 2007, and reached a total of $990 million USD in 2009. In comparison with such data, the direct investment from the UK during the 2010s was more impressive: $1,334 million USD in 2010, $3,315

[198] ibid.

[199] ibid.

[200] See n 143.

[201] UNCTAD Bilateral FDI Statistics. Available <http://unctad.org/Sections/dite_fdistat/docs/webdiaeia2014d3_BRA.pdf> accessed 07 April 2015.

[202] Central Bank of Brazil, 'Censo de Capitais Estrangeiros no País'. Available at <https://www.bcb.gov.br/Rex/CensoCE/port/treemap_ied/treemap.asp> accessed 7 April 2015.

million USD in 2011, and $2,176 million USD in 2012.[203] In 2013, the UK was responsible for 3.32% of FDI stock in the Brazilian economy.[204]

Finally, the US MNCs kept their position as prominent investors in the Brazilian economy. In 2001, US investment amounted to $3,902 million USD, keeping almost the same level of investment in 2005 ($3,673 million USD). 2009 experienced the lowest level of investment during the 2000s, amounting to $1,277 million USD. During the 2010s, FDI from the US was even more remarkable than in previous years, peaking at $13,509 million USD in 2012.[205] In 2013, the US was responsible for 15.30% of FDI stock in the Brazilian economy.[206]

At this point, it is worth noting that this chapter does not provide an in-depth analysis on the desirability of a broad tax treaty network for developing countries. Nonetheless, it is possible to assume that, had Brazil entered into tax treaties with the US and the UK, and kept the German treaty in force, some distortions could have been avoided. Available data indicates that it is likely that investors originally situated in countries that did not have a tax treaty with Brazil have since taken advantage of income tax agreements the country has entered into. The origin country's FDI stock share in the Brazilian economy shifts depending on the location of the final investor.[207] For example, this is the case with investment from companies located in the Netherlands, in Spain and in Luxembourg.[208]

[203] UNCTAD Bilateral FDI Statistics (n 201).

[204] Central Bank of Brazil (n 202).

[205] UNCTAD Bilateral FDI Statistics (n 201).

[206] Central Bank of Brazil (n 202).

[207] The Central Bank of Brazil offers two different types of dataset: one considering the final investor origin, and a second considering intermediate investors. Data available at Central Bank of Brazil (n 152). For an explanation on the method used for the gathering of such data, see Central Bank of Brazil, 'Censo de Capitais Extrangeiros no País – Resultados para 2013'. Available at < http://www.bcb.gov.br/Rex/CensoCE/port/Censo%202014%20ano-base%202013%20-%20resultados.pdf> accessed 07 April 2015.

[208] Brazil concluded income tax agreements with the Netherlands in 1990, with Spain in 1974, and with Luxembourg in 1978. See Annex I.

Table 2.6: Percentage of FDI stock - final and the intermediate investor - 2013

	US	UK	Germany	Netherlands	Spain	Luxembourg
Final investor	20.30	7.34	4.06	3.93	10.71	2.59
Intermediate investor	15.30	3.32	2.12	28.57	11.52	6.86

Source: Central Bank of Brazil[209]

Based on the final investor scenario, investment from the Netherlands accounted for 3.93% in 2013. The same data shows investment from Spain representing 10.71% of the total, while FDI from Luxembourg accounted for 2.59% of the total in the same year. In this scenario, final investors situated in the US get the main share of FDI stock, with 20.30% (116 billion USD) of its total, as opposed to the position highlighted above (15.30%, 87 billion USD). The same data shows different percentiles for investment from final investors located in the UK and in Germany: 7.34% (as opposed to 3.32%) and 4.06% (as opposed to 2.12%), respectively. On the other hand, data concerning the intermediate investor show a higher FDI stock from the Netherlands in 2013 (28.57%). The same trend is observed for investors from Spain and Luxembourg in the same year: 11.52% and 6.86%, respectively.[210]

2.5 Conclusion

This chapter highlighted that the three compared countries followed different paths when implementing their first income tax legislation. Income tax legislation was transplanted into the Indian and South African legal systems during their colonial era. In spite of being clearly influenced by the European experience, Brazil did not borrow an entire set of regulations from a specific jurisdiction. In reality, the first Brazilian income tax legislation was shaped considering the financial needs of an already independent country. Notwithstanding these differences, all the compared countries, to some extent, shared the same concerns on the attraction of FDI from the beginning of the latter half of the twentieth century; India and South Africa clearly from their independence from the UK.

[209] Central Bank of Brazil (n 202).

[210] ibid.

Such concerns influenced the building up process of the tax treaty networks of Brazil, India, and South Africa, which evolved distinctively. South Africa was the first to enter into income tax treaties. However, mainly due to political constraints, its tax treaty network did not significantly evolve until the 1990s, when the country experienced the political turnover towards a democratic system. India pursued a policy aiming at attracting FDI immediately after its independence from the UK. Although mainly following the international practice, since the beginning it was clear to the Indian government that the tax treaty framework offered, and massively followed, by the international community didn't fulfil the needs of developing countries. Nevertheless, both India and South Africa, at different stages, built up an impressive tax treaty network.

This does not fit the Brazilian scenario. To the contrary, the construction process of Brazil's tax treaty network was restrained by particular political assumptions, such as the lack of benefits in entering into tax treaties since the country followed a territorial taxation approach until the mid-1990s. However, the fact that Brazil has far fewer tax treaties than its peers does not seem to have affected the attraction of FDI into the country's economy. Economic data shows that investment from the US, the UK, and Germany have steadily, and impressively, flowed into the Brazilian economy in the last decades. Both the US and the UK have never entered into tax agreements with Brazil, while the tax agreement with Germany was terminated in 2005. However, the same data show that, depending on the final and the intermediate investors' origin, the amount invested into the Brazilian economy from the US, the UK, and Germany changed. It suggests that there have been distortions caused by the lack of tax agreements.

Such analysis lays down the background for the next chapters, which will address an in-depth investigation regarding the subjects examined in this thesis.

CHAPTER 3

Permanent Establishment – Article 5

3.1 Introduction

After the identification of the pattern adopted by Brazil, India, and South Africa on the building-up of their treaty networks, it is necessary to scrutinise the particular provisions of their income tax conventions that are relevant to the present thesis. The first step, therefore, is to shed light on the treaty policy adopted by the compared countries on Article 5. This task stems from the role played by the separate legal entity principle as the underlying rationale for the allocation of taxing rights on business profits between the treaty parties. Although Article 5 does not of itself establish which jurisdiction taxes which category of profits, one needs to understand the way in which the compared countries' treaty provisions define a PE and, therefore, set up the threshold whose passing triggers the taxable presence of an enterprise in the host country. The scrutiny of the diversity of conditions as laid down by the respective paragraphs of Article 5 plays a significant role in such a task. As a result, the analysis on how those treaties widen the PE concept leads to the identification of the extent to which they favour the host country's taxing rights. This lays down the foundations for the subsequent understanding of the approach adopted by Brazil, India, and South Africa on Article 7, being, therefore, intrinsically linked to Chapter 4.

It is necessary to clarify from the outset, however, that the present chapter does not intend to advance the challenges put forward before the compared countries' courts in respect of the application of Article 5; such examination is part of the next chapter. Equally, this chapter does not formulate a new proposal for Article 5 to be adopted by developing countries; nevertheless, its findings are of utmost importance to the proposal to be advanced, for they identify the path the compared countries follow when dealing with the MNEs' activities in their jurisdictions.

Considering the above, this chapter is structured in a way that provides the thesis with a comparative framework that will also be adopted throughout subsequent chapters. Section 3.2 approaches the compared countries' domestic regulation on the PE concept,

while Section 3.3 evolves into an analysis of specific PE topics that receive different treatment by the model conventions. The primary aim of Section 3.3 is to examine to what extent the compared countries depart, if at all, from the OECD MC on Article 5. In doing so, each of its subsections first advances the nature of the subparagraphs under study and identifies the mismatches between the model conventions on the issue. This is done with due emphasis on the reasons underlying the particular approach adopted by the UN MC. Next, they outline the countries' respective treaty policy stances on each of Article 5's relevant subparagraphs; the subsections refer primarily to the model conventions' subparagraphs' numbers without paying special attention to any particular order adopted by the treaties. It is worth mentioning that although the treaties analysis was carried out with regard to all conventions signed by Brazil, India, and South Africa, this chapter refers mainly to the conventions that are still in force; it refers to the terminated ones only where occasional shifts in the treaty policy are relevant. As a result, the comparison outcome frames the full, or lack of, treaty policy alignment with either the OECD MC or the UN MC; when that is not the case, the comparison makes clear the deviation from both the model conventions. Finally, each subsection focuses on the level of deviation from the OECD MC considering the treaties' counterparts as either UN countries or OECD member countries. A comparative table of the conventions in force highlighting each country's treaty policy is provided, with regard to each relevant subparagraph of Article 5.

Section 3.4 concludes the analysis based on the previous section's findings. The aim of Section 3.4 is to check whether the alignment with the OECD MC happens with regard to treaties signed with countries where relevant investors are based. The level and origin of foreign direct investment flow into the compared jurisdictions' economies is key in such a comparison. It weighs the results of Section 3.3's scrutiny and the data on FDI inflow against the assumption that a closer alignment with the OECD MC is desirable when it comes to attracting a high level of investment from MNEs. Section 3.5 concludes this chapter.

3.2 PE regulation in the domestic legislation

As indicated in Chapter 1,[211] the analysis of the tax policy by the compared countries with respect to the existence of permanent establishments departs from the analysis of their legislations.[212] It is in the domestic regulation that one finds, in general, the limits of the presence of the PE and the way profits are to be taxed. The income tax treaties restrict the enforcement of such legislation in a way that the treaty parties[213] cannot consider a company resident in one of them as having a PE in the other one unless in the hypotheses provided by Art 5. Once the notion of the functionally separate entity is set by the regulation and by the treaty's provisions, the profits to be attributed to the PE are limited to its dealings with the enterprise as a whole.[214] The proposal for a framework of attribution of profits to subsidiaries and to PEs as put forward in Chapter 6 comes back to this theme.

3.2.1 Brazil's domestic regulation on PEs

In spite of the country being the destination of investment by transnational companies, one can affirm that Brazil has not approached the concept of permanent establishment in a cohesive way.[215] During the last decades, its domestic legislation has adopted only a few provisions tackling the PE issue, which were mainly included in its Income Tax Code.[216] According to Article 147 of the code, branches, agencies, and representative offices of foreign companies are regarded as legal entities that are subject to the

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[211] See Subsection 1.3.

[212] For the early developments in the PE concept, see Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press 2011), p. 110ff.

[213] On the limited scope of tax treaties, see Peter Harris and David Oliver, *International Commercial Tax* (Cambridge University Press 2010), 343ff.

[214] Chapter 4 elaborates on the compared countries' policy on the issue.

[215] The general concept of an enterprise's establishment has been part of the country's legal system for a while, as in the case of the provision of Article 1,142 of Law 10,406 of 2002 (Brazil's Civil Code). See André de Souza Carvalho, 'Brazil' (2009) 94a CDFI 151, p. 154.

[216] Decree 3,000, published on 26 March 1999, provides for the regulation of the income tax's legal framework in Brazil.

incidence of income tax in the country. Such treatment was also extended to commissionaires or nominees of foreign principals.[217]

Only recently did Brazil give more attention to the topic. When hosting major sport events in the country, specifically the International Football Association's Federation Cup and the World Cup tournaments and the Olympic Games, the legislation was enacted[218] where the term permanent establishment was clearly mentioned; all the same, provisions included therein did not put forward a thorough PE[219] concept.[220] A quite recent regulation on PEs was enacted by the Brazilian authorities in 2016, which was a move aiming at the implementation of the OECD's Country by Country (CbC) Report[221] as put forward by the BEPS Project.[222] Art 2 (IV) of Normative Ruling 1,681/16[223] provides for the definition of permanent establishment, which, in general, mirrors the definition as included in Article 5 of the OECD MC; the first part of the head of item (IV) reflects the wording of Article 5 (1), while its final part and letters (a) to (g) embody the provisions of Article 5 (2) and (3).[224] Even though such provision was laid down in the context of the introduction of the CbC Report's framework in Brazil[225] and with the precise role of defining PEs with respect to the application of such framework, it is nevertheless considered that such a concept was finally

[217] Art 147 (II) and (III).

[218] Law 12.350, published on 21 December 2010 (FIFA's tournaments), and Law 12.780, published on 9 January 2013 (Olympic Games).

[219] Paragraph 4 of Art 7 of Law 12,350/10 provided that any temporary installation in the country of specific foreign legal entities dedicated to the organization of the FIFA's events were not to be considered as constituting PEs.

[220] Paragraph 1 of Art 3 of Law 12,780/13, as amended by Law 13,161/15, excluded specific legal entities established in the country and linked to the realisation of the Olympic Games (such as the international sports federations, the World Anti-Doping Agency, and the National Olympic Committees) as being PEs.

[221] The CbC Report acts as a tool intended to provide tax administrations with adequate information on transfer pricing-related issues. For an explanation on its nature and its features, see OECD, *Country-by-Country reporting*. Available <http://www.oecd.org/tax/beps/country-by-country-reporting.htm> accessed 2 August 2018.

[222] See Subsection 6.6.

[223] Normative Ruling 1,681, published in the Official Gazzete on 29 December 2016.

[224] Art 2 (IV) (g) of Normative Ruling 1,681/16 provides that 'a building site or construction or installation project, only if it lasts more than 12 (twelve) months' constitutes a PE. On the PE construction clause, see Subsection 3.3.1.

[225] Art 1 of Normative Ruling 1,681/16 establishes that such legal diploma was enacted aiming at the regulation of the CbC Report in the country, while the head of Art 2 clarifies that its wording applies to such a framework.

inaugurated in the country's legal system via normative ruling.[226] Nevertheless, one could argue that the concept of PE still needs further regulation in the country's legislation due to the non-statutory nature of normative rulings in Brazil.[227]

3.2.2 India's domestic regulation on PEs

India adopts a fairly diverse approach to its domestic legislation.[228] In fact, it does not have a rule stating the PE concept since it relies on the rules pertaining to business connection instead. Section 9(1) (i) of the Indian Income Tax Act 1961 provides for all the income accruing or arising, directly or indirectly, through or from any business connection in the country to be deemed as accruing or arising in the country.[229] Explanation 2 to Section 9(1) (i), as amended by the Finance Act 2003,[230] then clarifies the meaning of business connection, which, to some extent, reflects the agency PE provision[231] as put forward by many of the countries' treaties.[232] The concept, however, is broader than the PE concept since the only requirement is the existence of a business in the country;[233] e.g. no fixed place of business in the country is required for the existence of a business connection.[234]

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[226] André de Souza Carvalho and Juliana Andrade Costa, 'Permanent Establishments and the Taxable Presence of Non-Residents in Brazil' (2017) 71 Bull Intl Taxation 307, p. 308.

[227] Normative rulings are regarded as instruments of a regulatory nature in relation to laws enacted by the parliament.

[228] For an overview on the Indian tax system, see Shreyas Shah, 'India – Corporate Taxation', IBFD Research Platform - Country Analysis. Available at <www.ibfd.org> accessed 20 June 2018.

[229] The provision reads as follows: '9. (1) The following incomes shall be deemed to accrue or arise in India: (*i*) all income accruing or arising, 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 the transfer of a capital asset situate in India'.

[230] Explanation 2 was inserted in Section 9(1) (i) by the Finance Act 2003. See Shefali Goradia and Shashi Kapila, 'India', (2009) 94a CDFI 345, p. 347.

[231] ibid.

[232] See Subsection 3.3.4 for India's treaty policy on the issue.

[233] Since the term, to some extent, leads to an imprecise definition, the existence of business connection is determined through the analysis of the facts and circumstances involved in each specific case. See Goradia and Kapila (n 230), p. 365.

[234] Amar Mehta, 'The Indian Version of Permanent Establishment: Business Connection' (2014) 20 Asia-Pacific Tax Bulletin 7.

It is also worth mentioning that the taxation of associated enterprises in the Indian regulation refers to the term PE.[235] In the context of the computation of the arm's length price, Section 92F (iii.a) defines the term PE as *a fixed place of business through which the business of the enterprise is wholly or partly carried on.*[236] Finally, the Explanation to Section 44DA of the ITA, which deals with the computation of income related to royalties or fees for technical services, refers to the meaning of PE as inserted in Section 92F (iii.a).[237]

3.2.3 South Africa's domestic regulation on PEs

Among the compared countries, South Africa's domestic regulation[238] seems to be the one that is the most aligned to the concept of PE in international tax practice.[239] According to Section 1 (*Interpretation*) of the South African Income Tax Act 1962, the meaning of PE should be understood as that put forward by Article 5 of the OECD MC as defined from time to time. Such a way of defining a PE has been regarded as a sign of the importance given to the OECD MC and respective commentaries in the interpretation of the concept of PE.[240] Section 1 of the Income Tax Act 1962 reads as follows on the issue:

> '**1. Interpretation**. (1) In this Act, unless the context otherwise indicates – […] **"permanent establishment"** means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that

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235 On the Indian TP framework, see Section 5.4.

236 Section 92F (iii.a) reads as follows: 'Definitions of certain terms relevant to computation of arm's length price, etc. - 92F. In sections 92, 92A, 92B, 92C, 92D and 92E, unless the context otherwise requires, […] (iii.a) 'permanent establishment', referred to in clause (iii), includes a fixed place of business through which the business of the enterprise is wholly or partly carried on;' (emphasis as in the original). Clause (iii) puts forward the concept of enterprise.

237 It reads as follows: 'Explanation. For the purposes of this section, […] 'permanent establishment' shall have the same meaning as in clause (iii.a) of Section 92F.' (emphasis as in the original).

238 For an overview on the Indian tax system, see Johann Hattingh, 'South Africa – Corporate Taxation' IBFD Research Platform - Country Analysis. Available at <www.ibfd.org> accessed 20 June 2018.

239 On the international tax policy adopted by South Africa, see Johann Hattingh, 'Chapter 8 – South Africa' (n 188).

240 See Jennifer Roeleveld and Craig West, 'South Africa', (2009) 94a CDFI 569, p. 571.

partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;' (emphasis as in the original)

3.3 The OECD and the UN model conventions mismatch: from 1980 to date[241]

3.3.1 Article 5 (3) (a): assembly projects and supervisory activities

Both the OECD and the UN MCs contain at Article 5 a construction clause providing for the existence of a PE in case some requirements are met.[242] The nature of such provision is, to some extent, under debate since there is disagreement on it being or not an additional condition to the ones inserted in Article 5 (1).[243] The alternative to an additional provision interpretation would be the case for the DTC providing for a deemed PE apart from Paragraph (1).[244] The latter view is adopted by some jurisdictions, which, to a great extent, could affect the way their legal systems deal with the PE issue since the conditions stated at Paragraph (1) would not necessarily be met by the construction or installation projects. Despite the opposing views on such provision, and in spite of the OECD MC's silence on its very nature, it is assumed hereafter that the most common interpretation favours the additional aspect of Paragraph (3)[245] when designed in the OECD MC fashion. When appropriate, the diverse views provided by the compared countries on the issue will be highlighted

[241] This chapter refers to the compared countries' tax treaties as available at <www.ibfd.org> accessed 1 October 2017.

[242] On issues related to the application of Paragraph (3) of Article 5, see Ekkehart Reimer, 'Permanent Establishment in the OECD Model Tax Convention' in Ekkehart Reimer, Stefan Schmid and Marianne Orell, *Permanent Establishments – A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (4th ed, Wolkers Kluwer 2015).

[243] Brian J Arnold, 'Article 5: Permanent Establishment' in Global Tax Treaty Commentaries (IBFD 2017), Subsection 2.3.1; Robert L Williams, *Fundamentals of Permanent Establishments* (Updated and expanded 2nd ed, Kluwer Law International 2014), p. 100; Hans Pijl, 'The Relationship between Article 5, Paragraphs 1 and 3 of the OECD Model Convention' (2005) 33 Intertax 189. For the construction clause as a rule proceeding from the PE basic rule, see Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation 1991), pgs. 344ff.

[244] The fact that this rule appears under the same heading of the service PE's one in the UN MC works as an argument in favour for a stand-alone provision. Williams (n 243).

[245] Arnold (n 243).

accordingly by means of the tax treaties comparison and the case law analysis on the matter.[246]

With regard to the UN MC departing from the OECD MC, apart from the appearance of the construction PE provision under the same heading of the service PE's one,[247] it relates to the inclusion of an assembly project or supervisory activities as cases for a PE existence, and to a lower time threshold; Article 5(3)(a) of the UN MC reduces the period threshold to six months as opposed to the OECD MC's 12-month limit. The appearance of the differences in Article 5 (3) goes back to the 1980 UN MC edition, with its commentaries even pointing to a few developing countries' positions in favour of the suppression of the time threshold altogether.[248] The final version of Subparagraph (a) ended up with the six-month test, however. It is worth noting that, depending on bilateral negotiations, the 1980 UN MC Commentaries also provided for an alternative to a time limit no less than three months.[249] The subsequent versions contain a slightly different wording with no significant changes.[250] The UN MC's paragraph reads as follows:

> (3) The term 'permanent establishment' also encompasses:
> (a) A building site, a construction, assembly or installation project or supervisory activities in connexion therewith, but only if such site, project or activities last more than six months.

This subsection focuses on the compared countries' treaty provisions without paying attention to minor wording mismatches. Nevertheless, the most relevant deviations from the OECD MC approach are scrutinised, namely the assembly project and supervisory activities inclusions and the diminished time-threshold condition. On the latter, the analysis does not distinguish between the 183 days and six months

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[246] See Chapter 4, Section 4.7.

[247] On the UN MC service PE provision, see Subsection 3.3.2.

[248] *1980 UN MC* (n 17), commentaries on Paragraph (3) of Article 5.

[249] ibid. This alternative time threshold relates also to Subparagraph (b). See Subsection 3.3.2.

[250] The 2001 UN MC replaced the wording 'also', 'if such site' and 'last more than' for the 1980 version's 'likewise', 'where such site' and 'continue for a period of more than', respectively. There was no further amendment made by the 2011 UN MC.

wordings.[251] It does, however, pay attention to diverse periods of time adopted by the DTCs as is the case with the alternative rule in the UN MC fashion; such treaties are included either in the Alternative (UN MC alternative) or Other categories. A particular treaty is identified as matching one of the model conventions only in cases where it fully mirrors the relevant provision. It also draws attention to occasional time aggregation between the multiple sites scenario provided by a few treaties. Additionally, the differences regarding the treaties' counterparties are also stressed, with their positions as UN countries or OECD member countries being highlighted.[252]

(i) Brazil's tax treaties

The analysis shows that Brazil entered into a reduced number of treaties that are fully patterned on the UN MC, those being the treaties with China (1991), Mexico (2003), and Peru (2006). Only one treaty follows the current wording of the OECD MC where it does not include the assembly project and supervisory activities wordings and adopts 12 months as the time limit.[253] The majority of conventions that Brazil has entered into have adopted a provision that fully matches neither of the current versions of the model conventions, however. It was noted that the treaties with Argentina (1980), Finland (1996), and Korea (Rep.) (1989) deviate from the OECD MC only where they adopt a time threshold of six months. Additionally, 26 treaties include the assembly project wording in Article 5 (3); this pattern was observed even with regard to treaties signed after the 1977 OECD MC edition.[254] Out of those treaties, 22 provide for a six-month time threshold, while two others provide for a 12-month one; the treaties with Israel

[251] This subsection considers the 'last 183 days/six months or more' and 'continue for a period of more than 182 days' wordings as also being influenced by the UN MC, as is the case with the treaties India signed with Kuwait (2006) and Saudi Arabia (2006), respectively.

[252] For the methodology adopted, see Chapter 1.

[253] It is the treaty with Ukraine (2002).

[254] That is the case, e.g. of the treaties with Ecuador (1983, Article 5(2)(g)) and Trinidad and Tobago (2008, Article 5 (2) (i)).

(2002) and Russia (2004) have a nine-month limit. Two treaties provide for a time aggregation rule.[255] No UN MC alternative provision on the issue was noted.

With respect to Brazil's conventions with OECD member countries, only one adopted a UN MC provision;[256] it was not observed that any treaty with an OECD member country fully matches the OECD MC. Most of them (20 DTCs)[257] adopted a six-month threshold.[258] It is also worth noting that all but three treaties with such jurisdictions include the assembly project wording.

(ii) India's tax treaties

As for India, its tax conventions are mostly patterned on the UN MC when it comes to the wording of Paragraph (3) (a) of Article 5. Eighty-seven out of 96 tax treaties in force[259] include assembly project and supervisory activities in their PE articles;[260] only the treaty India signed with Libya (1981) has a first part of Paragraph (3) that follows the OECD MC, although matching neither of the model conventions on the time-limit threshold.[261] Rather interestingly, though, eight treaties include either assembly project or supervision activities only in their PE provisions.[262]

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[255] Treaties with Chile (2001) and Peru (2006), both referring to associated enterprises. Article 5 (3) of the treaty with Chile (2001) provides for the supervisory activities as relevant for the aggregation of the time threshold, although not included as a case for a PE.

[256] Treaty with Mexico (2003).

[257] For example, the treaties with Belgium (1972), Canada (1984), Netherlands (1990), and Portugal (2000).

[258] Israel (2002) adopted a nine-month limit, while Turkey (2010) shows a 12-month one.

[259] The present analysis and the table on Article 5 (3) does not include the treaty India signed with Sierra Leone (1956) for it mainly refers to refund of income tax, without any relevant PE provision to be compared with either the UN MC or the OECD MC. Therefore, the table below includes 96 of the total number of India's tax treaties still in force. This pattern is adopted also with respect to the next subsections. See treaty with Sierra Leone (The Income Tax (Double Taxation Relief) (Dominions) Rules, 1956).

[260] Interestingly, the treaty with Japan (1989) includes assembly projects in Paragraph (3), while Paragraph (4) provides for a deemed PE with regard to supervisory activities.

[261] The treaty with Libya does not even entirely follow the OECD MC. Its Article 4 (2) (g) reads as follows: '(g) a building or building site which continues for a period of more than three months.'

[262] Treaties India signed with Bangladesh (1991), Brazil (1988), Egypt (1969), France (1992), Greece (1965), Netherlands (1988), and Slovenia (2003) all include the assembly project wording. The opposite happens in relation to the treaty with the Philippines (1990) since it includes supervisory activities only.

Although not as notable as it was in regard to the first part of Subparagraph (a), the influence of the UN MC on India's conventions is still relevant in relation to the time-threshold rule. Fifty-eight tax conventions have a six-month time-limit rule, with an additional eight treaties matching the UN MC's alternative approach, with their time periods ranging from three to six months.[263] Only nine conventions follow the OECD's 12-months pattern.[264] Diverse time limits were also observed, with 21 treaties providing for a rule that neither aligns with the OECD nor with the UN MC.[265] The treaty with Greece (1965) does not provide for any time limit at all.[266] Finally, it is important to highlight that 16 treaties have a time aggregation between the multiple sites rule[267] in their construction PE provisions.[268]

It is noteworthy that, in relation to Article 5 (3) (a), India's tax treaty network shows provisions patterned after the UN MC with both OECD member and non-member countries. The most striking example, though, relates to the assembly project and supervisory activity inclusion in Paragraph (3), where the only treaty that matches the OECD approach is the one signed with a non-member of the OECD, that is to say the treaty with Libya (1981). On the time-limit provision, the analysis shows that all treaties following the OECD MC are those signed with developing countries that are not OECD member countries.[269] The other three categories (UN, UN Alternative, and Other time-limit rules) are made with developed and developing countries, OECD member

[263] For example, the treaties with Bhutan (2013, four months) and Georgia (2011, 90 days). The treaty with Libya (1981, three months) is also included in this category. See n 51.

[264] That is the case, e.g. of treaties signed with Croatia (2014) and Mozambique (2010).

[265] A diverse range of time limits were observed, as is the case with the treaties signed with Estonia (2011, nine months), Hungary (2003, nine months), Morocco (1998, eight months), and Myanmar (2008, 270 days).

[266] On the time-limit rule, the treaty with Greece (1965) is considered as 'other' in the comparative table.

[267] Such treaties include the conventions with Belgium (1993), Denmark (1989), Italy (1993), and the United States (1989).

[268] It is worth noting that the protocols of the treaties signed with Mexico (2007, Protocol, section I) and Colombia (2011, Protocol, section I) refer also to the aggregation rule in relation to associated enterprises within the meaning of Article 9 provided that both enterprises' activities 'are identical or substantially similar for the same or connected project'.

[269] Treaties with Albania (2013), Croatia (2014), Kazakhstan (1996), Mozambique (2010), Russia (1997), Serbia (2006), Slovenia (2003), Tajikistan (2008) and Uzbekistan (1993).

countries and UN countries alike.[270] It is important to say, however, that when India does not follow either one of the model conventions on the matter, its treaties extend the time limit beyond the one proposed by the UN MC. Such a pattern is adopted mainly in relation to developing countries that are not OECD member countries.[271]

(iii) South Africa's tax treaties

On South Africa's part, the analysis' outcome provides for a rather interesting scenario. As a rule, the majority of its DTCs follow the UN MC on the inclusion of assembly project and supervisory activities in Subparagraph (a). Sixty-nine tax treaties out of the total of 79 have such influence; only two tax treaties are patterned on the OECD MC.[272] In addition, eight other tax treaties fully follow neither model conventions,[273] usually including assembly projects only in Subparagraph (a).[274] As for the time-limit rule, South Africa has adopted an approach that virtually splits its tax conventions between those matching either the UN MC or the OECD MC.[275] Thirty-seven tax treaties have a six-month time threshold included in Subparagraph (a), thus mirroring the UN MC provision; the exact same number is observed with regard to those that mirror the OECD MC's subparagraph. Only five treaties follow a different path on the time-limit rule.[276] This is the case, for example, in the treaty with Malawi (1971), which does not include a time threshold at all, while the treaty with Romania (1993) includes a nine-

[270] For instance, for the UN MC, the treaties with Austria (1999), Azerbaijan (1988), and Israel (1996); for the UN MC alternative, the treaties with Bhutan (2013, four months), and Norway (2011, three months).

[271] Fourteen out of 21 such treaties are signed with countries that are not members of the OECD. The treaties with OECD countries are the ones India entered into with Estonia (2011), Hungary (2003), Iceland (2007), Latvia (2013), Lithuania (2011), Luxembourg (2008), and Portugal (1998).

[272] Treaties with Austria (1996) and Korea (Rep.) (1995).

[273] The treaties with Grenada (1960, Article II (1) (j)), Sierra Leone (1960, Article 2(j)), and Zambia (1956, Article II, (1) (k)) are included in such category since they do not provide for a construction PE in the UN MC nor in the OECD MC fashion.

[274] Treaties with Brazil (2003), France (1993), Germany (1973), and Malawi (1971). On the contrary, Australia (1999) includes supervisory activities only.

[275] Even though the exact figure does not represent 50 per cent of the tax treaties per MC influence, it is considered as such since most of the treaties that do not match either of them are those signed before the 1963 Draft Convention.

[276] Treaties that do not provide for a construction PE are also included in this category.

month one. No UN MC's alternative provision was observed. Finally, five of South Africa's treaties[277] include an aggregation rule.[278]

South Africa has entered into treaties providing for Subparagraph (a) in the UN MC fashion with OECD member countries and UN countries alike. It has signed 26 DTCs with OECD member countries that include assembly project and supervisory activities into such a provision.[279] With regard to the time-limit rule, the country has signed treaties patterned on the UN MC with six OECD member countries only.[280]

Table 3.1: Article 5 (3) (a) – Construction PE – UN MC v. OECD MC

<table>
<tr><th></th><th colspan="4">Ass. Proj. + Sup. Act.</th><th colspan="6">Time-limit rule</th><th>Ag.</th></tr>
<tr><th></th><th colspan="2">UN</th><th>OECD</th><th>Other</th><th colspan="2">UN</th><th>Alt.</th><th>OECD</th><th>Other</th><th></th></tr>
<tr><td rowspan="3">Brazil</td><td colspan="2">3</td><td rowspan="3">4</td><td rowspan="3">26</td><td colspan="2">28</td><td rowspan="3">----</td><td rowspan="3">3</td><td rowspan="3">2</td><td rowspan="3">2</td></tr>
<tr><td>UN</td><td>OECD</td><td>UN</td><td>OECD</td></tr>
<tr><td>2</td><td>1</td><td>8</td><td>20</td></tr>
<tr><td rowspan="3">India</td><td colspan="2">87</td><td rowspan="3">1</td><td rowspan="3">8</td><td colspan="2">58</td><td rowspan="3">8</td><td rowspan="3">9</td><td rowspan="3">21</td><td rowspan="3">16</td></tr>
<tr><td>UN</td><td>OECD</td><td>UN</td><td>OECD</td></tr>
<tr><td>57</td><td>30</td><td>35</td><td>23</td></tr>
<tr><td rowspan="3">South Africa</td><td colspan="2">69</td><td rowspan="3">2</td><td rowspan="3">8</td><td colspan="2">37</td><td rowspan="3">----</td><td rowspan="3">37</td><td rowspan="3">5</td><td rowspan="3">5</td></tr>
<tr><td>UN</td><td>OECD</td><td>UN</td><td>OECD</td></tr>
<tr><td>43</td><td>26</td><td>31</td><td>6</td></tr>
</table>

3.3.2 Article 5 (3) (b): furnishing of services

(i) Appearance of the service PE provision

The 1980 version of the UN MC built into Article 5 a provision dealing with the furnishing of services by an enterprise,[281] which did not appear in previous versions of

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[277] As is the case with the treaty with Australia (1999).

[278] The treaties with Chile (2012, Protocol, 2), Mexico (2009, Article 5 (3), final part), and New Zealand (2002, Article 5 (6)) include an aggregation provision in relation to associated enterprises.

[279] Out of the 31 treaties South Africa entered into with OECD-member countries, the conventions with Austria (1996) and Korea (Rep.) (1995) contain neither the assembly project nor the supervisory activities wordings. The conventions with France (1993) and Germany (1973) contain assembly only, while the convention with Australia (1999) provides for supervisory activities only.

[280] Treaties with Australia (1999), Chile (2012), Greece (1998), Israel (1978), Mexico (2009), and New Zealand (2002). All but the treaty with Israel (1978) also have an aggregation rule.

[281] For the different treatment of services in the model conventions, see Wim Wijnen, Jan de Goede and Andrea Alessi, 'The Treatment of Services in Tax Treaties' (2012) 66 Bull Intl Taxation 27.

the OECD MC. The immediate effect of the provision was the widening of the PE definition,[282] even providing for a PE to be deemed to exist when an enterprise performs consultancy services, therefore granting taxing rights in favour of source states.[283] It is telling that the 1980 UN MC was weighted, again, in favour of developing countries,[284] as its commentaries cite the very large sums of money involved when enterprises resident in developed countries furnish services in developing countries as the underlying reason for the proposed Paragraph (3) (b) to Article 5.[285] Originally, Subparagraph (b) provided for six months within any 12-month period as the time threshold, which was later amended to 183 days in any 12-month period by the 2011 UN MC. This version also included the wording 'commencing or ending in the fiscal year concerned'. Currently, it reads as follows:[286]

> 3. The term 'permanent establishment' also encompasses:
> […]
> (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 (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 commencing or ending in the fiscal year concerned.[287]

Apart from the service PE provision as framed above, the 2011 UN MC also provided for the insertion of a new subparagraph (c) when the respective tax treaty does not contain an Article 14 dealing with taxation of personal services.[288] The reason for the 2011 UN MC proposing an alternative version in such cases is that a possible deletion of the independent personal services article in the OECD's fashion could diminish the

[282] Arnold (n 243).

[283] On the deviation nature of the UN MC provision from the OECD approach, rather than an originally intended clarification of Article 5 (1), see Reimer and Rust (29), p. 399.

[284] On how important the issue had become for developing countries before the 1980 UN MC edition, see Stanley S Surrey, *United Nations Model Convention for Tax Treaties Between Developed and Developing Countries: A Description and Analysis* (IBFD 1980), p. 16.

[285] *1980 UN MC* (n 17), commentaries on Paragraph (3) of Article 5.

[286] This subsection does not consider the six-months/183-days difference regarding the 1980 and 2011 provisions to be relevant to the subject of the thesis. The tables contained in this chapter give special relevance to the last part inserted by the 2011 UN MC in subparagraph (b), however. Accordingly, subsection 3.4.1 highlights such a mismatch when analysing the compared countries' tax treaties on the matter.

[287] *2011 UN MC* (n 11).

[288] ibid, commentaries on Article 5, 15.1. On the changes in other articles when Article 14 is deleted, see points 15.5 onwards of the same commentaries.

source state's taxing rights.[289] Its wording is similar to that of Subparagraph (b), maintaining the same time-limit approach.[290] In the case of the adoption of Subparagraph (c), however, the 2011 UN MC indicates the need for a deletion of the expression '*including consultancy services*' contained in Subparagraph (b) on the grounds that it was unnecessary and confusing.[291] This chapter refers to Subparagraph (c) when a tax treaty includes such provision, as it creates a deemed PE, accordingly highlighting its characteristics. Nevertheless, the chapter will not further analyse Article 14 itself, since Article 14 deals with taxation of independent personal services, which is outside the scope of the thesis.

Finally, it is worth nothing the discussion that took place in the UN Committee on the inclusion of a limitation of profits condition to be added to Article 5 on the occasion of the 1980 UN MC edition. In such a case, a Subparagraph (c) would be included, leaving to the contracting states the negotiation on the amount of profits to be considered to give rise to tax to be levied by the source state. This proposal did not go through.[292]

(ii) The OECD's alternative provision

The 2008 OECD MC also provided for a service PE provision, this time as an alternative to be added to the body of Article 5 in case contracting states want to include such provision in their treaties.[293] The reason[294] for this was the position of some member states regarding broader taxing rights that could favour source countries in the case of taxation of services, which contradicts the residence principle, according to which services performed into a contracting state by an enterprise resident in the other

[289] ibid, 15.2.

[290] It reads as follows: *(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned.*

[291] *2011 UN MC* (n 11).

[292] *1980 UN MC* (n 17), commentaries on Paragraph 3 of Article 5.

[293] *2008 OECD MC* (OECD 2008), commentaries on Article 5, 42.21. The 2014 OECD MC Commentaries also provides for such alternative provision at paragraph 42.23 of the commentaries on Article 5.

[294] On the background for such alternative provision inclusion in the 2008 OECD MC Commentaries, see Reimer and Rust (n 29), p. 400.

contracting state should not give rise to tax collection in the source country.[295] Therefore, considering the residence principle, no deemed PE should be considered. All the same, and highlighting the difficulties related to administrative and compliance burdens involved,[296] the commentaries to the 2008 OECD MC considered the possibility of a subparagraph dealing with services performed in the jurisdiction of the source state, services performed in the other contracting state being excluded.[297]

Here, it is important to highlight the main features of the OECD MC version. As was the case with the UN MC version, the OECD MC also puts forward a threshold of 183 days in any 12-month period. It deviates from the UN MC in the case of services performed by an individual, however, when it restricts at Subparagraph (a) the existence of a deemed PE only in cases in which more than fifty per cent of the enterprise's gross revenue as a whole refers to those services in the source state. The reason for the inclusion of this revenue threshold is twofold: the risk of taxing services that are not performed in the source state; and the need to tax profits derived from the services performed instead of gross revenue connected to them. Subparagraph (b) does not contain such limitation.[298]

(iii) UN's proposal for a new article dealing with fees for technical services

Concerns on the erosion of the tax base of developing countries have been present throughout the UN work on international taxation in the last years, with taxation of services as one of its major interests. Accordingly, and bearing in mind the opportunities for avoidance provided to taxpayers of the residence state when the furnishing of services does not fall into the PE provision, the UN Committee has proposed a new article dealing with taxation of fees for technical services. The rationale behind the proposed provision leads to an article patterned on the taxation of royalties in the UN MC's fashion; that is to say, the provision has as a starting point the allocation

[295] *2008 OECD MC* (n 293).

[296] ibid, 42.12.

[297] *2008 OECD MC (n 293)*, commentaries on Article 5, 42.21.

[298] ibid, 42.19.

of taxing rights to the residence state, giving the source state the option to impose withholding tax on fees for the services furnished.[299]

The main features of the proposed provision can be summarised as follows:[300]

(a) Paragraph (1): fees for technical services furnished to a resident of the source state, and paid to a resident of the other state, may be taxed in the residence state;

(b) Paragraph (2): the source state may also tax such fees, provided the levy does not exceed a specific percentage of the gross amount of the fees to be decided by the contracting states;

(c) Paragraph (3): it sets down the technical services meaning;

(d) Paragraph (4): it excludes the application of paragraphs (1) and (2) in cases in which the beneficial owner of fees for technical services has a PE or fixed base situated in the source state, and the fees *'are effectively connected with such PE or fixed base, or business activities referred to in (c) of paragraph 1 of Article 7'*;

(e) Paragraph (5): it deems the fees as arising in a contracting state in cases in which the payer is a resident of that state, or carries out business through a PE or fixed base to which the fee payment obligation is connected;

(f) Paragraph (6): it excludes the tax imposition in cases in which the payer is a resident of a contracting state and carries out business, or performs independent personal services, in the other contracting state or third state through a PE or a fixed base situated therein, and the fees are borne by such a PE or fixed base; and,

(g) Paragraph (7): it provides for the application of the ALP in case of a special relationship between the payer and the beneficial owner of the fees or between them and some other person.

An analysis of the taxation of services will be dealt with in more detail in Chapter 4, which deals with Article 7 and related problems of the taxation of technical services. It

[299] Arnold (n 243). On the new service PE article's proposal, see Andrés Báez Moreno, 'The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed - Yet Appropriate - Proposal for (Developing) Countries?' (2015) 7 WTJ.

[300] UN, Proposed Article XX – Fees for Technical Services.

is briefly referred to here, however, since it provides for a departure from the pattern adopted by both MCs, wherein they provide taxing rights for the source country only in the case of the presence of a PE or a fixed base to which the income is connected.

(iv) Comparison of the tax treaty networks

(iv.1) Brazil's tax treaties

Although the service PE provision occupies a prominent position in the UN efforts to protect the taxing rights of developing countries, the assumption of its appearance throughout a large number of tax conventions signed by all three compared countries did not materialise. The Brazilian case can be referred to here as an unexpected example of the lack of influence of the UN MC on a developing country's tax treaty policy.[301] The country has signed only one tax treaty that contains a service PE provision. In this case, Brazil has followed the 1980 UN MC's Article 5 (3) (b) wording.[302] Even though the country did not adopt a UN MC policy on the matter, the Brazil's tax administration enacted a series of regulation that, in the end, tax services in the source country. Chapter 4 returns to this point since it equally refers to the allocation of profits to the PE and,[303] also, to a series of case law therein analysed.

(iv.2) India's tax treaties

The analysis of India's tax treaty network shows it has the most heterodox approach among the compared countries in terms of Article 5 (3). Although India includes a service PE provision in forty-two treaties into which it has entered that are still in force - therefore in less than a half of its conventions -,[304] it is noteworthy the multiplicity of time limit rules and other features one can find in such provision. Twenty-one of India's tax treaties contain a provision mirroring the 1980 UN MC on the issue, and it is

[301] Rocha, 'Brazil's Treaty Policy' (n 162), p. 336.

[302] Treaty with China (1991).

[303] See Subsection 4.4.

[304] The treaty with Sierra Leone (1956) is not included in this analysis. See n 49.

possible to identify conventions signed by the country with such wording as recently as 2015.[305] Among them, with regard to the 2011 UN MC approach, only the treaty with Botswana includes the wording '*commencing on or ending in the fiscal year concerned*' in Article 5 (3) (b).[306]

It seems, however, that the most outstanding feature of India's treaty network refers to other diverse periods linked to the deemed PE provision that appears in a few conventions. Apart from those conventions in line with the 183 days within a 12-month framework, India has signed twenty-one tax treaties that are still in force containing a different time limit, ranging mainly from ninety days to nine months within a 12-month period. More than half of those treaties fall into the first category, as is the case with the treaties signed with Cyprus (2016), Georgia (2011), Malaysia (2012), and Sri Lanka (2013);[307] the latter scenario accounts for only two treaties.[308]

Other noteworthy features relate to the inclusion of a subparagraph providing for a deemed PE in cases in which services are performed for a related enterprise. Few treaties contain such a subparagraph coupled with the service PE rule as proposed by the UN MC. In regards to such a rule, one can even observe the lack of a time-limit rule in two cases, as in the provision contained in Article 5 (2) (l) (ii) in the convention India signed with Canada (1996).[309] In other cases, such provision states for a thirty-day time limit.[310]

[305] This is the case of Article 5 (3) (b) of the treaty signed with Korea (Rep.) (2015). Other examples of conventions signed during the last decade that show such a feature include the treaties with Colombia (2011), Ethiopia (2011), Finland (2010), Norway (2011), and Romania (2013).

[306] Treaty with Botswana (2005).

[307] Other examples on different time limits can be referred to here, as are the cases with the treaties with Fiji (2014) and Saudi Arabia (182), both providing for 182 days in a 12-month limit.

[308] Treaty with United Arab Emirates Tax Treaty (1992), in Article 5 (2) (i), and treaty with Mozambique (2010), in Article 5 (3) (b).

[309] Treaty with Canada (1996). It is noteworthy that the Protocol signed along with the Canada treaty states that, in cases in which the period of furnishing services extends over two fiscal years and continues for less than thirty days in one of them, the tax should be levied regarding the income connected to the other year only. Protocol, 3. Ibid. The treaty India signed with the US also does not contain a time limit in such a scenario. Article 5 (2) (l) (ii) of the treaty with the US (1989).

[310] Treaties India signed with Switzerland (1994) and the UK (1993), the latter stating a limit of 30 days in 12 months.

India does not adopt the alternative version contained in the OECD MC commentaries.

Last, with regards to the treaty counterparties, India signed fifteen treaties with OECD member countries that contain a service PE rule in Article 5 (3). That is the case of the conventions signed with Iceland (2007),[311] Korea (Rep) (2015),[312] and Poland (1989).[313]

(iv.3) South Africa's tax treaties

An examination of South Africa's treaty policy shows a completely different scenario from the previous two countries. Forty of the tax treaties the country has entered into that are still in force to date contain a provision dealing with the service PE, being roughly patterned on the UN MC. South Africa's tax conventions that contain a provision in line with the 1980 UN MC's wording span from 1996 to 2003. It is important, however, to refer to the treaty with Canada signed in 1995 as the first one including a service PE provision, although its wording does not match entirely the 1980 version of the UN MC.[314] The versions present in the country's treaties that match the 2011 UN MC are mainly those found in conventions signed from the 2000s onward,[315] accounting for more than half of South Africa's tax treaties with Subparagraph (b).

The country's tax treaty network also shows, in a few cases, a deviation from the UN MC regarding the time threshold for the service PE rule. Bearing in mind that the shorter the period threshold for a PE to exist, the more beneficial the convention for services-importing countries, it is not irrelevant that South Africa significantly lowered

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[311] The treaty with Iceland (2007) provides for a more than ninety days within any twelve-month period rule.

[312] The treaty with Korea (Rep.) (2015) provides for a more than hundred and three days within any twelve-month period rule.

[313] Although the treaty with Poland was signed in 1989, it was only in 2013 that the treaty parties agreed on a service PE provision. Article 4 of the Protocol provide for a service PE in case the activities continue (for the same or a connected project) for more than six months in any twelve-month period. See the Protocol to the treaty with Poland (1989) signed on 29/01/2013.

[314] Treaty with Canada (1995). Its Article 5 (3) (b) provides for the furnishing of services to continue for a period of more than twelve months and does not contain the '*any 12-month period*' ending.

[315] A few exceptions can be highlighted here. The treaties signed with Croatia (1996), Egypt (1997), Thailand (1996), and the US (1997) all mirror the 2011 UN MC on the matter.

the time-limit condition in some instances. This is the case, for example, in the treaties signed with Oman (2002),[316] Swaziland (2004),[317] and Lesotho (2014),[318] wherein Subparagraph (b) states a ninety-day threshold. It is also noteworthy that the limit was extended to longer periods in some treaties, as is the case with the conventions signed with Canada (1995),[319] China (2000),[320] and the United Arab Emirates (2015).[321]

With regard to the adoption of Subparagraph (c) in Article 5 (3), South Africa adopted a slightly different approach. While roughly half of its treaties have a service PE provision at Subparagraph (b), one cannot conclude a remarkable influence either by the UN MC or by the OECD MC in terms of the deemed PE in the case of services furnished by individuals. Nevertheless, it is not irrelevant that almost a quarter of its tax treaties contains a provision dealing with services furnished by individuals in Article 5 (3), therefore adopting the alternative Subparagraph (c) version as put forward by the 2008 OECD MC. As expected, those treaties do not contain an Article 14, or any equivalent provision, dealing with taxation of individuals as previously put forward by the OECD or in the UN MC fashion.

Finally, when including a service PE provision in its treaties, South Africa mostly does so with regards to conventions signed with UN countries. Only six treaties that have such rule in Article 5 (3) were signed with OECD member countries. Those are the ones signed with Canada (1995), Chile (2012), Czech Republic (1996), Greece (1998), Mexico (2009), and the US (1997).[322]

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[316] Treaty with Oman (2002).

[317] Treaty with Swaziland (2004).

[318] Treaty with Lesotho (2014).

[319] Treaty with Canada (1995). It provides for a twelve-month threshold. Also, it is important to highlight that its Article 5 (3) (b) does not contain the '*in any 12-month period*' ending.

[320] Treaty with China (2000). It provides for a twelve-month threshold. Subparagraph (b) of the treaty with China has a '*within any twenty-four-month period*' wording.

[321] Treaty with the United Arab Emirates (2015). It provides for a nine-month threshold.

[322] The treaty with Canada (1995) provides for a twelve months rule, without an *in any twelve month period* wording. The treaties with Chile (2012), Czech Republic (1996), and Mexico (2009) all provide for a period exceeding one hundred eighty-three days/six months in any twelve-month period rule. Greece (1998) provides for a one hundred and twenty days in any twelve-month period threshold. The convention with the US (1997) has a more than one hundred and eighty-three days in any twelve month period provision.

Table 3.2: Article 5 (b) and (c) – Service PE – UN MC v. OECD MC

<table>
<tr><th></th><th colspan="2">Service PE</th><th>No Service PE</th></tr>
<tr><td rowspan="3">Brazil</td><td colspan="2">1</td><td rowspan="3">32</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>1</td><td>----</td></tr>
<tr><td rowspan="3">India</td><td colspan="2">42</td><td rowspan="3">54</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>27</td><td>15</td></tr>
<tr><td rowspan="3">South Africa</td><td colspan="2">40</td><td rowspan="3">39</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>34</td><td>6</td></tr>
</table>

3.3.3 Article 5 (4) (a) and (b): delivery of goods and merchandise

The reach of the PE definition contained in Article 5(1) is, to a certain extent, limited by a series of exceptions as provided by Paragraph (4). Its subparagraphs contain a list of scenarios where activities of a preparatory or auxiliary nature do not give rise to the PE presence.[323] The difficulty involved in allocating profits to those activities, coupled with the higher level of certainty provided by such exclusions since they avoid disproportional allocation of profits, are often described as the reasons underpinning the very existence of Article 5(4).[324] Pertinent to the present comparison, the OECD MC version of Paragraph (4) (a) and (b) reads as follow:

> 4. Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:
> (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
> (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

The UN MC departed from the OECD MC approach when the 1980 UN MC excluded the word 'delivery' from the exceptions provided for by both Subparagraphs (a) and (b).[325] The reason for such deviation lays upon the fact that a group of UN members

[323] See Baker, *Double Taxation Conventions* (n 10), 5B.20, 5-2/10.

[324] Arnold (n 243).

[325] The 2001 and 2011 editions of the UN MC did not include any further amendments to those subparagraphs, with the 2001 edition's commentaries showing minor deletions from the 1980's one. The 2011 commentaries, however, is rather succinct for it just refer to 'The deletion of the word 'delivery' reflects the majority view of the Committee that a 'warehouse' used for that purpose should, if the

understood that the maintenance of goods for prompt delivery in the host country was a factor that favoured the sales of the MNEs' products; hence, the same effect would be observed regarding the profits. Concerns were raised also regarding the amount of profits to be attributed to the PE; the same group of countries considered the determination of income attributable to PEs as being a separate matter though.[326]

This subsection mainly focuses on the full, or lack of, alignment of the compared countries' treaty policy with either the OECD MC or the UN MC. The analysis also makes clear where a particular treaty slightly deviates from both the model conventions by including such convention in the 'Other' category in the table below. The position of the treaty counterparts as UN countries or OECD member countries is noted accordingly.

(i) Brazil's tax treaties

The scrutiny of Brazil's DTCs shows the country mostly adopts an OECD MC approach on the issue.[327] Out of all its treaties in force, only the treaties with India (1988), the Philippines (1983), and Russia (2004) are patterned after the UN MC, a pattern therefore adopted with UN countries only. It is equally important to draw attention to the fact that a couple of conventions, while influenced by the OECD MC, provide for an exception at the end of Subparagraphs (a) and (b) since their wordings condition the exclusion of the existence of a PE upon the activities not constituting a sale; that is the case with the treaties with Peru (2006) and Venezuela (2005). These treaties are included in the 'Other' category.

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requirements of paragraph 1 are met, be a permanent establishment.' See 2001 and 2011 UN MCs' commentaries on Article 5(4), paragraph 17.

[326] *1980 UN MC* (n 17), commentaries to Article 5(4).

[327] The treaty with Japan (1967) also follows the OECD MC, although having the provisions under analysis at Article 5 (3) (c) and (d), respectively.

(ii) India's tax treaties

On the opposite side, India excludes delivery of goods and merchandise from the majority of its tax treaties. Fifty-three of the country's conventions in force[328] exclude deliveries from subparagraphs (a) and (b).[329] Twenty-two out of that total are treaties signed with OECD member countries.[330]

It is important equally to refer to treaties that fully align neither with the UN MC nor with the OECD MC. The treaties with Belarus (1997), Uganda (2004), and Ukraine (1999)[331] exclude delivery from Subparagraph (b) only, with their Subparagraph (a) matching the OECD MC wording. Other treaties include an *occasional delivery* wording in Subparagraphs (a) and (b), as is the case with the ones signed with Canada (1996), Malta (2013), Namibia (1997), the US (1989), and Vietnam (1994).[332] Although not including delivery in the body of Article 5, the Protocol of the treaty with the Slovak Republic (1996) provides for the application of both subparagraphs in the case of delivery of spare parts and components by way of replacement.[333] All these conventions are regarded as part of the 'Other' category in the comparative table below.

Finally, apart from such partial alignment with the UN MC, it is worth referring to the fact that India includes a wording in various treaties that sets aside the exceptions for the PE's existence in case the enterprise maintains other fixed places of business in the host country for any other purpose other than those listed in Paragraph (4).[334] This

[328] The treaty with Sierra Leone (1956) is not included in this analysis. See n 49.

[329] Article 5 (4) (a) and (b) of the treaty with Taiwan (2011) follow the OECD MC, and as such it is considered in this subsection. Point 3 of its Protocol provides for an amendment in case the treaty with China is revised, though.

[330] This number includes the treaty with Greece (1965). Its Article II (h) (cc), when referring to the matter, does not exclude delivery as in the OECD MC.

[331] It refers to 'unloading of goods or merchandise'. Nevertheless, subparagraph (a) of the Treaty with Ukraine (1999) is considered as matching the OECD MC.

[332] The other treaties are Serbia and Montenegro (2006), Singapore (1994), and Turkey (1995).

[333] Section I (ii) of the Protocol to the treaty with the Slovak Republic (1986).

[334] The treaty with Belarus (1997) provides an example of such provision: 'However, the provisions of sub-paragraphs (a) to (f) shall not be applicable where the enterprise maintains any other fixed place of business in the other Contracting State for any purposes other than the purposes specified in the said sub-paragraphs.' A variation of such wording is also observed, as is the case of the treaty with Singapore (1994): '[…] fixed place of business in the other Contracting State *through which the business of the enterprise is wholly or partly carried on*.' (emphasis added).

wording is observed in a few treaties with UN countries and OECD member countries alike, with most of them following the UN MC approach in regard to Subparagraphs (a) and (b).[335]

(iii) South Africa's tax treaties

South Africa, for its part, follows an approach similar to that of Brazil on the issue. The country has patterned its DTCs mostly on the OECD MC, excluding the word 'delivery' from 13 tax treaties only.[336] In addition, a reduced number of treaties show Subparagraphs (a) and (b) that differ from both the UN MC and the OECD MC; those are the treaties with Australia (1999),[337] Grenada (1960), and Sierra Leone (1960).[338] These treaties are included in the 'Other' category in the table below. None of the treaties that match the UN MC were signed with OECD member countries.

Table 3.3: Article 5 (4) (a) and (b) – Exclusionary list - UN MC v. OECD MC[339]

	UN MC			OECD MC	Other
	Total	UN	OECD		
Brazil	3	3	----	28	2
India	53	31	22	31	12
South Africa	13	13	----	63	3

3.3.4 Article 5 (5) (b): stock agents

The provision contained in Paragraph (5) of Article 5 provides for a deemed agency PE in case a person who has the authority to conclude contracts, therefore considered as a

[335] For example, treaties with Australia (1991), Bulgaria (1994), and Moldova (1988). The treaty with Singapore (1994) also contains a similar provision, even though it does not fully align with the UN MC.

[336] Article 5(5) of the treaty with Nigeria (2000) considers a fixed place of business used as a sales outlet as being a PE. The treaty is not included into the 'other' category though since its Paragraph (4) follows the OECD MC.

[337] The treaty with Australia (1999) refers to irregular delivery at Article 5 (6) (a) (b).

[338] Article II (1) (j) of the treaties with Grenada (1960) and Sierra Leone (1960), in what is similar to Article 5 (4), provides for the exclusion of the purchase of goods or merchandise from a fixed place of business only.

[339] The table's subheadings 'UN' and 'OECD' refer to the treaty parties, where 'UN' relates to countries that are not OECD member countries.

dependent agent,[340] acts on behalf of an enterprise.[341] This provision applies irrespective of the existence of a fixed place[342] of business in the source jurisdiction, therefore irrespective of the meaning of the provisions contained in Paragraphs (1) and (2) of the same article.[343] In addition to the requirements for the authority to conclude contracts, Paragraph (5) of the OECD MC conditions the existence of such deemed PE to the dependent status of the agent;[344] to the fact that the dependent agent exercises habitually its authority; and as long as the activities are not of a preparatory or auxiliary nature as those contained in Paragraph (4).[345] It is worth mentioning that this deemed rule contained in Paragraph (5) has not been subject to substantial changes since the 1963 Draft Convention;[346] the most important amendment is the reference, instead of only to the purchase of goods or merchandise for the enterprise, to all the activities referred to at Subparagraph (4).[347]

In respect to the UN approach, the 1980 UN MC splits Paragraph (5) into two distinct parts, where Subparagraph (b) provides for the existence of a PE in case the agent, without the authority to conclude contracts in the name of the relevant enterprise, habitually maintains a stock of goods or merchandise, and makes deliveries from there,

[340] On the agency PE as a deemed PE, see Baker, *Double Taxation Conventions* (n 10) , 5-2/12, 5B.24. Also, on the origins and relevance of the agency PE in double tax conventions, see Ekkehart Reimer, 'Permanent Establishment in the OECD Model Tax Convention' (n 1). On the concept of agency in common law and civil law systems, see Christiana HJI Panayi, 'Agency Permanent Establishments in Securitization Transactions' (2005) 33 Intertax 286. On the problems of the agency PE rule's application, see R Vann, 'Tax Treaties: The Secret Agent's Secrets' [2006] B.T.R. 345; Sidney I Roberts, 'The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View (Part One)' (1993) 21 Intertax 396 and Sidney I Roberts, 'The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View (Part Two)' (1993) 21 Intertax 488.

[341] On the individuals' authority to conclude contracts, and the wording variation in certain treaties, see Arnold (n 243).

[342] On the existence of an enterprise's fixed base PE and agency PE in the host country at same time, see Arthur Pleijser, 'The Agency Permanent Establishment: The Current Definition-Part One' (2001) 29 Intertax 167, p. 170.

[343] *2014 OECD MC* (OECD 2014), Commentaries, commentary to Article 5 (5), paragraph 31.

[344] For the analysis of the existence of a PE and the independent agent activities, see point 3.3.6. Also, on the concept of agency and the relationship between Paragraph (5) and Paragraph (6) of the OECD MC, see Guiseppe Persico, 'Agency Permanent Establishment under Article 5 of the OECD Model Convention' (2000) 28 Intertax 66.

[345] Bearing such requisites in mind, the OECD considers this paragraph as an alternative test to the existence of a PE. *2014 OECD MC* (n 342), Commentaries, paragraph 35.

[346] The dependent agency PE was dealt with in Article 5 (4) of the 1963 Draft Convention.

[347] Article 5 (5) of the 1977 OECD MC amended the 1963 Draft Convention on the matter.

on behalf of the enterprise.[348] Article 5 (5) of the UN MC's provision reads as follows, with emphasis added to the deviations from the OECD MC's version:[349]

> 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom *paragraph 7* applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:
> (a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; *or*
> *(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*

On the reasons underlying the inclusion of the provision contained in Subparagraph (b), the 1980 UN MC Commentaries considered Article 5 (5) to be too limited in scope since it restricted its reach to a single type of agent only. In doing so, and according to some developing countries' opinion, such a rule could be a factor favouring tax evasion since an agent who was in fact a dependent one could present himself as one of independent status.[350] The 2001 UN MC Commentaries further explained the UN stance on the matter, stressing that there was no PE to be considered where all the activities linked to the sales occur outside the host country and only the delivery takes place therein. The exception would be, however, the scenario where activities linked, and contributing, to the sales occur also in the host state.[351]

The comparison carried out below does not pay special attention to the amendment of the 1963 Draft Convention by the 1977 OECD MC for it is immaterial with regard to

[348] There was no further amendment to the provision in the 2001 and 2011 UN MCs.

[349] The reference to paragraph 7, instead to paragraph 6 (OECD version), in the UN MC's Article 5 (5) is not relevant to the comparison in this section. See point 3.3.6.

[350] *1980 UN MC* (n 17), commentary to Article 5.

[351] The UN refers to advertising or promotion as examples of such sales-related activities. See *2001 UN MC Commentaries*, commentary to Article 5, paragraph 25. The 2011 UN MC Commentaries amended the commentaries on this provision, with some deletions, e.g. the reference to tax evasion contained in paragraph 24 of the 2001 version. In substance, however, the 2011 UN MC Commentaries kept the same position as the previous one. See *2011 UN MC* (n 11).

the search for the treaties' alignment with the UN MC. It does, however, pay attention to deviations from both model conventions and occasional additions to Subparagraph (b).

(i) Brazil's tax treaties

The vast majority of the treaties Brazil has entered into do not follow the UN MC on the matter. Only a reduced number of conventions include a Subparagraph (b) providing for the maintenance of a stock of goods or merchandise by the agent as a case for a deemed PE. The treaty with Trinidad and Tobago (2008) is the only one that fully aligns with Article 5(5) (b) in the UN MC fashion.[352] Interestingly, the treaty with Japan (1967) sets up the existence of a contract previously concluded by the enterprise, with certain characteristics, as an additional condition to the application of Subparagraph (b).[353] It is also worth pointing out that the treaty with Ukraine (2002) sets the regular sale of goods and merchandise in the name of the enterprise from the stock maintained by the agent as a condition for the deemed PE.[354] These two treaties are included in the 'Other' category in the table below.

(ii) India's tax treaties

India does not adopt a similar standard on the agency PE rule.[355] It includes a UN MC provision in 83 of its tax treaties, mostly following such a pattern irrespective of the treaty counterpart being a UN country or an OECD member country; on the latter, only the treaty signed with Israel (1996) mirrors the OECD MC. It is also important to note that India even broadens the scope of Article 5 (5) in some cases. The country does so by including in the majority of its conventions a paragraph dealing with an agent securing orders in the name of the principal. Additionally, a few treaties also have a

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[352] Article 4 (b) of the treaty with Trinidad and Tobago (2008).

[353] Article 4 (b) of the treaty with Japan (1967) reads as follows (emphasis added): '(b) maintains in that Contracting State a stock of goods or merchandise belonging to the enterprise from which he regularly fills orders on behalf of the enterprise, *consecutive to a contract previously concluded by the enterprise without specifying either the quantity to be delivered, or the date and the place of delivery*.'

[354] Article 5 (5) of the treaty with Ukraine (2002).

[355] The treaty with Sierra Leone (1956) is not included in this analysis. See n 49.

subparagraph where the agent manufactures or processes goods or merchandise for the principal.[356] Sixty-six tax conventions contain a paragraph providing for a deemed PE in case the agent secures orders for the enterprise,[357] while the treaty analysis shows nine of the total conventions in force with a paragraph on manufacturing and processing activities; the country usually couples the latter one with the former.[358] Those provisions are in most of the cases Subparagraphs (c) and (d), respectively. The following are examples of their wordings:

> (c) habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise itself.[359]
>
> (d) in so acting, the person manufactures or processes in that State for the enterprise goods or merchandise belonging to the enterprise.[360]

(iii) South Africa's tax treaties

South Africa's tax treaties mostly align with the OECD MC on the issue. Nineteen conventions only have a Paragraph (5) patterned on the UN MC.[361] Among those, six treaties also provide for a deemed PE provision where the agent secures orders on behalf of the principal;[362] its usual wording is similar to the one adopted by India as referred to above. All the treaties that have a stock agent subparagraph were signed with

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[356] That is the case, e.g. of the treaties with Italy (1993), Kuwait (2006), and Russia (1997).

[357] Rather interestingly, Article 5 (5) (b) of the treaty with Taiwan (2011) provides for a PE only in case the agent secures orders on behalf of the enterprise. However, the treaty's Protocol (Section 4) provides for an automatic revision of Article 5 in case the treaty with China in revised to include a provision to the effect that the maintenance of a stock of goods or merchandise constitutes also a PE. The treaty with China (1994) has not been revised on the matter so far.

[358] This is not the case of the treaty with Switzerland (1994). In addition to the UN MC approach, its Article 5 (5) (iii) provides for a deemed PE only in case the agent manufactures or processes goods or merchandise for the enterprise. This provision also clarifies its reach, as follows: '[…] provided that this provision shall apply only in relation to the goods or merchandise so manufactured or processed.'

[359] Article 5 (5) (c) of the treaty with Latvia (2013).

[360] Article 5 (5) (d) of the treaty with Australia (1991).

[361] The treaty with Malaysia (2005), instead of delivery of goods and merchandise from the stock maintained by the agent, provides for orders regularly obtained and executed on behalf of the enterprise. The treaties with Namibia (1998), Romania (1993), Russia (1995), and Taiwan (1994) all require the agent to regularly fill orders from the stock of goods or merchandise on behalf of the enterprise. The ones with Thailand (1996) and Tunisia (1999) require the agent to either fill orders or make deliveries on behalf of the enterprise. All of them are considered in the analysis as following the UN MC, though.

[362] For example, the treaties signed with Namibia (1998) and Taiwan (1994).

UN countries. Rather interestingly, though, in some cases South Africa entered into treaties that do not have a stock agent provision in the UN MC fashion and, at the same time, slightly deviate from the OECD MC. The treaty with Australia (1999) provides for a deemed PE in case the agent manufactures or processes goods or merchandise belonging to the principal;[363] the one with Nigeria (2000) provides for a deemed PE in case the agent habitually secures orders for the sales of goods or merchandise exclusively or almost exclusively for the principal; [364] and the convention with Zambia (1956) provides for a PE in case the agent maintains a stock of merchandise from which he regularly fills orders on the principal's behalf, stock of goods not being included.[365] All three of these conventions are referred to as part of the 'Other' category in the table below.

Table 3.4: Article 5 (5) (b) – Agency PE – UN MC v. OECD MC[366]

<table>
<tr><th rowspan="2"></th><th colspan="4">UN MC</th><th rowspan="2">OECD MC</th><th rowspan="2">Other</th></tr>
<tr><th colspan="2">Stock Agent</th><th>Sec. orders</th><th>Manufacture</th></tr>
<tr><td rowspan="3">Brazil</td><td colspan="2">1</td><td rowspan="3">----</td><td rowspan="3">----</td><td rowspan="3">30</td><td rowspan="3">2</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>1</td><td>----</td></tr>
<tr><td rowspan="3">India</td><td colspan="2">83</td><td rowspan="3">66</td><td rowspan="3">9</td><td rowspan="3">13</td><td rowspan="3">----</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>50</td><td>33</td></tr>
<tr><td rowspan="3">South Africa</td><td colspan="2">19</td><td rowspan="3">6</td><td rowspan="3">----</td><td rowspan="3">57</td><td rowspan="3">3</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>19</td><td>----</td></tr>
</table>

3.3.5 Article 5 (6): insurance activities

Different to the OECD framework, the UN MC provides for the existence of a PE of an enterprise doing business in the insurance sector other than through a fixed place PE or agency PE. Article 5 (6) of the UN MC deals with the taxation of insurance companies by the attribution of taxing rights to the source country in cases where the

[363] Article 5 (7) (b) of the treaty with Australia (1999).

[364] Article 5 (6) (b) of the treaty with Nigeria (2000). The same subparagraph also extends such PE provision to enterprises controlled by the principal or where the principal has controlling interest.

[365] Article II (1) (k) of the treaty with Zambia (1956).

[366] The table's subheadings 'UN' and 'OECD' refer to the treaty parties, where 'UN' relates to countries that are not OECD member countries.

company collects premiums or insures risks in its territory. As an exception, though, the UN MC excludes from the reach of Paragraph (6) companies doing business in the re-insurance sector and those cases where an independent agent acts on behalf of the foreign company. Such provision reads as follows:

> 6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

The UN MC has departed from the OECD approach since its 1980 edition.[367] Its commentaries point to the inadequacy of treatment of the definition of the PE by the OECD MC in regard to the insurance business.[368] From the developing countries' views, on one hand, the difficulties involved in taxing the insurance companies were stressed since dependent agents usually would not be allowed to conclude contracts on behalf of the enterprise, therefore being out of the scope of Article 5 (5) (a) of the UN MC. On the other hand, in a case where the agent was of an independent status, the same difficulty would be observed given that both the UN and the OECD model conventions do not grant taxing rights to the host country in such a scenario.[369] Consequently, consensus was reached that the place where the premiums are paid indicates the jurisdiction where tax may be imposed. The taxing rights of the country where the risks are located depend, however, upon the presence therein of the person acting on behalf of the enterprise collecting the premiums and through whom the risks are insured.[370] Finally, it is worth noting that the 1980 UN MC's Commentaries refers to the debate on the presence of a PE in cases of independent agents acting on behalf of insurance companies. Considering the intricacies involved in such a scenario, and

[367] The OECD MC does consider the case for bilateral negotiation on the matter, though. See the *2014 OECD MC* (n 342) Commentaries*,* commentaries on Article 5, paragraph 39.

[368] *1980 UN MC* (n 17), commentaries on Paragraph 6 of Article 5. The 2001 and 2011 versions, with minor changes, incorporate the substance of the 1980 commentaries.

[369] On the taxation of agents of independent status, see point 3.3.6.

[370] *1980 UN MC* (n 17), commentaries on Paragraph 6 of Article 5.

the opposing views from the developing[371] and developed countries' perspectives,[372] the inclusion of a particular provision dealing with the issue was left to bilateral negotiations.[373]

(i) Brazil's tax treaties

The examination of Brazil's treaties shows that the country adopted a policy that predominantly follows the OECD MC on the matter. Eighteen treaties do not provide for an insurance deemed PE. Of the remaining conventions, even though a large number have such provision, 11 that are still in force do not except the re-insurance companies from having a PE in the host country; the majority of these were signed before the 1980 edition of the UN MC.[374] Those treaties' counterparties are UN countries and OECD member countries alike.[375] They are included in the 'Other' category in the table below. Only four treaties fully align with the UN MC wording; they are the ones signed with Mexico (2003), Netherlands (1990), Peru (2006), and the Philippines (1983). No provision providing for a PE in case of an independent agent acting on behalf of an insurance company was observed.

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[371] Apart from the argument that the allocation of risks and the proper nature of the insurance business allowed the conclusion for the presence of a PE, the developing countries pointed to the fact that agents could act on a part-time basis, making it difficult to identify whether or not they were acting in an independent capacity. *1980 UN MC* (n 17), commentaries on Paragraph 6 of Article 5.

[372] See *1980 UN MC* (n 17), commentaries on Paragraph 6 of Article 5.

[373] Even though the issue is subject to bilateral negotiation in the UN MC, the table on insurance PE refers to it as the 'UN Alternative' for simplicity's sake.

[374] Only three treaties with such provision were signed from 1980 onwards. They are the treaties with Argentina (1980), with Canada (1984), and with Ecuador (1983).

[375] Nine out of 22 treaties in force Brazil signed with OECD member countries have such provision, e.g. the treaties with Belgium (1972), France (1971), and Luxembourg (1978).

(ii) India's tax treaties

As for India, the country adopts an insurance PE provision in 51 of its tax treaties that are in force,[376] all of them matching the UN MC wording[377] in excluding the re-insurance sector from the deemed PE concept.[378] The inclusion of the requirements of collection of premiums and insurance of risks taking place in the host country were also observed in all of those treaties.[379] Among the treaties with the insurance provision, 13 were signed with OECD member countries. No provision providing for a PE in case of an independent agent acting on behalf of an insurance company was observed.

(iii) South Africa's tax treaties

South Africa has a different approach in comparison with India since the vast majority of its treaties do not include the insurance PE rule, therefore following the OECD MC. The country includes an insurance PE into 12 conventions only. In all of those treaties, the requirements for the existence of an insurance PE, and the exclusion of the re-insurance sector, were observed. All of the treaties with such provisions save the ones signed with Chile (2012) and Mexico (2009) are conventions with UN countries. No PE provision dealing with an independent agent acting on behalf of an insurance company was observed.

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[376] See n 49 on the treaties in force and exclusion of Sierra Leone (1956) from the analysis. The treaty India signed with Italy (1993) does not include a particular paragraph dealing with the insurance business in its text. Nevertheless, a Protocol signed in 2006 amended the 1993 convention in order to provide for such deemed PE. On the Protocol's details, see 'Protocol between India and Italy – details', IBFD's Tax Treaties Database. The 1981 treaty with Italy (terminated) did not contain any provision on the matter.

[377] Among all India's tax conventions, only the treaty with Kenya (1985, terminated) did not except the re-insurance sector when adopting the insurance deemed PE concept. The new treaty signed in 2016 contains an insurance PE provision fully matching the UN MC.

[378] It is noteworthy that an insurance PE provision should be included in the treaty with Estonia (2011) in case the country adopts such approach in later tax conventions. See treaty with Estonia (2011, Protocol, Section 1).

[379] The protocol for the treaty with Saudi Arabia (2006) even clarifies that the provision applies for both individuals and companies, and that it is not even necessary for the agent to be resident or to have a place of business where it acts for the enterprise. Treaty with Saudi Arabia (2006, Protocol, 6).

Table 3.5: Article 5(6) – Insurance PE – UN MC v. OECD MC[380]

<table>
<tr><th></th><th colspan="2">UN MC 5 (6)</th><th>UN Alt.</th><th>OECD MC</th><th>Other</th></tr>
<tr><td rowspan="3">Brazil</td><td colspan="2">4</td><td rowspan="3">-----</td><td rowspan="3">18</td><td rowspan="3">11</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>2</td><td>2</td></tr>
<tr><td rowspan="3">India</td><td colspan="2">51</td><td rowspan="3">-----</td><td rowspan="3">45</td><td rowspan="3">----</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>38</td><td>13</td></tr>
<tr><td rowspan="3">South Africa</td><td colspan="2">12</td><td rowspan="3">-----</td><td rowspan="3">67</td><td rowspan="3">----</td></tr>
<tr><td>UN</td><td>OECD</td></tr>
<tr><td>10</td><td>2</td></tr>
</table>

3.3.6 Article 5 (7): agents with one principal and the arm's length limitation

Article 5(6) of the OECD MC excludes the existence of a PE in case an enterprise does business in a particular country through a broker, general commission agent or other person of independent status. The reason for the inclusion in the model convention of such provision lies in the fact that, as a rule, an independent agent acts on a separate basis from other business entities.[381] Factors such as the entrepreneurial risks borne by the agent, the control exerted by the other enterprise, and the agent's exclusivity are pointed out as important indicators when one intends to assess the level of independence of the agent.[382] The UN MC reproduces the same rule in the first sentence of its Article 5 (7), adding an extra wording, though. In the UN MC version, a deemed PE is to be considered in case the agent devotes his activities wholly or almost wholly on behalf of the principal, therefore being considered as an agent of a dependent status.

Considering the provision's evolution in time, it is necessary to split the paragraph's analysis into two parts. The first deviation from the OECD happened through the 1980 UN MC edition, which was once more based on the developing countries' position in

[380] The table's subheadings 'UN' and 'OECD' refer to the treaty parties, where 'UN' relates to countries that are not OECD member countries.

[381] Arnold (n 243). On the origins of the terms included in the independent agent PE provision, see Baker, *Double Taxation Conventions* (n 10), 5-2/13, 5B.27.

[382] See the *2014 OECD MC* (n 342), Commentaries, commentaries on Paragraph 6 of Article 5, paragraphs 38ff.

favour of a wider PE concept. The argument put forward by the 1980 UN MC's commentaries in favour of a different approach was that an agent of an independent status cannot be considered as such in cases where he acts exclusively, or almost exclusively, on behalf of a particular foreign enterprise; the same goes for centrally controlled affiliated enterprises.[383] It is also worth noting the concerns raised by some developing countries on the need for an agreement supporting the conclusion for the agent's dependency on the foreign enterprise, for such requirement would make the provision ineffective.[384] The second deviation of the UN MC relates to the amendment of the independent agent provision on the occasion of the UN MC's 2001 edition. Its wording shows now an arm's length test to be applied to the relationship between the agent and the enterprise. [385] Article 5 (7) of the UN MC reads as follows, with emphasis added to the provision's deviation from the OECD MC:

> 7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. *However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.*

The 2011 UN MC does not contain further amendments in Paragraph (7), although its commentaries bring a revised, expanded approach to the issue. According to them, the arm's length test is the most important factor for an agent to be treated as not being of an independent status.[386]

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[383] *1980 UN MC* (n 17), commentaries to Paragraph 7 of Article 5.

[384] On this requirement, 'It was stated that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise.' ibid.

[385] The 2001 UN MC made clear that the intention of such amendment was to avoid any wrong interpretation in cases where the independent agent was in fact working solely for one enterprise. *2001 UN MC* (n 46), commentaries to Paragraph 7 of Article 5.

[386] The commentaries also add that the agent acting on behalf of only one enterprise could be considered as an indicator of the absence of independency. See *2011 UN MC* (n 11), commentaries to Paragraph 7 of Article 5, paragraph 33.

Apart from the influence of the OECD MC and the UN MC, the analysis of the compared countries' tax treaties also bears in mind the differences between the UN MC editions on the issue. In this respect, the conventions' comparison is split into two categories: the first one identifies the treaties following the 1980 UN MC; and the second identifies those following the 2001 UN MC where they include an arm's length test at Article 5 (7). The analysis equally identifies the treaty counterparties with regard to those conventions influenced by the UN MC. The table below also identifies the treaties that fully match neither of the model conventions.

(i) Brazil's tax treaties

The vast majority of the treaties Brazil has entered into, with both UN countries and OECD member countries alike, does not align with the UN MC's independent agent approach. Only the treaties signed with China (1991), Ecuador (1983), [387] and Venezuela (2005) have a paragraph fully matching UN MC; none of those treaties include an arm's length test in their wording. The convention with India (1988) has a subparagraph that is influenced by the UN MC although not limited by its wording since it also extends the provision to enterprises controlling the principal, controlled by the principal, or subject to the same common control in relation to the principal.[388] On the other hand, although the treaties with Chile (2001)[389] and Mexico (2003)[390] are influenced by the OECD MC, they link the application of the provision on condition that commercial or financial relations between the principal and the agent do not differ from those ones with independent agents. Those treaties are, therefore, considered as also providing for an arm's length test.

(ii) India's tax treaties

The analysis of India's tax conventions shows a different approach. India has an independent agent PE provision influenced by the UN MC in 81 of its tax treaties in

[387] Article 5 (5) of the treaty with Ecuador (1983) aligns with the OECD MC. Nevertheless, Section 3 of the treaty's Protocol provides that, when the activities are performed all or almost all in the name of the enterprise, the agent should not be deemed one of an independent nature.

[388] Article 5 (5) of the treaty with India (1988).

[389] Article 5 (6) of the treaty with Chile (2001).

[390] Article 5 (7) of the treaty Mexico (2003).

force.[391] Out of that total, however, only 67 treaties fully reproduce the wording of Article 5 (7) UN MC, 55 match the 1980 UN MC, while 12 others include an additional arm's length test in Paragraph 7.[392] The remaining treaties (14) are not limited by the UN MC provision since they provide for the reach of such PE rule in case the agent also acts on behalf of a centrally controlled group of enterprises. Among all the conventions influenced by the UN MC, 26 were signed with OECD member countries.[393] Finally, the treaties with Germany (1995) and Israel (1996), although following the OECD MC, provide also for an arm's length test.

(iii) South Africa's tax treaties

South Africa's DTCs mostly follow the OECD MC framework. Only eight treaties match the UN MC with regard to the independent agent PE, all signed with UN countries. Out of those treaties, only four contain an arm's length test.[394] The convention with Thailand (1996), although influenced by the 1980 UN MC, also refers to the application of the independent agent provision in cases where the agent acts on behalf of an enterprise either controlled by the principal or where he has a controlling interest in it.[395] Rather interestingly, even though the treaties with Chile (2012) and Mexico (2009) follow the OECD MC, they also add an arm's length test's equivalent wording at the subparagraph dealing with independent agents.[396]

Table 3.6: Article 5 (7) – Independent Agent PE – UN MC v. OECD MC[397]

	UN MC			Counterparts		OECD MC	
	1980	2001	Control	UN	OECD	Para 6	AL test
Brazil	3	----	1	4	----	27	2
India	55	12	14	55	26	13	2
South Africa	3	4	1	8	----	69	2

[391] The treaty with Sierra Leone (1956) is not included in this analysis. See n 49.

[392] For instance, Article 5 (6) of the treaty with the Netherlands (1988).

[393] That is the case, e.g. of the treaty signed with Norway (2011).

[394] They are the treaties with Cameroon (2015), Iran (1997), Kenya (2010), and Malta (1997).

[395] Article 5 (6) of the treaty with Thailand (1996).

[396] Article 5 (7) of the treaties with Chile (2012) and Mexico (2009).

[397] The number of treaties that follow the OECD MC is to be considered as the result of the addition of both the 'Para 6' and 'AL test' columns' figures.

3.4 Findings from the treaty policy comparative analysis

3.4.1 The UN MC influence throughout Article 5

The analysis of the compared countries' tax treaty network shows that none of them adopted a binary option in following either one of the model conventions throughout all the paragraphs of Article 5. In fact, even a pattern of one of the conventions being more influential with regard to a specific paragraph of Article 5 in all three treaty networks did not materialise. One can say beyond any shadow of a doubt that Brazil, India, and South Africa do not adopt a coordinated pattern when laying down the PE threshold in their tax treaties. Therefore, their tax treaty policies, individually considered, do not seem to relate to the fact that they are emerging countries, and part of the BRICS bloc. Nevertheless, important features emerged from the comparison on the PE provision.[398]

The figures included in this subsection show the model conventions' influence on the paragraphs of Article 5 throughout the compared countries' treaty networks. They adopt as a departing point the full influence exerted by the OECD MC. Their nodes are positioned towards the right end of the horizontal axis in accordance with the percentage of treaties still in force that adopt a policy influenced by the UN MC, thereby deviating from the OECD MC approach.[399]

(i) India

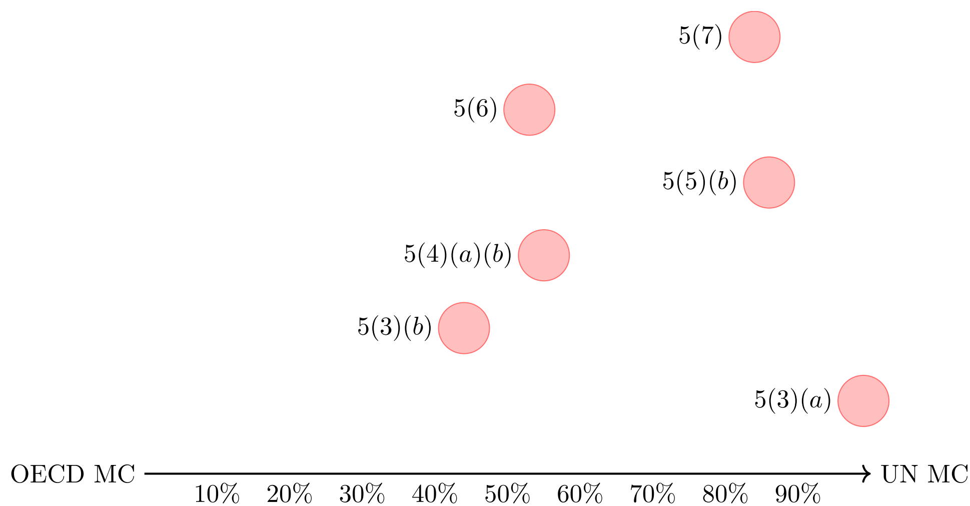
In this sense, India is the country that most clearly deviates from the OECD MC influence. The country's treaty policy follows the UN MC at least in 50 per cent of its conventions with regard to all but one of the paragraphs analysed. Even when the UN MC approach is not followed, the pattern adopted does not massively comply with the

[398] On the intended compared countries' policies as a bloc, see Chapter 2.

[399] On the construction PE's paragraph, the figures do not consider the mismatches between the time-limit thresholds; they only consider the inclusion of assembly project and supervisory activities in Paragraph (3) (a). The treaties that adopt either assembly project or supervisory activities are included in the analysis as well. On the insurance PE, the treaties included in the Other category are also included in the analysis since they clearly deviate from the OECD MC toward the UN MC framework.

OECD MC; this is the case with the service PE paragraph. Still a relevant number of treaties show such a provision (42 out of 96), with exactly half them providing for a less than six-month time limit.[400] On the other paragraphs, the UN MC influence is outstanding. For instance, on the construction PE just one treaty does not include assembling project or supervisory activities in Paragraph (3), while just nine conventions provide for a 12-month time threshold in the OECD MC fashion.[401] When shedding light on the treaty counterparties, the comparison also showed that India mostly adopts a UN MC approach even when entering into agreements with OECD member countries; the only exceptions, although not irrelevant, are with respect to the service and insurance PEs (15 and 13 treaties signed with OECD member countries, respectively).

Figure 3.1: Article 5 - Influence of the UN MC on India's tax treaty network



(ii) South Africa

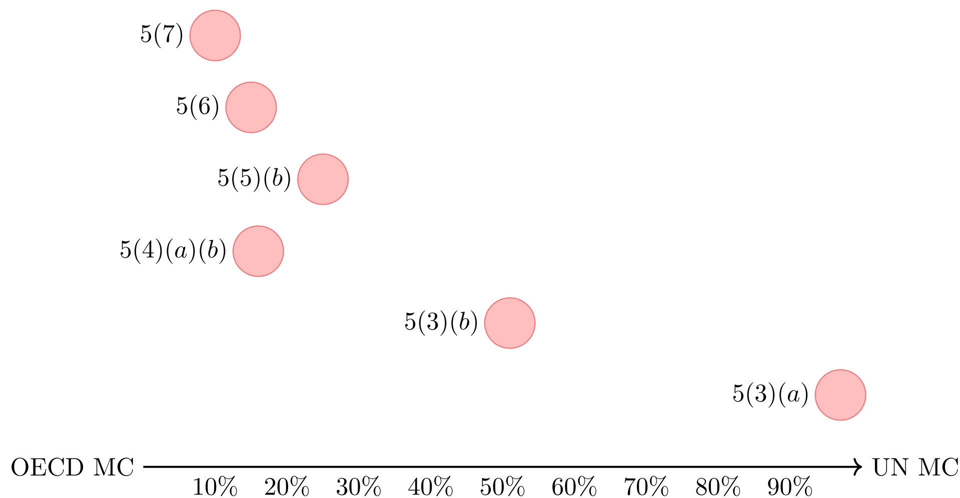
South Africa occupies the second position among the compared jurisdictions on the matter. Only the provision dealing with the construction PE shows an outstanding UN

[400] See Subsection 3.2.2 at (iv.2).

[401] See Subsection 3.3.1 at (ii).

MC influence, although limited only to the inclusion of assembly project and supervisory activities to Paragraph (3) (a); on the time-limit rule, the model conventions influence is virtually split.[402] The UN MC was not massively adopted by South Africa's conventions; only just half of the country's treaties have a service PE paragraph, the majority of them signed with UN countries.[403]

Figure 3.2: Article 5 - Influence of the UN MC on South Africa's tax treaty network[404]



(iii) Brazil

Finally, out of the total paragraphs analysed, Brazil deviates in only one case from the OECD MC. Only the construction PE provision shows a clear UN MC influence; apart

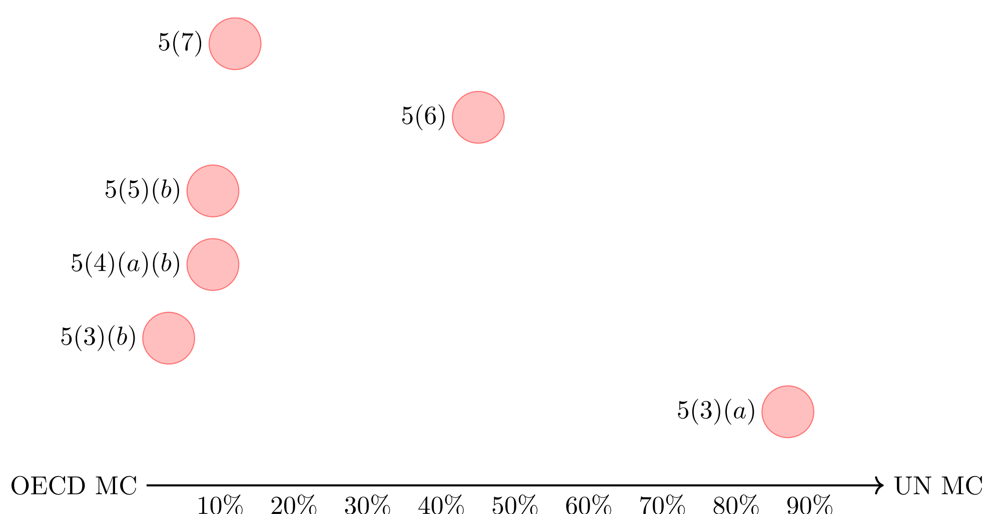
[402] See Subsection 3.3.1 at (iii).

[403] See Subsection 3.3.2 at (iv.3).

[404] The node that represents Paragraph (5) (b) of Article 5 (agency PE) includes the treaty South Africa signed with Zambia for it provides for a PE in case the agent maintains a stock of merchandise in the host country from which he regularly fills orders on the principal's behalf. See Subsection 3.2.4 (iii). Therefore, although not entirely matching the UN MC, it is considered in the figure as being influenced by it.

from three treaties fully aligning with the UN MC,[405] and one fully aligning with the OECD MC,[406] either the assembly project or supervisory activities wording were observed in the majority of the conventions, while the time rule in all but five treaties follows the six-month period threshold.[407]

Figure 3.3: Article 5 - Influence of the UN MC on Brazil's tax treaty network[408]



3.4.2 Patterns adopted considering the FDI origin

Apart from the above, one also needs to understand the level of influence the model conventions exert on the compared countries' tax treaty networks with regard to the FDI origin jurisdictions. Considering that countries also enter into tax treaties to offer a secure legal environment wherein foreign enterprises and individuals alike can invest, such analysis can shed light on the possible negative effects caused by a lack of alignment with the OECD MC of particular treaties. In this sense, this subsection carries

[405] Treaties with China (1991), Mexico (2003), and Peru (2006). See Subsection 3.2.1 at (i).

[406] Treaty with Ukraine (2002). ibid.

[407] See Subsection 3.2.1 at (i).

[408] The node that represents Paragraph (5) (b) of Article 5 (agency PE) includes the treaties Brazil signed with Japan (1967) and Ukraine (2002) that are classified in the Other category in the respective table. See Subsection 3.2.4 (i).

out a comparison between those treaties that follow a UN MC approach and the level of FDI flow into the compared countries' economies. This comparison considers the 20 most important origin jurisdictions on the matter.

(i) Brazil's tax treaty network

Brazil clearly adopted a UN MC approach to the construction PE with regard to the treaties it signed with relevant FDI origin jurisdictions.[409] Although the treaty with Mexico (2003)[410] is the only one among those conventions that fully adopted the UN MC's wording on Article 5 (3) (a), the majority of tax agreements with the top 20 counterpart economies deviate from the OECD MC; 12 treaties with such countries have a construction PE rule that has the assembly project wording, all of them providing for a six-month time threshold.[411] The treaties that do not show a six-month time-limit rule in Article 5 (3) (a) are treaties with countries that do not act as important investors in Brazil's economy; hence, Ecuador (12-months), Israel (nine-months), Russia (nine-months), Turkey (12-months), and Ukraine (12-months)[412] do not account for relevant FDI in Brazil, having invested less than one per cent each of the total foreign direct investment the country received in 2015.[413] It is also important to highlight that few conventions have an insurance PE rule as in the UN MC,[414] while only one follows

[409] For the classification of the most relevant FDI's origin jurisdiction, see Brazilian Central Bank, *Brazil's FDI stock from 2010 to 2015, Direct Investor Origin Jurisdiction*. Available at <http://www.bcb.gov.br/Rex/CensoCE/port/resultados_censos.asp?idpai=CAMBIO> accessed 31 December 2017.

[410] Mexico occupied the 12th position in the FDI's origin jurisdiction classification in 2015.

[411] For example, the treaties with Netherlands (1990), Luxembourg (1978), and Norway (1980). They are positioned, respectively, as the 1st, 4th, and 15th most important counterpart economies with regard to the FDI flow into the Brazilian economy. The only treaty that adopts an OECD MC's approach on the matter is the treaty with Korea (Rep.) (1989); this country occupies the 19th position in the same classification. On such influence of the UN MC on Brazil's tax treaty network, see Subsection 3.2.1.

[412] All those treaties but the one with Ukraine (2002) include an assembly project in Paragraph (3) (a).

[413] The figures for 2015 are as follows: US$ 5,000,000 from Ecuador; US 184,000,000 from Israel; US$ 1,000,000 from Russia; US$ 13,000,000 from Turkey; and US$ 103,000 for Ukraine. The figures from 2010 to 2014 do not show any relevant difference since none of the countries was responsible for one per cent or more of the total FDI inflow into the Brazilian economy (there was no FDI from Ukraine from 2010 to 2014). See Brazilian Central Bank (n 406).

[414] Eight treaties are influenced by the UN MC on the insurance PE rule: treaties with Netherlands (1990), Spain (1974), Luxembourg (1978), France (1971), Canada (1984), Mexico (2003), Italy (1978), and Sweden (1975). All these countries are positioned among the top 20 FDI origin jurisdictions with regard to Brazil.

such a model convention on the agency PE provision.[415] Finally, as shown in Chapter 2, Brazil does not have a DTC with important FDI origin jurisdictions, as are the cases of the US, the UK, and Germany.[416]

(ii) India's tax treaty network

The analysis of India's treaty policy, for the country is the one that deviates most from the OECD MC as shown above, offers an interesting picture on the matter. With regards to the FDI inward from the 20 most important origin jurisdictions, India has mostly adopted a UN MC pattern throughout Article 5. The only exception relates to the insurance PE paragraph since the country has signed treaties with only seven of those jurisdictions that contain such a rule.[417] Per the other paragraphs of Article 5, the conventions signed with such countries show a significant, if not outstanding, UN MC influence. Regarding the construction PE and the service PE rules, the majority of those conventions adopt a provision fully matching the UN MC; with respect to the former, several other treaties adopt provisions that are even more beneficial to the host country.[418] Regarding the exclusionary list of Paragraph (4) (a) and (b), most of the treaties the country signed with those top counterpart economies follow the UN MC as well.[419] India signed treaties with the vast majority of those 20 countries that follow a

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[415] Treaty with Japan (1967).

[416] In 2015 those countries occupied the 2nd, 7th, and 9th position in the list of the countries that most invest in Brazil. Other top 20 relevant jurisdictions that do not have a treaty with Brazil are Switzerland (8th position), Cayman Island (18th position), and Bermuda (20th position). See Brazililian Central Bank (n 406).

[417] Out of the group of treaties analysed, India has adopted Paragraph (6) in the UN MC fashion in the conventions with the following jurisdictions: Switzerland, Taiwan, Korea (Rep.), Cyprus, Sweden, Luxembourg, and Italy. See, for the FDI flow into India's economy in 2015, the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: India, Inward Direct Investment Positions (Top 20 Counterpart Economies). Available <http://data.imf.org> accessed 31 December 2017.

[418] For example, the treaties with Canada (1996) and with the US (1989) both have a time-limit threshold of 120 days, while the treaty with Taiwan (2011) has a 270-day rule. Those jurisdictions are positioned as the 2nd, 20th, and 9th most important investors' origins as for 2015. Interestingly, none of the treaties that do not adopt a UN MC's provision contains an OECD MC's Paragraph (3); either they include both assembly project and supervisory activities but have a time-limit threshold between 183 days and 12 months (treaties with Mauritius (1982), United Arab Emirates (1992), and Luxembourg (2008)), or they include assembly project only (treaties with France (1992) and the Netherlands (1988)). No treaty matching the OECD MC on the matter was noted.

[419] For instance, the treaties with Japan (1989) and Spain (1993). They occupy the 5th and 15th positions respectively as for 2015.

UN MC pattern on the agency PE;[420] a similar level of influence is also noted for the independent agent PE since only two treaties follow the OECD MC on the matter.[421]

(iii) South Africa's tax treaty network

South Africa adopted a mixed approach with regard to the top 20 counterpart economies investing in the country. Although its tax treaty network mostly deviates from the OECD MC on the construction and service PEs, only Paragraph 3 (a) of the treaties with those economies shows a clear influence of the UN MC. Fifteen tax treaties include assembly project and supervisory activities in such a rule; however, only one of these treaties adopts a six-month time threshold[422] on the construction PE.[423] The only treaty that fully matches the OECD MC is the convention signed with Austria (1996).[424] On the service PE, the UN MC influences seven treaties South Africa signed with those counterpart economies.[425] No exclusionary list rule in the UN MC fashion was noted among the conventions with the top counterpart economies; the same applies

[420] The treaties with Taiwan (2011) and United Arab Emirates (1992) follow the OECD MC. The United Arab Emirates occupy the 14th position with regard to the FDI flow into India's economy as for 2015.

[421] Treaties with Japan (1989) and Germany (1995). These countries occupy, respectively, the 5th and 6th positions in the FDI origin jurisdiction classification as of 2015.

[422] See, for the FDI flow into South Africa's economy in 2015, the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: South Africa, Inward Direct Investment Positions (Top 20 Counterpart Economies). Available <http://data.imf.org> accessed 31 December 2017.The treaty with Malta (1997) is the only one that fully matches the UN MC. The treaty with Australia (1999) also adopts a six-month time limit. However, that convention does not include assembly project in the wording of the construction PE provision. Those jurisdictions occupy the 14th and 9th positions respectively as of 2015.

[423] South Africa has not entered into an income tax convention with Bermuda yet; the country occupies the 15th position among the most important FDI origin jurisdictions as of 2015. ibid. The remaining conventions, either including assembly project and supervisory activities or not in Paragraph 3 (a), adopt a 12-month time threshold.

[424] Austria occupies the 16th position among the top 20 counterpart economies' classification on the FDI flow into South Africa as of 2015.

[425] For example, the treaties with Malaysia (2005) and Mauritius (2013) (11th and 12th positions, respectively). Few conventions, although they have a service PE provision, provide for a 12-month time threshold in Paragraph (3) (b). In this section, they are considered as influenced by the UN MC as well. That is the case with the treaties with China (2000) and Canada (1995). It is worth noting that the IMF's survey differentiates between China: Mainland and China: Hong Kong. The origin cited above refers to China: Mainland. The treaty South Africa signed with Hong Kong (2014) adopted a UN MC provision on the matter, which provides for a six-month time threshold.

to the insurance PE paragraph. Finally, only the treaty with Malaysia (2005) adopted a UN MC agency PE provision, while the treaty with Malta (1997) is the sole agreement to follow such a model convention on the independent agent PE rule.

3.5 Conclusion

This chapter aimed at presenting a detailed comparison of Brazil, India, and South Africa's domestic laws and tax treaty networks with regard to the concept of permanent establishment and the respective PE thresholds as included in Article 5 of those countries' tax conventions. It has as a departing point the differences between the UN MC and the OECD MC on the matter, highlighting the main deviations and respective reasons for the UN MC having adopted a singular stance on the PE issue. Having set up the model conventions' different approaches for each of the relevant paragraphs of Article 5, each subsection scrutinised the compared countries' treaties, highlighting where they stand in respect to the broadening of the PE concept. They then identified whether the paragraphs of Article 5 favour most the host country or the residence one. When appropriate, the comparison also shed light on particular features of the provisions under examination. The subsections equally paid particular attention to the counterparts of every treaty analysed. The intention was to understand to what extent developing countries, such as the ones under study, follow consistently either of the MCs; particularly, the intention was to check whether the OECD member countries entered into agreements with the compared countries only when the latter adopted an OECD MC approach.

The findings of the comparative task show that Brazil, India, and South Africa do not fully follow consistently either of the MCs throughout Article 5. Indeed, there is no such a thing as a coordinated approach by those emerging BRICS countries on the PE issue. On many occasions, however, they adopt a framework that does not align with the OECD MC when entering into agreements with either UN countries or OECD member countries alike; however, the degree to which they deviate from the OECD MC varies for each of the compared countries. Additionally, it was noted that in several cases the tax treaties neither fully aligned with the UN MC; in fact, multiple situations were observed where Article 5 provides for a PE threshold that favours even more the

host country than the UN MC's one. Finally, the scrutiny of economic data on FDI inflow into the compared countries' economies, coupled with the comparative results on the treaty provisions, show that Brazil, India, and South Africa adopted, on many occasions, provisions in the UN MC fashion, irrespective of the treaty counterpart being a relevant FDI origin jurisdiction or not.

The coming chapters will investigate the way the compared countries' domestic laws and treaty networks allocate business profits to enterprises doing business in the host jurisdiction. In doing so, together with the findings of this chapter, they will identify the extent to which Brazil, India, and South Africa align with either of the model conventions on business profits taxation.

CHAPTER 4

Attribution of Profits to Permanent Establishments – Article 7

4.1 – Introduction

Once the concept of PE as adopted by the compared countries' income tax treaties and the extent to which they deviate from the OECD MC (and also sometimes from the UN MC) have been highlighted, it is necessary to shed light on the treaty rules pertaining to the attribution of profits to the enterprise's activities in the host country. The taxation of business profits, and the influence of the arm's length principle therein, constitutes a central element of this thesis, and so understanding how Article 7 of the compared countries' conventions functions is of key relevance. As a consequence, the analysis of an approach extending the attribution of profits to permanent establishments in comparison to the OECD MC position is crucial for the possible proposal, for developing countries, of a more beneficial framework that deviates from the current arm's length standard.

Considering that Article 5 and Article 7 share a strong connection, this chapter builds upon the comparative framework laid down in Chapter 3, in that it scrutinises the main mismatches in the OECD MC and UN MC regarding the latter provision. At the same time as seeking to investigate the path chosen by the compared countries' domestic legislation and treaty provisions with regards to the rules contained in Article 7, this chapter also focuses on the challenges posed by any particular treaty policy that could reveal possible obstacles to the adoption of the proposal put forward in the last part of the thesis. In considering this, Section 4.2 analyses the domestic legislation provisions on the attribution of profits to permanent establishments, while 4.3 engages with the identification and comparison of the mismatches between the model conventions and their influence on the compared countries' tax treaty networks. First, Subsection 4.3.1 briefly scrutinises the stances of Brazil, India, and South Africa on the Authorised OECD Approach, as laid down by the 2010 amendment of the OECD MC. Despite the data showing that even developed countries do not substantially follow the AOA,

investigation of its adoption is also instrumental for understanding the interpretation of Article 7 under the ALP.

Next, Subsection 4.3.2 analyses the limited force of attraction endorsement as provided by Paragraph (1) of Article 7 in the UN MC fashion. The main features of such a provision are highlighted, with reference (when relevant) to deviations from both the UN MC and OECD MC; additionally, the subsection refers to the treaty counterparts' nature as either UN countries or OECD member countries with regard to those treaties that allow for an expanded attribution of profits to PEs. The ensuing subsections adopt the following approach: Subsection 4.3.3 scrutinises the inclusion (or not) of the clarification wording in paragraph (3), while Subsection 4.3.4 frames the inclusion of the provision with regard to allowing for the allocation of profits by means of the application of a formulaic approach. With regard to the latter, it is important to clarify beforehand that, despite not showing a mismatch between the UN MC and the OECD MC in its pre-2010 wording, its analysis is instrumental, since it shows how feasible, at the treaty level, the design of a policy proposal that deviates from the current arm's length standard would be. Subsection 4.3.5 compares the treaties' provisions with regards to the allocation of profits in the case of the purchase of goods or merchandise by the PE. Section 4.4 analyses the Brazilian case for the taxation of services. However, it does not aim at a thorough comparison of the treaties' Article 12. Instead, its goal is to understand how Brazil turned the taxation of services into a taxation of PEs, which widens the scope of the application of Article 5 and, particularly, of Article 7. This section lays the foundations for the later analysis of Brazil's case law. Additionally, drawing from an examination of the treaties' provisions, Section 4.5 weighs the compared countries' treaty policy against the origins of the foreign direct investment inflow into their economies; this subsection follows the same analytical approach put forward in Subsection 3.4.

Finally, as a way of checking the main constraints posed by the application of the treaties' provisions and domestic regulations regarding the PE's profits faced by MNEs when investing in the compared countries, Section 4.6 analyses the main case law on the matter. This section gathers the main case law presented before the administrative and judicial courts of the compared countries on the application of Article 5 and Article 7. Together with the case law analysis of Chapter 5, they form a proxy for the challenges

faced by developing countries' jurisdictions when applying the ALP; consequently, they are taken into consideration when Chapter 6 designs a proposal for a transfer pricing system in those countries. Section 4.7 focuses on the findings from the case law analysis, while 4.8 concludes the chapter.

4.2 Attribution of profits to PEs in the domestic legislation

4.2.1 Brazil's domestic regulation on attribution of profits to PEs

The Brazilian domestic regulation contains only a few rules dealing with the attribution of profits to PEs, as is the case of the attribution of profits to agents of foreign enterprises.[426] Article 397 of the Income Tax Code stipulates which costs and expenses can be deducted in the process of computing the PE's profits, while Article 398 deals with the attribution of profits to agents and commissionaires with regard to the amounts received by the principal; the rule inserted therein applies irrespective of the agent having either an independent or a dependent status.[427] The following features of such provision are worth mentioning:[428]

> (i) the agent that is the importer or consignee of goods must account for its profits separately from those of the principal resident or domiciled abroad;
> (ii) the intermediary's profits shall be the difference between the remuneration received for his services and the costs and expenses incurred by him;
> (iii) the agent's profits shall be the difference between the sales price in Brazil and the import value of the goods plus the commissionaire's operational costs, including the remuneration for his services;

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[426] On Brazil's domestic legislation with regard to PEs, see Isabel Calich and João Dácio Rolim, 'Chapter 4 – Tax Treaty Disputes in Brazil' in Baistrocchi (ed) (n 49); Sergio André Rocha, 'Agency Permanent Establishment Brazilian Style: Taxation of Profits Earned through Commission Merchants, Agents and Representatives' (2013) 41 Intertax 444.

[427] See Carvalho and Costa (n 226), p. 311.

[428] See items (I) to (V) of the Sole Paragraph of Article 398 of the Income Tax Code.

(iv) in case the profit computation as in the items above is not possible, the intermediary's profits should be attributed in an arbitrated basis as provided by the Income Tax Code; and,

(v) the intermediary should comply with the rules applicable to foreign enterprises' branches, and he is liable with regard to the income tax on the profits earned by its principal.

Apart from the above, the country's regulation provides for diverse approaches when sales are made through agents or representatives and the purchase price is invoiced by the foreign principal directly to the buyer. According to Article 539, profits should be attributed to the agent on an arbitrated basis[429] in such a case. It also provides for an additional requirement: the agent must have power to act on behalf of the principal and, accordingly, bind the latter with regard to the contractual terms.[430] Article 539 further clarifies that the agent acting as a mere intermediary, without powers to bind the principal, is not enough to trigger the attribution of profits to the agent through the arbitration process.[431] Once those requirements are satisfied, the agent's profits shall be attributed accordingly. The Income Tax Code sets different percentiles of the gross revenue (according to the economic sector) to be deemed as profits through the arbitration method,[432] to which shall be added 20%[433] in order to achieve the final tax base figure.[434]

[429] On the topic, it is also worth referring to Article 399 of the Income Tax Code, which reads as follows: 'Art. 399. In the event the sales are made in the country through agents or representatives of persons established abroad, the taxable income will be arbitrated in accordance with the provisions of Art. 539.' (article's wording translated by the author). The expression 'arbitrated', in this context, means 'ascertained'.

[430] Item (I) of the Sole Paragraph of Article 539.

[431] Item (II) of the Sole Paragraph of Article 539.

[432] The percentiles range from 1.6% (e.g. resale of natural gas) to 32% (e.g. furnishing of services) according to Article 519 of the Income Tax Code. As a result, considering the additional 20% to be applied to the tax base as provided by it, the deemed profits in the case of arbitration range from 1.92% to 38.4%. See Carvalho and Costa (n 226).

[433] Such is Article 532's provision: 'Art. 532. The arbitrated profit of legal entities, per the wording of paragraph 11 of Article 394, when gross revenue is known, shall be determined by applying the percentages set forth in Art. 519 and its paragraphs, plus twenty percent' (article's wording translated by the author).

[434] The tax authority has already issued guidance (Ruling DISIT/SRRF04 n. 4/2013) on the attribution of profits through an arbitration basis in such cases. On the topic, Vanessa Arruda Ferreira, 'Brazil-Corporate Taxation', IBFD Research Platform, Country Analysis. Available at <www.ibfd.org> accessed 20 June 2018. See, particularly, 7 – International Aspects.

The presumptive tax base and the arbitration process as provided for by the Income Tax Act are not exclusive to the computation of PE profits. Once some of the requirements are met, enterprises are subject to those profit computation methods.[435] Also, it is worth mentioning that the Brazilian TP rules do not apply to the computation of profits of PEs, being restricted to transactions between associated enterprises; therefore, the country does not adopt the AOA at the domestic law level.[436] Finally, there is no force of attraction provision in the domestic regulations.

4.2.2 India's domestic regulation on attribution of profits to PEs

The Indian domestic regulation provides for the attribution of profits to foreign enterprises in Section 9 (1) of the Income Tax Act 1961. According to it, all income accruing or arising, whether directly or indirectly, through or from any business connection[437] in India should be deemed as accruing or arising in the country.[438] Also, the Explanation to Section 9 (1) (i) provides that the business income of the operations that are carried out in India should be deemed to reflect *the income as is reasonably attributable to the operations carried out in India.*[439] Nevertheless, the indirect attribution of profits as provided by Section 9(1) has, to some extent, presented a way to attribute profits to PEs regarding activities that are carried out outside the country; as a result, the tax right of the source jurisdiction is expanded,[440] which triggers litigation[441] on the reach of such a force of attraction rule.[442]

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[435] For an overview of the Brazilian income tax framework, see Ferreira (n 431).

[436] See Subsection 5.4.

[437] For the meaning of business connection as put forward by the Indian domestic legislation, and its application to the PE concept, see Subsection 5.2.2.

[438] Section 9(1) reads as follows: '9. (1) The following incomes shall be deemed to accrue or arise in India: (i) all income accruing or arising, 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 the transfer of a capital asset situated in India'.

[439] Explanation 1 to Section 9(1)(i) reads as follows on the topic: 'Explanation 1. For the purposes of this clause (a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India'.

[440] See Aseem Chawla, 'Chapter 6 - Tax Treaty Disputes in India' in Baistrocchi (n 49), p. 978.

[441] See Subsection 4.6.2.

[442] The indirect attribution of profits to PEs was even strengthened through the Explanation to Section 9(2) in case the non-resident has a place of business in the country or has rendered services in India. It

In addition to the above, the Indian legislation provides that any income arising from international transactions shall be computed having regard to the arm's length price.[443] More specifically, Section 92F (iii) expressly provides that in the context of the application of the arm's length principle to the taxation of international transactions, the term 'enterprise' also means permanent establishment.[444] In cases where the profits cannot be definitely ascertained, Rule 10 of the Income Tax Regulation 1962 clarifies the methodologies through which the tax authorities shall determine the income tax levied on profits arising through or from any business connections in the country (therefore applicable to PEs). To some extent, Rule 10 bears similarities with a formulaic provision.[445]

Also, the country's regulation provides for few rules on the deduction of expenses, as is the case of Section 44C of the Income Tax Act 1961, which sets a cap to be observed in the case of expense deductions in the nature of head office expenditure.[446] Finally, it is relevant to highlight that presumptive taxation[447] and deemed tax are determined in certain cases.[448]

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applies to profits connected to deemed interest, royalties, and fees for technical services. It reads as follows: '*Explanation.* For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (*v*) or clause (*vi*) or clause (*vii*) of sub-section (1) and shall be included in the total income of the non-resident, whether or not, (*i*) the non-resident has a residence or place of business or business connection in India; or (*ii*) the non-resident has rendered services in India'.

[443] Section 92 of the Income Tax Act 1961.

[444] See Rakesh Kapur and Radhakishan Rawal, 'India', (2006) 91b CDFI 387, p. 390. The authors highlight the application of TP rules to dealings between the head office and the PE. ibid.

[445] In case the profits cannot be definitely ascertained, it provides for the income to 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'.

[446] Letters (a) and (c) of Section 44C set the limits of deduction of head office expenditure as follows: '(a) an amount equal to five per cent of the adjusted total income; or (b) [***] (c) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India, whichever is the least: […]'

[447] See Shah (n 228). The author points out to particular economic sectors where the presumptive taxation applies: 'A special presumptive taxation applies to non-residents carrying on shipping or air transport, turnkey projects or an equipment-letting business, whereby a specified rate between 5% and 10% is applied to total receipts'. ibid. point 7.3.3.2. Business profits.

[448] Section 44BB(1) provides for a deemed tax in the following way: '44BB. (1) Notwithstanding anything to the contrary contained in sections 28 to 41 and sections 43 and 43A, in the case of an assessee,

4.2.3 South Africa's domestic regulation on attribution of profits to PEs

The South African legislation does not provide for a detailed regulation on the attribution of profits to PEs. As a rule, a PE's tax liabilities are computed in accordance with the general principles[449] applicable to the taxation of legal entities in the country.[450] However, it is relevant to refer to provisions of the country's legal system that, to some extent, deal with the issue. Practice Note n. 7, which deals with taxation of associated enterprises in the context of Section 31 of the Income Tax Act 1962,[451] extends the application of the TP rules to PEs. Paragraph 6.4 of the Practice Note n. 7 reads as follows:

> 6.4 Although the provisions of section 31 of the Act are applicable to persons, which are separate legal entities, the contents of this Practice Note will also apply to determine the arm's length consideration for income tax purposes of cross-border transactions conducted by - a person with a connected person; - a person's head office with a branch of such person; or - a person's branch with another branch of such person, in the application of the tax treaties entered into by South Africa.

The applicability of Paragraph 6.4 to the taxation of PEs' business profits is not immune to controversies since the provision of Section 31 is concerned with transactions between separate entities;[452] therefore, it would not be applicable to dealings between

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being a non-resident, engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils, a sum equal to ten per cent of the aggregate of the amounts specified in sub-section (2) shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession" : […]'

[449] See Hattingh, 'South Africa – Corporate Taxation' (n 188), point 7.3.3.2.

[450] It is considered that the relevance of the PE issue in the country relates to the application of tax treaties: 'The allocation of business profits to a PE in South Africa is only relevant where a tax treaty applies in respect of income that may be sourced within South Africa. South Africa accordingly does not have any rules in this regard under domestic income tax law, as this is strictly speaking only a treaty question that is arguably governed by principles applicable to OECD and UN Model-based tax treaties'. ibid.

[451] See Subsection 5.4.3.

[452] See Johann Hattingh and Basil Newton, 'South Africa', (2006) 91b CDFI 555, p. 556.

the PEs and the enterprise as a whole.[453] Nevertheless, it is understood that South Africa's tax authority follows the TP regulation in cases where the country has entered into an income tax treaty.[454] The domestic legislation does not provide for a force of attraction rule.

4.3 – The OECD and the UN model conventions mismatch: From 1980 to the present date

4.3.1 – The Authorised OECD Approach (AOA)

(i) The AOA in the OECD MC

The amendment of Article 7 of the OECD MC in order to reflect the Authorised OECD Approach can be considered one of the most relevant endeavours carried out in the international tax arena in the last decades. The OECD's work on the attribution of profits to PEs that culminated in the AOA started during the 1990s.[455] The most important of those works, however, were carried out during the 2000s, whose conclusions resulted in two OECD reports on the issue (the 2008 and 2010 Reports).[456] The aim of such reports was to address the issue of the application of the arm's length principle to the allocation of profits between the PE and the rest of the enterprise,[457] which then aligns the interpretation of Article 7 with the ALP[458] as put forward by

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[453] Also, the fact that the Practice Notes issued by the South African Revenue Service (SARS) do not form part of the country's substantive law is an argument put forward against its enforcement with regard to the attribution of profits to PEs. ibid.

[454] Hattingh and Newton (n 449).

[455] On the development of the AOA previous to the 2000s, see Philip Baker and Richard Collier, 'General Report, Attribution of Profits to Permanent Establishments' (2006) 91b CDFI 21, p. 28ff. The authors refer also to the OECD's report 'The Taxation of Multinational Banking Enterprises (1984)' as a relevant contribution to the issue. ibid.

[456] Respectively, the *Report on the Attribution of Profits to Permanent Establishments* (OECD 2008) and the *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 2010).

[457] *Report on the Attribution of Profits to Permanent Establishments* (n 453), p 7.

[458] On the discussion that took place in the OECD with regard to the adoption of the functionally separate entity approach and the problems with its application in the PE arena, see Baker, *Double Taxation Conventions* (n 10), A7B.16ff, 7-31ff.

Article 9[459] and the TP Guidelines.[460] Article 7 was then amended in the 2010 OECD MC update, with its new Paragraph (2)[461] on the attribution of profits to PEs reflecting the AOA as approached by both reports.[462] It reads as follows:[463]

> Article 7(2)
> […]
> 2. For the purposes of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The UN Committee of Experts, however, regarded the AOA as in conflict with the rule in Article 7(3)[464] of the UN MC.[465] As a consequence, the UN MC's version of

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[459] On the AOA and the application of Article 7 and Article 9, see Raffaele Petruzzi and Raphael Holzinger, 'Profit Attribution to Dependent Agent Establishments in a Post-BEPS Era' (2017) 9 WTJ 263.

[460] See Reimer and Rust (eds) (n 29), p. 502.

[461] The amendment of the OECD MC carried out in 2010 also deleted provisions from Article 7 and provided for a new wording in its Paragraph (3). On the issue, see Dennis Weber and Stef Van Weeghel (eds), *The 2010 OECD Updates: Model Tax Convention & Transfer Pricing Guidelines: A Critical Review* (Wolters Kluwers Law & Business 2011). Also, on the debate regarding the redraft of Article 7, see Catherine Bobbett and John F Avery Jones, 'The Proposed Redraft of Article 7 of the OECD Model' (2010) 64 Bull Intl Taxation 20.

[462] The 2008 OECD MC Commentaries incorporated the 2008 Report's conclusions. See the 2008 OECD MC Commentaries, commentary on Article 7, I. Preliminary remarks, paragraph 7. The OECD highlighted the usefulness of its 2008's version as a 'background guidance to the 2008 revised Commentary's interpretation of the pre-2010 Article 7 for as long as bilateral tax treaties that are based on the text of that version of Article 7 are in force'. *2010 Report on the Attribution of Profits to Permanent Establishments* (n 453), p. 9. For a critical review on the 2008 changes to the Commentary on Article 7, see Philip Baker and Richard Collier, '2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments' (2009) 63 Bull Int Taxation 5.

[463] Article 7(2) of the 2014 OECD MC has the same wording.

[464] For the analysis of Paragraph (3) of Article 7 and the mismatches between the model conventions, see Subsection 4.2.3.

[465] On the UN MC's position on the matter, see Raffaele Petruzzi and Viktoria Wöhrer, 'Chapter 2: Business Profits, Permanent Establishments and Associated Enterprises' in Michael Lang et al., *The UN Model Convention and Its Relevance for the Global Tax Treaty Network* (IBFD 2017), p. 65ff.

Paragraph (2) still reflects the wording adopted by the OECD up to the 2010 amendment of its model convention.[466]

(ii) Compared countries' treaty policy[467]

As expected,[468] the treaties signed by the compared countries after 2010 do not adopt the OECD's AOA approach.[469] India entered into 27 tax treaties from 2010, with UN countries and OECD member countries alike,[470] while South Africa signed 10 treaties in the same period; the only convention South Africa signed with an OECD member country after 2010 was with Chile (2012). Brazil entered into a DTC with only one country in the same period (Turkey 2010).

It seems appropriate, therefore, to conclude that Brazil, India, and South Africa share a similarity in their tax treaty policy given their total rejection of the AOA as adopted by the OECD MC after 2010; the UN MC was the alternative followed by the three countries instead. Nevertheless, at the domestic regulation level, the scenario is different. Since India follows the TP regulations, it seems fair to affirm that the country's regulation adopts the underlying principle of the AOA, meaning its legislation attributes profits to a PE through the assessment of the functions performed, assets used, and risks assumed by it.[471] Case law analysis as carried out below returns to this topic.[472] On the other hand, the quite limited (and controversial) South African regulation on the issue does not provide enough material for such an assumption; it has

[466] On the stance adopted by the UN MC on the matter, see 2011 UN MC Commentaries, Article 7 – Business Profits, A. General Considerations, paragraph 1.

[467] This chapter refers to the compared countries' tax treaties as available at <www.ibfd.org> accessed 1 October 2017.

[468] Even the majority of OECD member countries do not adopt the 2010 OECD MC on the issue. Reimer and Rust (n 29), p. 521.

[469] For an account of the adoption of the AOA by OECD countries at both treaty and domestic law levels, see Steef Huibregtse and others, 'Status of Implementation of the Authorized OECD Approach into Domestic Tax Law and Tax Treaties – Part 1' [2015] European Taxation 363.

[470] For example, the treaties with Finland (2010) and Norway (2011).

[471] See Subsection 4.2.2.

[472] See Subsection 4.6.2.

been assumed that the country does not adopt the AOA at all.[473] Finally, the Brazilian domestic regulation does not provide for any regulation following the AOA, as shown in Subsection 4.2.1.

4.3.2 – Article 7 (1): Limited force of attraction

(i) Appearance of the limited force of attraction provision

In line with its position in relation to the widening of the PE concept, the UN MC deviates from the OECD MC stance on the attribution of profits to the enterprise present in the host country as put forward by Article 7 (1). In doing so, it grants taxing rights to the source country in relation to activities that would not otherwise fall under source jurisdiction.[474] The rationale underlying the adoption of the limited force of attraction by the UN MC is that the PE's activities, to a certain extent, contribute to the enterprise's activities as a whole, thus the need to connect the enterprise's profits regarding the activities in the host country with the PE's profits.[475]

As in other provisions of the model convention, the deviation from the OECD MC stems from the primary intention to provide for a set of rules more beneficial to developing countries. Such a design of Article 7 (1) reflected the developing countries' stance on the matter as expressed in the 1980 UN MC edition.[476] When assessing the possible adoption of a force of attraction provision, the UN Group of Experts sided with

[473] See Johann Hattingh, 'South Africa – Corporate Taxation' (n 188). Such is the author's position: 'The South African fiscal authorities officially rejected the OECD's new guidelines for the computation of income that must be attributed to a PE under the new Article 7 of the OECD Model. It is therefore likely that domestic income tax law won't be reformed in conformity with the OECD guidelines on the new model Article 7.' ibid, item 7.2.1.2.

[474] See Surrey (n 284), p. 14.

[475] Reimer and Rust (eds) (n 29).

[476] Even though the limited force of attraction rule, in the current wording of the UN MC Article 7 (1), appeared in the first edition of the model convention, its application was already part of discussions between UN members before 1980. On this issue, referring to the Second Report of the Ad Hoc Group of Experts (1970), see Daurer (n 15), p. 135.

the developing countries' point of view,[477] thus concluding that there was need for a paragraph extending the host country's taxing rights. Notwithstanding, the reach of the force of attraction was restrained by Subparagraphs (b) and (c), in that they require the sales of goods or merchandise to be of the same or a similar kind to those sold by the PE, or for the enterprise to be involved in similar activities in the host country as those of the PE; income from capital, sales through independent commission agents, and purchase activities are excluded from the application of such a rule.[478] It is also necessary to point out that the adoption of this approach did not pass without any controversy. As clarified by the 1980 UN MC Commentaries, some developed countries opposed the force of attraction provision on the grounds that their previous experience on the matter proved it unsatisfactory and that it was also a cause for uncertainty.[479]

The OECD MC Commentaries, for their part, adopt a point of view clearly against the UN MC position. The various editions of the OECD MC have pointed to the undesirability of a general, or even restricted, force of attraction on the grounds that the source state should levy taxes bearing in mind each separate source of income derived by the enterprise from its jurisdiction, and, in doing so, apply the permanent establishment threshold.[480] According to the OECD MC Commentaries, the observance of the permanent establishment test *allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on*.[481]

[477] In particular, the developing countries' following position on the point: 'Members from developing countries pointed out that the proposed 'force of attraction' approach did remove some administrative problems in that it made it unnecessary to determine whether particular activities were or were not related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country, but similar in nature to those conducted by the permanent establishment.' *1980 UN MC* (n 17), Article 7 – Business Profits, B. Commentary on the Paragraphs of Article 7, Paragraph 1.

[478] See Michael Lennard, 'The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments' (2009) 15 Asia-Pacific Tax Bulletin 4, p. 7.

[479] *1980 UN MC* (n 17).

[480] On the current position of the OECD, see the Commentaries for the *2017 OECD MC* (n 7), Commentaries on Paragraph 1 of Article 7, paragraph 12.

[481] ibid.

Article 7 (1) of the UN MC reads as follows, with emphasis added where it deviates from the OECD MC position:

> Article 7
> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to
> *(a)* that permanent establishment;
> *(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or*
> *(c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*

(ii) Compared countries' treaty policy

The compared countries' tax treaty networks are scrutinised against both positions as presented above in order to identify the influence exerted by each model convention. Apart from screening all the conventions on the adoption of Subparagraphs (a) and (b), an analysis of the counterparts of the treaties deviating from the OECD MC approach is also provided. Where a particular treaty does not fully mirror either of the model conventions, in that it includes a respective subparagraph only or provides additional wording, it is considered as part of the 'Other' category in the table presented below.

(ii.1) Brazil's tax treaties

Among the compared countries, Brazil is the only one that does not adopt a limited force of attraction in Article 7 (1) throughout its tax treaty network. In so doing, Brazil does not extend its taxing rights to any profits that, even though not straightforwardly related to a particular PE activity, are attributable to the sale of similar goods or merchandise or other similar activities carried out by the enterprise. The country's treaty policy reflects its domestic law approach on the issue.[482] Additionally, the fact that the very existence of PEs of foreign enterprises in Brazil is not as usual as the

[482] See Subsection 4.2.1.

setting up of subsidiaries[483] could, to some extent, diminish the importance of the insertion of such a provision into the country's domestic law and tax treaties. In other words, as a result of the lack of a significant number of PEs occasioned by the high level of red tape involved in setting up such a legal entity in the country, the attribution of profits through a limited force of attraction would not, in fact, generate any substantial additional tax collection.[484]

(ii.2) India's tax treaties

India, for its part, does not adopt the same approach. Despite the fact that the majority of its tax treaties do not have a limited force of attraction provision, it is worth stating that seventeen tax treaties India has entered into among those that are still in force[485] fully match the UN MC wording on the issue;[486] those conventions have as counterparties UN countries[487] and OECD member countries alike. With regard to the latter, India has signed thirteen treaties following a UN MC pattern, as in those with Denmark (1989), Finland (1983), Portugal (1998), and Turkey (1995).[488] It is also important to refer to conventions that, for certain peculiarities in their wordings, fully match neither one of the model conventions with respect to Article 7 (1). The treaties

[483] On the lack of a significant number of PEs in Brazil, see Schoueri, 'Chapter 4 - Brazil' (169), p. 53.

[484] On the Brazilian domestic legislation on the issue, See Subsection 4.2.1.

[485] Although still in force, the treaty with Sierra Leone (1956) is not considered in the analysis. See Chapter 3, n. 51.

[486] Section 2 of the Protocol to the treaty with France (1992) provides for the adoption of a limited force of attraction when India adopts a UN MC provision on the matter in the treaties with Germany and with the United Kingdom. Both treaties (Germany (1995) and the UK (1993)) do not contain such a rule in Article 7 (1), and therefore the treaty with France (1992) is not considered as matching the UN MC.

[487] The only treaties in this category are the ones signed with Belarus (1997), Faroe Island (1989), Mongolia (1994), and Zambia (1981).

[488] Article 7 (1) of the treaty with Turkey (1995) does not contain a limited force of attraction provision. Its protocol, however, provides for such a rule in Section 3, where it attributes to the PE profits from sales or other business activities of the same or a similar kind.

with Japan (1989),[489] Moldova (1988), Singapore (1994),[490] and the UK (1993)[491] refer to the profits being directly or indirectly attributable to the PE, while the second part of Paragraph (1) of the treaty with Morocco (1998) grants partial taxing rights to the host country in the case of the PE taking an active part in negotiating, concluding, or fulfilling contracts entered into by the enterprise.[492] On the other hand, the treaty with Bulgaria (1994), while providing for a force of attraction in the UN MC's Subparagraph (b) fashion, also provides for the inclusion of profits directly or indirectly attributable to the PE.[493] In addition, the Protocol to the treaty with Indonesia (2012) and the Protocol to the treaty with Germany (1995) provide for a limited force of attraction under certain conditions, i.e. only where it can be proved that the transaction took place as a means to avoid taxation in the host country and that the PE was in any way involved in it.[494] Because of these unique features, these treaties are included in the 'Other' category in the table below.

The Indian approach to the force of attraction at both the treaty and the domestic law levels[495] has led to a series of controversies being presented to the country's courts. This thesis addresses this issue below.[496]

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[489] Part III (Note from the representative of Japan, acknowledged by the representative of India at IV), Section 6 of the Exchange of Notes to the treaty with Japan (1989) clarifies the meaning of the terms 'directly or indirectly attributable to the permanent establishment' as contained in Article 7(1). As a result, profits are attributed to the PE 'to the extent appropriate to the part played by the permanent establishment in those transactions', even when the order is made or placed directly by the foreign enterprise.

[490] The treaties with Moldova (1988) and Singapore (1994), although having such wording in their Article 7 (1), do not provide for any clarification on the issue.

[491] The interpretation of the wording 'directly or indirectly' in Article 7 (1) of the UK (1993) treaty was subject to controversy in the courts. See Section 4.5.2. On the UK treaty policy against the inclusion of the force of attraction in its conventions, see Jonathan Schwarz, *Schwarz on Tax Treaties* (Fourth edition, Wolters Kluwer 2015), p. 232.

[492] On the amount of profits to be attributed to the PE, the final sentence of the second part of Article 7 (1) of the treaty with Morocco (1998) reads as follows: '[...], there shall be attributed to the permanent establishment that proportion of profits of the enterprise arising out of those contracts as the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole.' The treaty with the UK (1993) has a similar provision, this time in Paragraph (3).

[493] Section 1(a) of the Protocol to the treaty with Bulgaria (1994).

[494] See Section 1 of the Protocol to the treaty with Indonesia (2012). For the treaty with Germany (1995), see Section 1 (c) of its Protocol.

[495] See Subsection 4.2.2.

[496] See Subsection 4.6.2.

(ii.3) South Africa's tax treaties

South Africa sits alongside India on this matter, in that it has mostly adopted an OECD MC pattern on Article 7 (1), with exceptions numbering only a few treaties; in this sense, only three conventions fully align with the UN MC.[497] Where South Africa differs from India is that all those treaties were signed with UN countries. In addition, it is worth referring to treaties that are influenced by the UN MC but do not entirely mirror its wording. The convention with Mexico (2009) considers only the scenario where the enterprise sells goods or merchandise of the same or a similar kind as those sold by the PE. In addition, the final part of its Article 7 (1) excludes the taxing rights of the host country in cases where the enterprise demonstrates the transactions were not carried out in order to obtain any benefit under the treaty's provisions.[498] The treaties with Cameroon (2015) and Kenya (2010) provide for the same exception to the rules contained in their Subparagraphs (b) and (c).[499] Finally, the treaty signed with Saudi Arabia (2007), although not granting taxing rights to the host state in the case of the export of merchandise by an enterprise, provides, in Article 7 (4), for the taxation of activities contractually connected to such exports in cases where the referred activities are carried out by the permanent establishment.[500] These four conventions are included in the 'Other' category in the table below.

Table 4.1: Article 7 (1) – Limited Force of Attraction - OECD MC v. UN MC

	UN MC			OECD MC	Other
	Total	UN	OECD		
Brazil	----	----	----	33	----
India	17	4	13	71	8
South Africa	3	3	----	72	4

[497] The treaties with Ethiopia (2004), Indonesia (1997), and Thailand (1996).

[498] Treaty with Mexico (2009), Article 7 (1) (b). On the referred condition, Article 7 (1) reads as follows: 'However, the profits derived from the sales described in subparagraph (b) shall not be taxable in the other Contracting State if the enterprise demonstrates that such sales have been carried out for reasons other than obtaining a benefit under this Agreement.'

[499] Both Subparagraphs (b) and (c) in Article 7 (1) of the treaties with Cameroon (2015) and Kenya (2010) mirror the UN MC's wording.

[500] Article 7 (4) of the treaty with Saudi Arabia (2007).

4.3.3 – Article 7 (3): Deduction of expenses

(i) Appearance of the current wording of the UN MC Article 7 (3)

The UN MC approach to the wording of Article 7 (3) seems to be, in comparison to the other subsections of this chapter, the one that does not result in the greatest deviation from the OECD MC framework. The work carried out by the UN Group of Experts previous to the 1980 UN MC edition, which contained a series of recommendations to be later adopted by the model convention, was clear, while stressing the very nature of Paragraph (3) as a clarifying provision on the treatment of the head office's expenses.[501] The 1980 UN MC Commentaries,[502] in their turn, make clear that the inclusion of definitions and clarifications in the second part of Paragraph (3) aimed to assist those developing countries that were not part of the UN Group of Experts.[503] Further, the UN MC position mainly refers to the OECD MC stance on the issue as expressed in its Commentaries, which, in itself, confirms the provision's minor deviation from the latter.[504] As a result, one can assume that, until the 2010 amendment of the OECD MC,[505] the mismatch between both model conventions mainly refers to the wording of their provisions.[506] No further amendment is observed in the subsequent editions of the UN MC.

The UN MC version of Paragraph (3) of Article 7 reads as follows, with emphasis added to the sentences that are absent from the OECD MC previous to its 2010 amendment:

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[501] See Surrey (n 284), p. 19.

[502] The Commentaries to the 1980 UN MC also expressed the UN Group of Experts' opinion regarding a possible duplication of charges between the PE and the head office. It reads as follows on the matter: 'The Group agreed that if billings by the head office included the full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment.' *1980 UN MC* (n 17), commentaries on Article 7.

[503] ibid.

[504] ibid.

[505] On the lack of difference on the interpretation of both model conventions, see Sassevile and Vann (n 20).

[506] On the similarity of Article 7 (3) with the 2008 OECD MC's provision, see also Brian J Arnold, 'Tax Treaty News: An Overview of the UN Model (2011)', (2012) 66 Bull Intl Taxation 523, p. 526.

> 3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. *However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*

(ii) Compared countries' treaty policy

The comparative analysis of the compared countries' conventions mainly considers the UN MC wording deviation from the OECD MC; additional peculiarities observed are also indicated, as in the case of the insertion of either the second sentence (payments from the PE to the enterprise's head office) or of the third sentence (amounts charged by the PE to the enterprise's head office) only. Table 4.2 (p. 123) also identifies the treaty counterparties where the conventions adopt a UN MC wording.

(ii.1) Brazil's tax treaties

The vast majority of conventions Brazil has entered into adopted an OECD MC provision on the issue. In fact, only Article 7 (3) of the treaty with Venezuela (2005) fully aligns with the UN MC. Minor mismatches between the OECD MC and the treaties' wordings are not regarded here as important deviations. Such is the scenario

in the conventions signed with India (1998),[507] Peru (2006),[508] Portugal (2000),[509] and Trinidad and Tobago (2008).[510] Nevertheless, the country adopted a treaty policy that, on certain occasions, did not fully align with either of the model conventions, which are included in the table below in the 'Other' category. This is the case, for instance, in the treaties with Mexico (2003)[511] and Ukraine (2002),[512] where they adopt only the first and second sentences of Paragraph (3). This is to say that, apart from the sentence matching also the OECD MC, these conventions deny the deductions of payments made by the PE to the head office of the enterprise or to its other offices only; the provision is otherwise silent on the amounts charged by the PE. In addition, it is worth noting that the Protocol to the treaty with the Philippines (1983)[513] states that Paragraph (3) shall not affect the treatment of payments made or amounts charged by the PE, as put forward by the parties' domestic legislation.[514] Since it does not clearly deny the deductions as in the UN MC, it is also included in the 'Other' category.

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[507] Article 7 (3) of the treaty with India (1998) does not have the final wording: 'whether in the State in which the permanent establishment is situated or elsewhere'. It shows, instead, the following: '[…], in accordance with the provisions of and subject to the limitations of the taxation laws of the Contracting State concerned.'

[508] The treaty with Peru (2006) provides for deductions of 'necessary expenses' that are 'effectively incurred'. Also, it does not have the final part: 'whether in the State in which the permanent establishment is situated or elsewhere'.

[509] Article 7 (3) of the treaty with Portugal (2000) refers to expenses 'duly substantiated'. It also does not have the final part of the paragraph, which is provided for by Section 3 of the Protocol to the treaty.

[510] The final part of Article 7 (3) of the treaty with Trinidad and Tobago (2008) reads as follows (emphasis added): '[…] whether in the State in which the permanent establishment is situated or elsewhere *in accordance with the provision of the laws of that State*.'

[511] Article 7 (3) of the treaty with Mexico (2003).

[512] Article 7 (3) of the treaty with Ukraine (2002) does not include the final part of the UN MC second sentence, where it reads: '[…] or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.'

[513] Article 7 (3) of the treaty with Philippines does not provide for the place where the expense is incurred. Such provision is part of Section 4 (a) of the Protocol to the treaty, as follows: '4. It is understood that the provisions of paragraph 3 of Article 7: (a) shall be construed to mean that expenses incurred for the purpose of the permanent establishment including those for executive and general administrative expenses shall be allowed as a deduction whether incurred in the State where the permanent establishment is situated or elsewhere […].'

[514] The same Section 4, now at Subsection (b), provides for such treatment as follows: '[…] and (b) shall not affect the provisions of the internal laws of Brazil or the Philippines in respect of amounts paid or charged (other than reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of: (i) royalties, fees or other similar payments in return for the use of patents or other rights; (ii) commission for specific services performed or for management; and (iii) interest on money lent to the permanent establishment, except in the case of a banking institution.'

(ii.2) India's tax treaties

India adopted the opposite view on Article 7 (3). Forty-four of its conventions still in force[515] follow the UN MC wording.[516] Among these, nineteen were signed with OECD member countries,[517] as is the case of the treaties with Canada (1996), Japan (1989),[518] the Slovak Republic (1986), and the UK (1993). With regard to the latter, it is relevant to say that the equivalent provision of Paragraph (3) is split into two different paragraphs; although with additional wording, Paragraph (5) provides for a provision similar to the OECD MC,[519] while Paragraph (7) uses both UN MC sentences.[520] It is also important to refer to those treaties partially aligning with the UN MC: the Protocol to the treaty with Italy (1993)[521] allows deductions of expenses, royalties, commissions, and interest only, while in the treaty with Kazakhstan (1986), a second sentence is included in Paragraph (3) dealing with the payments made by the PE only.[522] For this reason, they are included in the 'Other' category in the table below.

(ii.3) South Africa's tax treaties

As for South Africa, the country patterned its tax conventions mainly after the OECD MC. Notwithstanding this influence, South Africa still signed twenty-one treaties that show a UN MC provision in Article 7 (3), e.g. the treaties with Algeria (1998), Cameroon (2015), Nigeria (2000), and Pakistan (1998). Out of that total, only two were

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[515] Treaty with Sierra Leone (1956) not included.

[516] Minor differences, as the inclusion of wording linking the deductions to domestic law regulations, are not considered as deviations. For instance, the final part of Article 7 (3) of the treaty with Bangladesh (1991) is still considered as following the OECD MC since it does not include any of the UN MC sentences.

[517] The treaty with the US (1989), although showing a different wording at Paragraph (3) mainly with regard to the OECD MC equivalent first sentence, is also included in the UN MC category.

[518] Such provision is found in the Exchange of Notes between India and Japan. See Exchange of Notes, Note from Japan's representative, III, Section 8 (duly confirmed by the Indian representative at IV).

[519] Article 7 (5) of the treaty with the UK (1993) includes the following wording: '[…], which are allowed under the provisions of and subject to the limitations of the domestic law of the Contracting State in which the permanent establishment is situated'.

[520] Paragraph (7) has a slightly different wording in comparison with the UN MC approach. Nevertheless, it is considered in the comparison as following such a model convention.

[521] Protocol to the treaty with Italy (1993), third paragraph, '(a)'.

[522] Its Article 7 (3) also adds the following wording at the end of the first sentence: '[…], in accordance with the provisions of a subject to the limitations of the tax laws of that State.'

signed with OECD member countries, i.e. those with Mexico (2009) and the US (1997).[523] No tax treaty deviating from both the model conventions was observed.

Table 4.2: Article 7 (3) – Deduction of expenses – OECD MC v. UN MC

	UN MC			OECD MC	Other
	Total	UN	OECD		
Brazil	1	1	----	29	3
India	44	25	19	50	2
South Africa	21	19	2	58	----

4.3.4 – Article 7 (4): A formulary apportionment provision

(i) Appearance of Paragraph (4) of Article 7

Even though the separate entity principle frames the taxation of business profits provisions, the possibility for a formulaic apportionment of the enterprise's profits to the PE is present in Article 7 (4) in both the UN MC (to date) and the OECD MC (up to its 2010 amendment).[524] Such a provision was introduced in the edition of the 1963 Draft Convention, with its Commentaries emphasising the view that, even considering the risks of profit allocation not being in line with separate accounting outcomes, a formulary apportionment system could be allowed where it has been customary for the treaty party to tax the PE in such a way.[525] However, the results of the allocation of profits in the formulaic fashion is required to be as close as possible to those ones that would be reached by applying the arm's length principle[526] as embodied in Article 7.

[523] The treaty with the US (1997), as in the case of the India/US treaty (1989) (n 92), has a slightly different wording in the first sentence of Article 7 (3), since it refers to the inclusion of '[…] *reasonable* allocation of executive and general administrative expenses, […]' (emphasis added).

[524] On the Article 7 amendments carried out by the 2010 OECD MC, see Mary Bennet, 'Article 7 – New OECD Rules for Attributing Profit to Permanent Establishments' in Weber and Weeghel (n 458).

[525] On the nature and importance of Article 7(4), see Baker, *Double Taxation Conventions* (n 10), A7B.26ff, 7-37 and 7-38.

[526] Commentaries to the 1963 Draft Convention, Commentary on Article 7, Paragraph 4, paragraph 22. Also, see the following part of paragraph 24: 'It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate

The UN MC basically adopts the OECD MC stance on the matter, having reproduced the latter's Commentaries on Paragraph (4).[527] Article 7 (4) of the UN MC and the 2008 OECD MC edition read as follows:

> 4. Insofar 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.

(ii) Compared countries' treaty policy

Although the lack of any widespread adoption of such a system by treaty parties and the difficulties of an arm's length similar outcome are referred to as hindrances to the application of an apportionment method,[528] this subsection analyses the compared countries' treaties as indicative of how feasible the adoption of a proposal that deviates from, and at the same time complies with, the OECD's arm's length standard would be.[529] In doing so, and despite the identity of approaches of both model conventions up to 2010, this subsection also highlights the inclusion of such a rule in treaties with OECD member countries, as the provision was deleted in the 2010 OECD MC after the introduction of the AOA. Equally, the comparison sheds light on treaties that, although not adopting the wording of Paragraph (4), allow for the application of domestic legislation, thus providing for a diverse method of profit computation.

(ii.1) Brazil's tax treaties

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as closely as possible to the figures that would have been produced on a separate accounts basis, […].' ibid.

[527] *1980 UN MC* (n 17). The following editions of the UN MC adopt the same pattern.

[528] See Sassevile and Vann (n 20) and Bennet (n 521).

[529] See Chapter 6.

Although Brazil does not adopt the AOA approach on the treaties signed from 2010 as a treaty policy,[530] the vast majority of the country's tax conventions do not have a formulary apportionment rule in Article 7 (4).[531] The only treaties that mirror the UN MC and the 2008 OECD MC provision are the ones signed with China (1991) and Venezuela (2005).[532] This treaty policy mirrors, to some extent, the domestic law of Brazil. It is not customary in Brazil to attribute profits to PEs through a formulary apportionment method, with such a rule being absent in the current legislations in force.[533]

(ii.2) India's tax treaties

In contrast to the Brazilian policy, India adopts a formulary apportionment rule in sixty-one of its treaties still in force.[534] Out of that total, nineteen treaties were signed with OECD member countries, as in those with Belgium (1993), Estonia (2011), and Norway (2011).[535] On an interesting note, the treaty with Australia (1991) states that, in cases where the tax authority cannot determine the correct PE profits or ascertaining those profits presents difficulties, the domestic legislation can be applied, provided that it is done in accordance with the principles laid down by Article 7.[536] By the same token, the Protocol to the treaty with Ireland (2000) allows for the apportionment of the total profits of an insurance enterprise to its various parts in accordance with a treaty party's domestic legislation; as in the previous case, such apportionment should nevertheless reflect Article 7's principles.[537] Finally, a couple of treaties provide for an

[530] See Section 4.2.1.

[531] This is even the case in the treaty signed with Turkey (conclusion date 16 December 2010), after the edition of the 2008 and 2010 OECD Reports and the 2010 OECD MC edition.

[532] The treaty with Venezuela (2005) adopts the formulary apportionment rule in Article 7 (6), which shows a slightly different wording in the first sentence.

[533] Brazil does adopt an arbitration rule in some cases though. However, such arbitration does not attribute profits to different parts of the enterprise in the formulary apportionment fashion. See Subsection 4.2.1.

[534] The treaty with Sierra Leone (1956) is not part of the analysis.

[535] The treaty with the Netherlands (1988) is also included in this category, although it does not provide for a formulary apportionment rule in Paragraph (4). It refers, in the second part of Article 7 (2), to the allocation of profits to the PEs through an estimation 'on the basis of an apportionment of the total profits of the enterprise to its various parts'.

[536] Article 7 (5) of the treaty with Australia (1991) does not have a Paragraph (4) provision.

[537] Section 2 of the Protocol to the treaty with Ireland (2000).

attribution of profits on a 'reasonable basis' in cases where the profits are incapable of determination or present exceptional difficulties of determination; this is the case with Paragraph (2) of the treaties with Italy (1993) and Poland (1989).[538] These four treaties are included in the 'Other' category in the table below.[539]

(ii.3) South Africa's tax treaties

South Africa sides with India on this issue. Fifty-three of its treaties in force adopt a formulary apportionment rule in Article 7 (4).[540] Eighteen of those conventions were signed with OECD member countries, as in the treaties with the Czech Republic (1996), Hungary (1994), and the Slovak Republic (1998).

Table 4.3: Article 7 (4) – Formulary apportionment provision – OECD MC v. UN MC

Article 7(4)	Brazil		India		South Africa	
Included	2		61		53	
	UN :2	OECD: ----	UN: 42	OECD:19	UN: 35	OECD: 18
Absent	31		31		26	
Other	----		4		----	

4.3.5 – Article 7 (5): Allocation of profits in case of the purchase of goods

(i) Appearance of taxation in case of the purchase of goods

The OECD, since the 1963 Draft Convention, adopted in Article 7 (5) a rule that excludes the attribution to the PE of profits related to purchasing activities for the

[538] The second sentence of Article 7 (2) of the treaties with Italy (1993) and Poland (1989) reads as follows: '[…] In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis.' However, these treaties are not considered in this Subsection as having a Paragraph (4) equivalent provision.

[539] It is important to refer to Rule 10 of the Income Tax Regulation 1962, which allows the tax authorities, in particular cases, to determine the profits of PEs in a rather formulaic fashion. See Subsection 4.2.2.

[540] The treaties with Germany (2008) and Gabon (2005), although not yet in force, also show such a provision in Article 7 (4). However, they are not considered in the comparison.

enterprise carried out in addition to other activities.[541] The 2010 OECD MC, however, removed the purchase of goods provision from Article 7.[542] The deletion of Paragraph (5) from the OECD MC relates to the fact that purchasing activities are nowadays considered as linked to the generation of profits of the enterprise,[543] and therefore the previous approach was not in line with the application of the arm's length principle anymore.[544] Article 7 (5), up to the 2008 OECD MC, reads as follows:

> 5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

In contrast to the OECD MC's former approach, the UN Group of Experts decided that the UN MC should not contain a similar provision in Article 7. The 1980 UN MC Commentaries, while making clear the disagreement between developing and developed countries on the issue, make clear the Group of Experts' position with regard to not including a Paragraph (5) in the OECD MC fashion, deciding instead for a recommendation for a bilateral negotiation between the treaty parties.[545] The 1980 UN MC Commentaries pointed to arguments put forward by developing countries, such as the fact that if a PE's activities are of a purchasing or other nature, the similar provision in Paragraph (5) should be redesigned in order to allocate profits from the purchasing activities to the PE. Otherwise, following the developing countries' position, where the PE engages solely in the purchase activities and such activities contribute to the overall profits of the enterprise, a proportionate allocation of profits to the PE should take place.[546] The developed countries' position as expressed by the Group of Experts was

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[541] On the reasons for the inclusion of Paragraph (5) in Article 7, see the 1963 Draft Convention Commentaries, Commentary on Article 7, Concerning the Taxation of Business Profits, Commentary on Paragraph 5, paragraphs 26-27. Such a position was kept up to the 2008 OECD MC edition. See the *2008 OECD MC* (n 293), Commentaries, Commentary on Article 7, Concerning the Taxation of Business Profits, Commentary on Paragraph 5, paragraphs 56-57.

[542] On the deletion of Paragraph (5), see Weber and Weeghel (eds) (n 458), p. 26ff.

[543] On the reasons for such amendment of the 2010 OECD MC, see Sassevile and Vann (n 20).

[544] On the 2008 and 2010 OECD Reports that provided for the AOA as adopted by the 2010 OECD MC edition, see Section 4.2.1.

[545] Such is the Note included at the end of the 1980 UN MC's Article 7, also reproduced in the 2001 and 2011 UN MC editions: '(NOTE: the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)'

[546] *1980 UN MC* (n 17).

in favour of the inclusion of such a rule in the 1980 UN MC.[547] The subsequent Commentaries to the UN MC maintained the Group of Experts' view that the question should be left to bilateral negotiations.[548]

(ii) Compared countries' treaty policy

All the three compared countries show a treaty policy that, in general, matches Article 5 (5) of the OECD MC. Brazil excludes the attribution of profits to the PE for the mere purchase of goods or merchandise for the enterprise in all its tax treaties. India follows a similar position, since almost the totality of its treaties still in force[549] contain a Paragraph (5) provision;[550] only the treaty India signed with Greece (1965) does not show such a rule.[551] In the same vein, South Africa also patterns almost all of its income tax conventions after the OECD MC as, previous to the 2010 amendment, only the treaty with Uganda (1997) did not take this approach. Nevertheless, it is worth mentioning that the treaty the country signed with Nigeria (2000) shows an additional rule providing for the allocation of profits to the PE in cases where it is also used as a sales outlet in respect to goods or merchandise purchased for the enterprise.[552] This treaty is included in the 'Other' category in the table below.

Table 4.4: Article 7 (5) – Purchase of goods – OECD MC v. UN MC

Article 7(5)	Brazil	India	South Africa
Included	33	95	77
Absent	---	1(OECD)	1(UN)
Other	----	----	1

[547] ibid.

[548] See the 2001 UN MC and the 2011 UN MC, both at commentaries to Article 7, Business Profits, A. General Considerations, paragraph 5.

[549] The treaty with Sierra Leone (1956) in not considered in this analysis. See Chapter 3 at n. 21.

[550] However, some treaties India entered into have this provision in other paragraphs, as is the case of Article 7 (4) of the conventions with Ireland (2000) and Latvia (2013).

[551] The treaty with Greece (1965) deals with business profits at Article III, which does not even mirror the 1963 OECD Draft.

[552] The second sentence of Article 7 (5) of the treaty with Nigeria (2000) reads as follows: 'Provided that where that permanent establishment is also used as a sales outlet for the goods or merchandise so purchased the profits on such sales may be attributed to that permanent establishment.'

4.4 – The case for turning taxation of services into taxation of the PE's profits

As stated in Chapter 1 (Introduction), this thesis focuses on taxation of corporate business profits as provided by Article 5, Article 7, and Article 9. A thorough analysis of other articles of the compared countries' tax treaty networks is therefore out of its scope. It does refer, however, to relevant treaty dispositions that have particular influence on the taxation of business profits as approached by those articles. This is the case of Article 12 (Royalties) with regard to the Brazilian tax treaty network.[553]

The difference between the wordings of the OECD MC and the UN MC with regard to the taxation of royalties refers mainly to the allocation of taxing rights also to the source state; the latter departs from the OECD MC's approach[554] of granting taxing rights exclusively to the residence country in the case of payments of royalties.[555] Nevertheless, both model conventions provide for an exception to the application of Article 12 when the beneficial owner of the royalties carries on business in the source state through a PE and the right or property in respect of which the royalties are paid is effectively connected to such a PE;[556] if that is the case, the attribution of profits rules of Article 7 apply.[557] Article 12 (2) of the UN MC provides that in the case the beneficial owner of the royalties is a resident of the other state, the treaty should set a

[553] For an analysis of taxation of services, see Marta Castelon, *International Taxation of Income from Services under Double Taxation Conventions - Development, Practice and Policy* (Wolters Kluwer 2018). Also, see Adolfo Martín Jiménez, 'Article 12: Royalties' in IBFD, *Global Tax Treaty Commentaries* (IBFD 2017) and, for a historical perspective of the origins of the taxation of royalties in tax treaties, Richard Vann, 'The history of royalties in tax treaties 1921–61: Why?' in John Avery Jones, Peter Harris, and David Oliver (eds.), *Comparative Perspectives on Revenue Law: Essays in Honour of John Tiley* (Cambridge University Press 2008), p. 166-196.

[554] On the OECD MC approach to taxation of royalties, see Baker, *Double Taxation Conventions* (n 10), 12B.01,12-1ff.

[555] See the *2011 UN MC* (n 11), B. Commentary on the Paragraphs of Article 12, 4.

[556] Paragraph (3) in the OECD MC and Paragraph (4) in the UN MC.

[557] The UN MC refers also to the application of Article 14 (performance of independent personal services and the right or property being effectively connected with a fixed base in the source country) and to the right or property being effectively connected with the activities referred to in its Article 7 (1) (c). For the limited force of attraction as adopted by the UN MC in its Article 7 (1), see Subsection 4.3.4.

maximum tax rate to be applied; the rate as adopted by the treaty parties being subject to bilateral negotiations.[558]

In addition to the alignment of the treaty with the wording of the UN MC, the tax base of the source country can be broadened by the adoption of a concept[559] of technical services that falls under Article 12.[560] Such an approach then allows the source country to levy tax on the gross amount paid in consideration for technical services rendered by a resident of the other state; as a result, the PE threshold is avoided.[561] This is the approach adopted by Brazil on this particular issue.

As showed in the previous sections, one can conclude that the influence of the UN MC on the compared country's tax treaty network is insignificant with regard to the allocation of corporate business profits to PEs. Such a treaty policy, taken at its face value, could raise questions over the need of developing countries to align with the UN MC on the taxation of business profits. Nevertheless, Brazil, to some extent, circumvented the absence of treaty rules more beneficial to the host country on the matter by enacting domestic legislation dealing with the taxation of service fees and by following a particular treaty policy on the application of Article 12.

The majority of treaties Brazil has entered into provide for the taxation of technical services in Article 12. The treaty policy adopted by the country aligns with the UN MC's approach since all its tax conventions grant taxing rights to both the resident and the host country with regards to payments of royalties. The meaning of royalties as put forward by such an article in the treaties Brazil has signed does not, itself, include

[558] The final difference between the model conventions is that Article 12 (5) of the UN MC provides for the place where the royalties shall be deemed to arise.

[559] According to both the OECD MC (Article 12 (2)) and the UN MC (Article 12 (3)), the term royalties also means payments received 'for information concerning industrial, commercial or scientific experience'.

[560] See the UN MC's commentaries: 'Given the broad definition of 'information concerning industrial, commercial or scientific experience', some countries tend to regard the provision of brain-work and technical services as the provision of 'information concerning industrial, commercial or scientific experience' and to regard payment for such information as royalties'. *2011 UN MC* (n 11), B. Commentary on the Paragraphs of Article 12, 14. For the OECD MC's stance on the issue, see 2010 OECD MC, Commentary on Article 12, Paragraph 2, 11ff.

[561] Fernando Souza de Man, *Taxation of Services in Treaties between Developed and Developing Countries - A Proposal for New Guidelines* (IBFD 2017), p. 200.

payments for technical services;[562] the protocols to the vast majority of those conventions, however, provide for Article 12's application to fees paid to a resident of a treaty party concerning the rendering of technical assistance and technical services.[563] Twenty-eight of Brazil's treaties in force have a protocol dealing with technical assistance and technical services as above.[564] Interestingly, the protocols to few conventions signed in the 2000s go further on the issue: the one to the treaty with Israel (2002) provides for the exclusion of technical assistance and technical services from the royalties definition in case Brazil does so in agreements it enters into after the signature of that convention;[565] this approach is also adopted with regard to the treaty with Mexico (2003), where its protocol refers to the services fees not being considered as falling within the scope of Article 7 and Article 14 in a similar context.[566] No convention was noted where Brazil has changed its policy on the issue after 2002. Also, the conventions with Peru (2006)[567] and Russia (2004)[568] clarify that Article 12 applies also with regard to the digital economy.

Since the concept of technical services is not put forward by the treaty provisions, the actual extension of Brazil's taxing rights was set up by the country's domestic

[562] That is the case, for example, of Article 12 (3) of the treaty with Canada (1984). That paragraph reads as follows: ' (3) The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, films or tapes for television or radio broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience'.

[563] For instance, Section 8 of the Protocol to the treaty Brazil signed with Canada (1984) reads as follows: 'It is understood that the expression "for information concerning industrial, commercial or scientific experience" mentioned in paragraph 3 of Article 12 includes income derived from the rendering of technical assistance and technical services'.

[564] The exceptions are the conventions with Austria (1975), Finland (1996), France (1971), Japan (1976) and Sweden (1975).

[565] Section 2 of the Protocol to the treaty with Israel (2002) restricts this rule to treaty counterparts not situated in Latin America.

[566] Section 6 (b) of the Protocol to the treaty with Mexico reads as follows: 'If, after the date of signature of this Convention, Brazil agrees with any other country to a provision under which income derived from the rendering of technical services which do not imply that any right foreseen in the paragraph of reference be regarded as income to which Article 7 or Article 14 apply, then such provision shall automatically apply in place of the provisions of the preceding subparagraph of this Protocol, from the moment of the entry into force of the Convention which includes such provision'.

[567] Section 4 of the Protocol to the treaty with Peru (2006) reads as follows: 'The provisions of this item also apply to digital and business services, including consulting'.

[568] Section 3 of the Protocol to the treaty with Russia (2004) extends the application of Article 12 to payments concerning any transactions with respect to computer software.

legislation.[569] The Brazilian Income Tax Code provided for withholding tax at a rate of 25% to be imposed on payments for the rendering of technical services and technical, administrative and similar assistance by persons (companies included) resident or domiciled abroad.[570] Such withholding tax was subsequently reduced to 15% by Article 2-A of Law 10,168/00. It reads as follows:

> Article 2-A. From the 1st of January 2002 on, the withholding tax on amounts paid, credited, delivered, used or sent abroad as remuneration for the rendering of services of administrative assistance and the like shall be reduced to 15% (fifteen percent).[571]

This approach aligned the taxation of technical services with the withholding tax imposed by the domestic legislation on the payments of royalties. Article 710 of the Income Tax Code provides on the matter as follows:

> Article 710. Amounts paid, credited, delivered, used or sent abroad as royalties are subject to a withholding tax of fifteen percent.[572]

The Brazilian tax authority has laid down a couple of non-statutory regulations dealing with the remuneration connected to the rendering of technical services and technical assistance without transfer of technology. According to the rules contained in the Declaratory Act COSIT n. 1/2000,[573] the payments to foreign residents with regard to the rendering of those services should be subject to withholding tax.[574] According to this regulation, such income falls within Article 21 (Other Income)[575] of Brazil's

[569] On the broad definition of technical services as adopted by Brazil, see Rocha, 'Brazil's Treaty Policy' (n 162).

[570] Article 708 of the Income Tax Code.

[571] Law 10,168/00 was amended by Law 10,332/01, which added Article 2-A to the former. Article 2-A was translated by the author.

[572] Article translated by the author.

[573] Declaratory Act COSIT n. 1/2000 issued by the Brazilian Federal Revenue, Official Gazzete of 19/01/2000.

[574] ibid, Section 1.

[575] On Article 21 of the model conventions, see Luís Eduardo Schoueri, 'Article 21 – Other Income' in IBFD, *Global Tax Treaty Commentaries* (IBFD 2017).

treaties;[576] the same conclusion applies[577] in case the treaty does not have an Article 21.[578]

The Declaratory Act RFB n. 5/2014[579] has replaced such regulation on the matter. It regulates the incidence of the treaty provisions with regard to services with and without transfer of technology in the following ways: (i) where the protocol to the treaty provides for the treatment of technical services and technical assistance as royalties, Article 12 applies; (ii) in the case of technical services and technical assistance dependent on the technical qualification of an individual or group of individuals, Article 14 applies; and, finally, (iii) where none of the rules above applies, the fees for such services should fall within Article 7. [580]

The fact that Brazil adopts such tax policy on the taxation of services, a highly controversial issue on the international taxation arena,[581] affects the way the country's case law deals with the allocation of profits to PEs.[582] Section 4.6 approaches the court's decisions of Brazil, India, and South Africa on Article 5 and Article 7, with the domestic regulation on taxation of technical services as the main background for the Brazilian decisions.

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[576] Declaratory Act COSIT n. 1/2000 (n. 152), Section 2.

[577] ibid.

[578] On the implications of Declaratory Act COSIT n. 1/2000, see Calich and Rolim 'Chapter 4 - Tax Treaty Disputes in Brazil' (n 423), p. 875.

[579] Declaratory Act RFB n. 5/2014 issued by the Brazilian Federal Revenue, Official Gazzete of 20/06/2014.

[580] On the context surrounding the edition of Declaratory Act RFB n. 5/2014, see Doris Canen, 'Permanent Establishments: The Latest Trends from the Brazilian Tax Authorities - A Case Law Update' (2016) 70 Bull Int Taxation 10.

[581] Apart from the treatment of royalties as dealt with in Article 12 of the model conventions, most of the controversy on the taxation of services revolves around the adoption of a service PE rule as put forward by the UN MC. On the issue and on the compared countries' treaty policy, see Article 5 (3) (b). On the debate on allocation of taxing rights considering the rendering of technical services, see João Francisco Bianco and Ramon Tomazela Santos, 'A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need to Resolve the Source versus Residence Dichotomy' (2016) 70 Bull Int Taxation 3.

[582] For the attribution of profits to PEs in accordance with the Brazilian domestic law, see Subsection 4.2.1.

4.5 – Findings from the treaty policy comparative analysis

4.5.1 – The UN MC influence throughout Article 7

An analysis of the compared countries' tax treaty networks on Article 7 shows an outcome different from the treaty policy adopted by Brazil, India, and South Africa with regards to Article 5. In the present case, a substantial influence of the UN MC was not observed in relation to any of Article 7's paragraphs. On the contrary, the OECD MC influenced most of the countries' conventions. Additionally, and again contrary to the results that emerged from the analysis in Chapter 3, a pattern was even observed in all three tax treaty networks, where a couple of paragraphs follow one of the model conventions. Even though such a fact does not suffice for the conclusion of a coordinated tax policy between the compared countries on Article 7, it is not irrelevant that the deviation from the OECD MC is not as significant as it was with the PE concept.

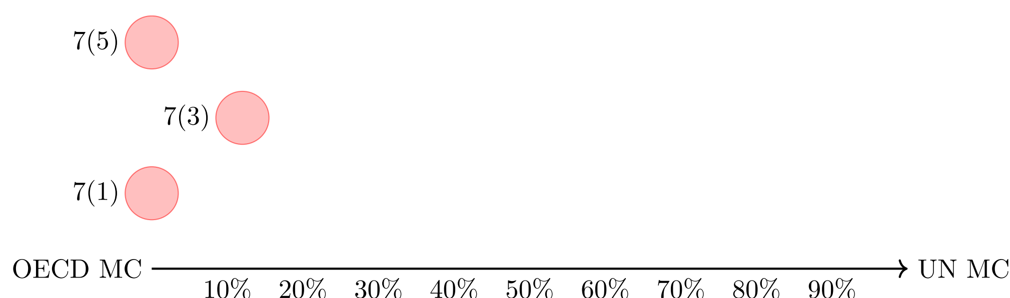
The figures included in this subsection show the model conventions' influence on the paragraphs of Article 7 throughout the compared countries' treaty networks. The analysis of the influence of the OECD MC considers its paragraphs as they stand in the convention's pre-2010 editions since there is a coordinated policy between the compared countries where they do not adopt the AOA; therefore, it is not considered in the figures. They adopt as a departing point the full influence exerted by the OECD MC. Their nodes are positioned towards the right end of the horizontal axis in accordance with the percentage of treaties still in force that adopt a policy influenced by the UN MC, thereby deviating from the OECD MC approach.

(i) Brazil

The clearest influence of the OECD MC relates to Brazil's treaties. Apart from the lack of adoption of the Authorized OECD Approach, Brazil has fully aligned its conventions with the OECD MC, where it does not include a force of attraction rule in Paragraph

(1).[583] A similar conclusion can be reached on Paragraph (3), since only one out of the total number of Brazil's treaties in force have explanatory wording about the deduction of expenses fully aligning with the UN MC;[584] nevertheless, in this case, the convention was signed with a UN country.[585] Finally, Brazil does not include a formulary apportionment provision as in Paragraph (4)[586] of the UN MC and the OECD MC (previous to 2010) in almost all its treaties; however, as there is no mismatch between them, this seems to be irrelevant for the analysis on the alignment with either one of the model conventions.

Figure 4.1: Article 7 - Influence of the UN MC throughout Brazil's tax treaty network



(ii) South Africa

South Africa mostly follows the OECD MC on Article 7. In spite of this, important features arise from scrutiny of its tax treaties. In some cases, a relevant influence of the UN MC on treaties signed by South Africa was noted. Such is the scenario in 21 conventions, where they have an explanation on the deduction of expenses in Paragraph (3).[587] The same level of influence, however, was not observed with regard to the force

[583] See Subsection 4.2.2 (ii.1).

[584] See Subsection 4.2.3 (ii.1).

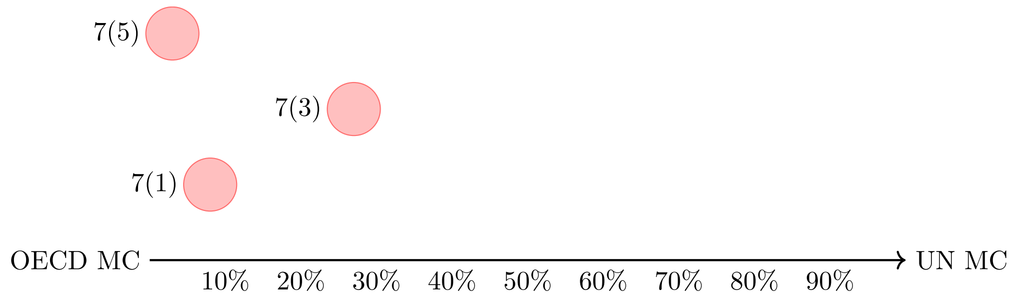
[585] The figure below considers the treaties with Mexico (2003), Ukraine (2002), and the Philippines (1983) as also influenced by the UN MC on Paragraph (3) of Article 7. See Subsection 4.2.3 (ii.1).

[586] See Subsection 4.2.4 (ii.1).

[587] See Subsection 4.3.3 (ii.3).

of attraction provision, since only three treaties, none of them signed with OECD member countries, have such a provision in Paragraph (1).[588]

Figure 4.2: Article 7 – Influence of the UN MC throughout South Africa's tax treaty network



(iii) India

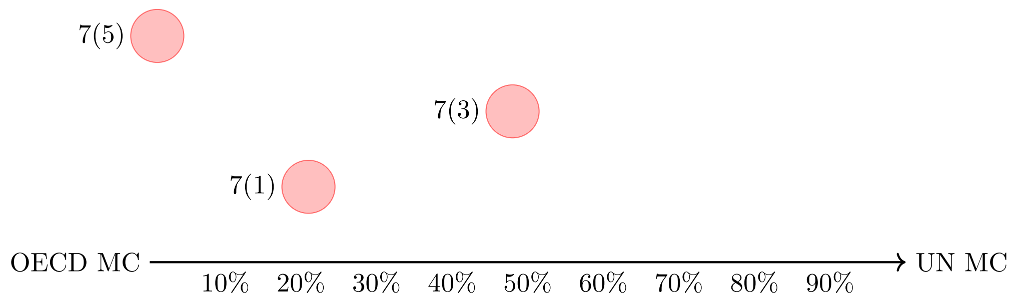
The shared characteristic with the analysis carried out in the previous chapter is that India is the jurisdiction that adopts the UN MC framework the most among the compared countries. The only provision that mirrors the OECD MC in virtually all its conventions is Paragraph (5): 95 out of 96 conventions.[589] In addition, it is noteworthy that several treaties adopting the UN MC wordings of Paragraphs (1) and (3) were signed with OECD member countries; in this vein, more than two-thirds of the treaties that fully align with the UN MC on the force of attraction provision were signed with OECD member countries.[590]

[588] The figure on South Africa's Article 7 (1) includes the treaties with Mexico (2009), Cameroon (2015) and Kenya (2010) since they show, to some extent, a UN MC influence. See Subsection 4.2.2 (ii.3).

[589] See Subsection 4.2.5 (ii).

[590] See Subsection 4.3.2 (ii.2).

Figure 4.3: Article 7 – Influence of the UN MC throughout India's tax treaty network



4.5.2 – Pattern adopted considering the FDI origin

In addition to the analysis of the compared countries' treaty policy as adopted throughout Article 7, it is also necessary to shed light on the influence of the model conventions with respect to the allocation of profits to PEs as provided by the treaties Brazil, India, and South Africa signed with relevant FDI origin jurisdictions (the 20 most relevant ones). As put forward by the former chapter's analysis on such influence exerted on Article 5, this examination can highlight the level of alignment with the OECD MC of particular treaties. In doing so, this subsection identifies those treaties that follow a UN MC approach and the level of FDI flow into the compared countries' economies. As a result, arguments in favour of and against the mandatory alignment with the OECD MC as a factor that is beneficial to the attraction of a high level of investment into Brazil, India, and South Africa's economies, and into developing countries' economies in general, can be put in check. The comparison below considers the 20 most important origin jurisdictions on the matter per compared country.

(i) Brazil's tax treaty network

As shown by Subsection 4.5.1, Brazil clearly adopts an OECD MC approach with respect to Article 7 (AOA excluded). The country does not deviate from such a pattern when it enters into tax conventions with the top FDI origin jurisdictions. When Brazil adopts a provision that fully aligns with the UN MC in comparison to the OECD MC

pattern (previous to 2010), in Article 7 (3) of the treaty with Venezuela (2005), it does so with a jurisdiction that does not count as a relevant investor in its economy; Venezuela accounted for less than one per cent of the total FDI flow into Brazil's economy in 2015.[591] Interestingly, the treaty with Mexico (2003), although it does not totally align with the UN MC, shows a deviation from the OECD MC, for it adopts the explanatory wording in Paragraph (3) with respect to payments made by the PE to the head office of the enterprise or to any of its other branches' offices. Mexico occupies the 12th position in the top 20 counterpart economies on the FDI flow into Brazil's economy. Finally, exactly 30% of the FDI into Brazil's economy in 2015 originated from jurisdictions the country does not have a tax treaty with.[592] To some extent, this raises the question about how relevant the alignment with the OECD MC is with regard to the allocation of profits rules at the treaty level. Finally, one needs to bear in mind that Brazil has, in fact, deviated from the international practice on the allocation of profits to PEs in some cases via the enactment of rules at the domestic level, [593] which has given rise to a series of challenges presented before the Brazilian courts.[594] Such tax policy resulted in the country enacting regulations more beneficial to the host jurisdiction without entering into negotiations to amend its treaty network to achieve a similar result.

(ii) India's tax treaty network

The analysis of India's treaty policy with regard to the FDI origin jurisdictions show the country does not necessarily follow the level of deviation from the OECD MC as observed in the previous subsection. This is the case, for example, of the inclusion in

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[591] See Brazilian Central Bank 'Brazil's FDI stock from 2010 to 2015 – Direct Investor Origin Jurisdiction' (n 406). Foreign direct investment from Venezuela amounted to only US$ 42,000,000 in 2015, with figures showing a slight variation in the previous years: the total invested per year from 2010 to 2015 ranged from US$42,000,000 (2010 and 2015) to US$64,000,000 (2014). Ibid.

[592] Those are the US (19% as of 2015), the UK (4% as of 2015), Switzerland (3% as of 2015), Germany (2% as of 2015), Cayman Islands (1% as of 2015) and Bermuda (1% as of 2015). These jurisdictions, with few variations in their positions, have constantly appeared in the top 20 FDI origin jurisdictions from 2010 to 2015. See Brazilian Central Bank 'Brazil's FDI stock from 2010 to 2015 – Direct Investor Origin Jurisdiction' (n 406).

[593] See Subsection 4.4.

[594] See Subsection 4.6.1.

the country's treaties of a limited force of attraction rule in the UN MC fashion. Even though the country does not adopt such a provision in the majority of its treaties, it is relevant that India has signed conventions with many OECD member countries that are patterned after the UN MC on the matter; many of those treaty counterparties are developed, capital-export countries.[595] One would not be surprised, therefore, that the same pattern would be observed with regard to the top 20 FDI counterpart economies. Nevertheless, such an assumption did not materialise. India has signed conventions providing for a limited force of attraction in Article 7 (1) with only five out of those 20 economies.[596]

Regarding the other paragraphs analysed above, India follows patterns similar to those adopted throughout its tax treaty network. With respect to Paragraph (4),[597] India signed 14 conventions with the most relevant FDI counterpart economies that provide for the application of a formulary apportionment system in the allocation of profits to PEs in certain circumstances.[598] Equally, the country has included explanatory wording about the deduction of expenses in Paragraph (3) as provided by the UN MC in 11 treaties with those relevant jurisdictions,[599] which roughly follows the same level of influence of the UN MC on the total number of India's tax treaties.[600] No influence of the UN MC was observed on Paragraph (5); again, this pattern matches the one adopted throughout the country's treaty network.[601]

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[595] See Subsection 4.3.2 (ii.2).

[596] Those countries are the US (2nd position as of 2015), Spain (15th position as of 2015), Italy (17th position as of 2015), Belgium (19th position as of 2015), and Canada (20th position as of 2015). See, on the FDI flow into India's economy in 2015, the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: India, Inward Direct Investment Positions (Top 20 Counterpart Economies) (n 414).

[597] See Subsection 4.3.4 (ii.2)

[598] For instance, the treaties with Singapore (4th position as of 2015), Japan (5th position as of 2015), Taiwan (9th position as of 2015), and Cyprus (12th position as of 2015). See the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: India, Inward Direct Investment Positions (Top 20 Counterpart Economies) (n 414).

[599] For example, the treaties with the UK (2nd position as of 2015), France (11th position as of 2015), Spain (15th position as of 2015) and Luxembourg (16th position as of 2015). ibid.

[600] See Subsection 4.3.3 (ii.2).

[601] See Subsection 4.3.5 (ii).

(iii) South Africa's tax treaty network

South Africa adopts the same pattern on the formulary apportionment rule in Paragraph (4) as the one observed throughout its tax treaty network.[602] The majority of conventions signed with the 20 most relevant FDI origin jurisdictions have such a rule.[603] Interestingly, the treaties signed with those jurisdictions do not show the same level of influence exerted by the UN MC on Paragraph (3) as observed throughout the country's tax treaty network; only two out of 20 treaties adopt a UN MC provision on the matter.[604] All the treaties South Africa signed with the top FDI counterpart economies follow the OECD MC on the purchase of goods. No limited force of attraction provision was observed.

4.6 – Case law analysis: Challenges posed before the courts on Article 5 and Article 7

4.6.1 – Brazil

(i) Telesat Brazil - Appeal n. 2000.38.00.044412-7[605]

Facts: The taxpayer, a Brazilian company doing business in the telecommunication sector (Telesat Brazil), was assessed by the tax authority regarding payments for services rendered by a Canadian company (Telesat Canada). Such services, according to the taxpayer, were not services with regard to the transference of technology, and therefore not of the category included in Article 12 (Royalties).[606] The fact that an employee of the Canadian company acted as a board member of Telesat Brazil was put

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[602] See Subsection 4.3.4 (ii.3).

[603] Eleven treaties have a formulary apportionment rule in Paragraph (4). For example, treaties with Japan (7th position as of 2015), Canada (10th position as of 2015) and Austria (16th position as of 2015). See the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: South Africa, Inward Direct Investment Positions (Top 20 Counterpart Economies) (n 419).

[604] Those treaties are the ones with the US (2nd position as of 2015) and with Mauritius (12th position as of 2015).

[605] Telesat – Serviços de Telecomunicações S/A e Outro(a) v Fazenda Nacional, Federal Tribunal – First Circuit (TRF1), Appeal n. 2000.38.00.044412-7/MG, Judgment date: 26.11.2013. Appeal pending of judgment before the TRF1. Available at <www.trf1.jus.br> accessed 30 August 2017.

[606] On the issue of the inclusion of technical services as royalties by Brazil (treaty with Canada included), see Section 4.4.

forward by the tax administration as the main factor for the taxpayer's liability. In addition, it was also pointed out that the Canadian entity was a shareholder of the Brazilian entity.[607] Accordingly, the tax authority argued that the taxpayer was a PE of the foreign entity under Article 5 of the treaty signed with Canada; therefore, income tax was due in Brazil according to Article 7 of the convention. The tax authority also contended that, since the tax treaty in question does not include the concept of services, it is for the domestic legislation to do so; therefore WHT was due in Brazil. The appellant emphasised that the companies were independent legal entities whose activities did not mix; Telesat Brazil provided its clients in Brazil with satellite communication services, while Telesat Canada was in charge of the telecommunication system's development. The tax administration's argument also contended that a Canadian national and employee of the foreign company acting on its board was proof of the PE's existence.

Decision: The Court found in favour of the taxpayer. The decision stressed that the sole participation of the foreign employee in the board of the Brazilian company cannot lead to the conclusion of the existence of a PE. As a result, Article 5 (2) (b)[608] is not applicable, since the board as a whole is in charge of decisions with regards to the Brazilian company and not the Canadian company employee considered individually. The decision went even further by pointing out that, according the Brazilian legal system, one person can be involved in both companies without this implying that the companies are the same. In addition, the fact that the foreign entity was also a shareholder of the taxpayer (although the decision does not refer to the possible control by the foreign company over the Brazilian entity) did not necessarily lead to the conclusion that the latter was a PE of the former under Article 5 (2) of the tax convention; therefore, since there is no PE in the country, no WHT was due by the taxpayer with regards to payments to the Canadian entity.

[607] However, the decision did not refer to a control exerted by the Canadian entity over the Brazilian company or to association between the companies.

[608] Article 5 (2) (b) of the treaty with Canada (1984) states for the inclusion of a branch as a PE, therefore matching the usual wording of the provision.

(ii) PCI Brazil – Appeal n. 2002.51.01.002701-0[609]

Facts: The taxpayer, a Brazilian company (PCI Brazil) doing business in the automotive market, entered into a services agreement with a carmaker company based in Brazil. Such services did not include those relating to the transfer of technology. In order to be able to fulfil its contractual obligations, the taxpayer entered into a second agreement with its parent company based in France (PCI France),[610] which, argued the taxpayer, was aimed at providing the Brazilian entity with administrative and commercial support with regards to its contract with the carmaker company.[611] Considering such a background, and the tax administration's position on the taxation of services provided by foreign entities,[612] the taxpayer appealed to the Court contending mainly: (a) that the Brazilian and French companies were, in fact, two legal entities, with residence in diverse jurisdictions; (b) that such payments were, in fact, profits attributable to its parent company in France; and that (c) considering the provision contained in Article 7 of the treaty with France,[613] Brazil did not have any taxing rights with regards to such payments.

Decision: The Court held against the taxpayer. The ruling elaborated on the concept of PE and the attribution of profits according to Article 7 of the tax treaty Brazil entered into with France and on the concept of profits and other income. On the payments made by PCI Brazil, the Court concluded that they were to be considered as other income (as provided by Article 21 of the model conventions)[614] and not as profits; therefore, Article 7 of the convention was not applicable to the case. On the PE issue, after scrutiny of the subject of the contract with the parent company, the Court concluded

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[609] PCI do Brasil Ltda. v Fazenda Nacional (Federal Tax Revenue), Federal Tribunal – Second Circuit, Appeal n. 2002.51.01.002701-0, Judgment date: 16.03.2010. Available at <www.trf2.jus.br> accessed 30 August 2017. Appeal pending of judgement before the Superior Court of Justice.

[610] Process Conception Ingenierie SA (PCI France) controlled the Brazilian entity through the ownership of 99.99% of PCI Brazil's shares; the remaining equity was owned by another group entity based in Argentina.

[611] Decision (n 606), p. 2.

[612] See Section 4.4.

[613] Article 7 of the treaty with France (1971).

[614] Interestingly enough, the treaty with France does not contain an 'Other Income' (or 'Income not expressly mentioned' as in the 1963 OECD Draft Convention) provision; Article 21 of the treaty deals with the taxation of students. See the treaty with France (1971).

that the French entity was, in fact, the one in charge of the services provided to the Brazilian carmaker;[615] therefore, the sole role of the Brazilian entity was to act as an intermediary for its parent company.[616] As a consequence, the Court found that PCI Brazil acted as a PE of PCI France as provided by Article 5.[617] Having concluded as above, the Court found the taxpayer, with regard to payments made to its parent company, liable to WHT in accordance with domestic legislation on the matter.[618]

(iii) Copesul – Special Appeal n. 1.161.467 – RS[619]

Facts: The taxpayer entered into service agreements with a Canadian company and a German company. As a result of fee payments to the foreign enterprises, the taxpayer was liable, according to the tax authority, to WHT with regard to the service fees, since they did not qualify as profits of the foreign entities, being instead of another income nature. The issue was presented before the Court through a Special Appeal lodged by the tax authority,[620] which, inter alia, contended that: (a) the payments for services could not be considered as profits but as revenue, since the net profits would be assessed only later on by the foreign entities; (b) as a result, the payment of service fees fell under Article 21 of the treaty signed with Canada and the respective provision of the treaty signed with Germany, not under Article 7 of such conventions;[621](c) therefore, according to Brazilian domestic legislation, the taxpayer was liable to WHT with regard to fees paid to the foreign entities.[622] The taxpayer contended the tax authority arguments mainly on the grounds that the treaty provisions overrule the domestic

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[615] Decision (n 606), p. 13.

[616] ibid, p. 15. Note that the treaty with France provides for Agency PE in Article 5 (4) in the 1963 OECD Draft Convention fashion. However, the decision does not refer to any authority of the Brazilian entity to conclude contracts in the name of the French one.

[617] It is worth mentioning that the decision considered the control exerted by the French entity as a factor in determining its PE presence in Brazil. Interestingly on this issue as well, the treaty with France did not contain an Article 5 (7) (PE/subsidiary).

[618] On the taxation of services and on WHT incidence in Brazil, see Section 4.4.

[619] Copesul Companhia Petroquímica do Sul v National Treasury, Superior Court of Justice, Special Appeal n. 1.161.467-RS, Judgement date: 17.5.2012. Available at <www.stj.jus.br> accessed 30 August 2017.

[620] A previous decision delivered by the Federal Tribunal – Fourth Circuit was in favour of the taxpayer. The tax authority then appealed to the Superior Court of Justice against such a decision. ibid, p. 3-4.

[621] ibid, p. 4.

[622] See Section 4.4.

legislation on the issue, and that only enterprises with a PE in the country would be liable to income tax in such a context.

Decision: The Court ruled in favour of the taxpayer. According to its understanding, the Brazilian company relied on Article 7 of both tax conventions when taking into consideration its tax liability with regards to the service fee payments. It went further by stressing that the wording 'profits of the enterprise', as contained in Article 7, should not be read as net profits, since the assessment of profits should occur in the residence countries after the fee payments; an opposite view would therefore render Article 7 useless.[623] Finally, relying on Brazilian Tax Code provisions, the Court decided that the treaties' provisions override domestic legislation on the matter (*lex specialis derogate legi generali* principle);[624] therefore, no WHT was due.

4.6.2 – India

(i) – Zero-sum approach - DIT (International Taxation), Mumbai v Morgan Stanley & Co Inc; Morgan Stanley & Co Inc v DIT (International Taxation), Mumbai [625]

Facts: In the present case, the Supreme Court of India was called upon to decide on appeals presented by both the taxpayer and the tax authority with regards to the presence of a PE in India and, accordingly, to the respective attribution of profits under the arm's length principle. Relevant to this subsection, and apart from the domestic legislation on the PE concept and transfer pricing regulation, the application of Article

[623] Decision (n 616), p. 16.

[624] Article 98 of the Brazilian Tax Code provides for the nature of the tax treaties' provisions as *lex speciali* under the Brazilian legal system.

[625] Morgan Stanley & Co Inc v DIT (International Taxation), Supreme Court of India, Civil Appeal ns 2914 and 2915 of 2007, Judgment Date: 9 July 2007. 9 ITLR 1124.

5 (2) (l)[626] and Article 7 (2)[627] of the US (1989) was under scrutiny. Morgan Stanley Advantages Services Pvt Ltd (MSAS) was part of the Morgan Stanley Group, a well-known financial institution; as such, MSAS was considered as an associated enterprise by India's domestic legislation. MSAS entered into an agreement with its parent company, whereby the latter provided support services (through its personnel) to the Indian company, i.e. stewardship and secondment activities. The issues under scrutiny refer to the conclusion with regards (a) to the nature of MSAS as a possible PE and (b) to the amount of profits to be allocated to the PE. The question on a possible allocation of profits to the PE, apart from those resulting from the application of the arm's length principle,[628] assumed particular relevance in such a discussion.

Decision: With regard to the presence of the foreign enterprise in India, the Supreme Court decided that only the work connected to secondment activities gave rise to a service PE in the country as provided by Article 5 (2) (l) of the treaty.[629] According to the Court, the back office functions performed by the Indian company did not give rise to a PE in terms of Article 5 (1) of the treaty; there was no agency PE either, since the company in India did not have the authority to enter into or conclude contracts.[630] In concluding for the PE, the court stated that: (a) the TNMM method as applied by the taxpayer, and respective costs' mark-ups as provided for a previous study, were adequate; and, most importantly, (b) since the attribution of profits to the PE was carried out in accordance with the arm's length principle and respective transfer pricing regulation, and therefore with due consideration of the functions performed and risks assumed by the PE, no further profits should be allocated to the enterprise in India.[631] As stated by the Court's ruling, under Article 7 (2) of the US treaty, only the profits that show economic nexus with the enterprise in India were to be attributed to the PE.

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[626] Article 5 (2) (l) of the treaty with the US provides for the concept of service PE. See the treaty with the US (1989).

[627] Article 7 (2) of the treaty with the US matches the OECD MC.

[628] On India's domestic regulation on transfer pricing and the arm's length price, see Chapter 5.

[629] Morgan Stanley & Co (n 62), paragraph 33, p. 1147.

[630] ibid, paragraphs 8 and 9, p. 1132.

[631] ibid, paragraphs 32 and 33, pp. 1147 and 1148.

In deciding the above, the Supreme Court of India adopted the 'zero-sum approach' on the attribution of profits to PEs in such circumstances.[632]

(ii) – Residual income and discretionary profits apportionment - Convergys Customer Management Group Inc. v ADIT[633]

Facts: The taxpayer, a US-based company, was dedicated to providing IT-enabled customer management services. Its Indian subsidiary provided IT-enabled call centre/back office support services to the parent company, services whose risks and liabilities, according to the US entity, were borne by the parent company.[634] The taxpayer appealed against the fact that it was considered as having a fixed place PE (Article 5 (1)) and a place of management (Article 5 (2) (a)) in India,[635] and against the way profits were allocated to the PE. The taxpayer put forward arguments against the profit assessment by way of a head-count methodology, which allocated income considering the employees in India as a proportion of the worldwide number of employees of the MNE.

Decision: The Court decided mostly in favour of the taxpayer. It was held by the ITAT that the taxpayer did have a fixed place PE under Article 5 (1) of the US treaty;[636] on the contrary, the decision did not consider the enterprise as having a dependent agent PE in the terms of Article 5 (4) of the treaty.[637] More importantly for the current analysis, the ITAT considered the profit allocation on a head-count basis as previously set up as inadequate. The tribunal held that the profit allocation to the PE should follow

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[632] ibid, Editor's Note, p. 1125.

[633] Convergys Customer Management Group Inc. v ADIT, Income Tax Appellate Tribunal (ITAT), New Delhi, ITA ns. 1443/Del/2012 and 5243/Del/2011, Judgement date: 10 May 2013. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017.

[634] ibid, paragraph 3.1.

[635] Originally, the tax authority considered the US enterprise as having a PE under paragraphs (1), (2)(c) and (2)(d) of Article 5; as having a service PE under Article 5 (2) (l); and as having a dependent agent PE under Article 4 (a) and (c) as read with Article 5(5), all provisions from the US treaty. ibid, paragraph 3.3. The Service PE and Dependent Agent PE were excluded by a decision previous to that of the ITAT. With regard to the former, such a decision considered that the services fell under Article 12 of the treaty. ibid, paragraph 3.9

[636] ibid, paragraphs 9.7ff.

[637] ibid, paragraph 10.

the arm's length principle and, in so doing, reliance was placed on previous case law on the matter (notably, the Morgan Stanley & Co case). Accordingly, once the arm's length price has been established, 'no further profits can be attributed to a PE'.[638] Interestingly, however, after reference to such a principle, the ITAT allocated residual profits to be taxed at the PE level. In so doing, and bearing in mind the OECD Commentaries on the matter and Article 7 of the treaty with the US, the Court set up a series of steps to be followed in such circumstances: Step 1 – Compute global operating income from the annual report; Step 2 – The results should be applied to the end-customer revenue with regard to contracts/projects where services were procured from the PE; Step 3 – The operating income from Indian operations is to be reduced by the profit before tax of the PE, which translates to the residual income; and Step 4 – The profit attributable to the PE should then be estimated on residual profits, as in Step 3. The court went further when considering the allocation of 15% of the foreign enterprise's profits to the PE as a means of justice; it decided on such a percentage based on rather old Supreme Court of India case law.[639] In so allocating residual profits, the ITAT, in fact, deviated from the zero-sum approach[640] as decided by the Supreme Court of India in Morgan Stanley & Co v DIT (International Taxation).[641]

(iii) Centrica India Offshore Private Ltd v CIT[642]

Facts: Centrica India was a wholly owned subsidiary of a UK enterprise (Centrica Plc), which, in turn, was also a parent company to companies based in the UK and in Canada.

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[638] ibid, paragraph 11.9.

[639] Namely, Anglo French Textile Company Ltd. Vs CIT and Hukum Chand Mills Ltd. Vs. CIT; the first case set up a 10% profit allocation, while the latter set up a 15% one. No other reason for the adoption of the higher percentile was given, apart from, in the ITAT's view, that it met 'the ends of justice'. Accordingly, 'the attribution of Indian PE income should be made at 15% of profit retained by CMG [parent company] in the US.' ibid, paragraphs 11.23 and 11.24.

[640] On the same conclusion, see Aseem Chawala, 'Chapter 6 – Tax Treaty Disputes in India' in Baistrocchi (n 49). Also, Amar Mehta in the IBFD's Summary on Convergys Customer Management Group Inc. v. ADIT, 10 May 2013. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017.

[640] ibid, paragraph 3.1.

[641] See (n 622).

[642] Centrica India Offshore Private Ltd v CIT, High Court of Delhi, New Delhi, W.P. n. 6807/2012, Judgement date: 25.04.2004. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017.

Together, these foreign companies entered into an outsourcing agreement for back office support functions with the Indian entity. The foreign entities' employees were accordingly seconded to Centrica India, which, as established by the aforesaid agreement, was to exert direct control and supervision over the employees' activities; therefore, all the risks were to be borne by the Indian company.[643] Centrica India made payments to the foreign enterprises as a way of 'reimbursement' for the salaries of the seconded employees, which were paid by the foreign companies. The tax authority was of the position that such payments were income received by the foreign companies, since they fell under the 'fees and technical services' category, and that the foreign companies had a PE in India according to the respective tax treaties signed between the country with the UK and Canada. An Advanced Ruling decision on the issue held that the enterprises had a PE in India, and therefore an appeal was filed by Centrica India before the High Court of Delhi. The appellant contended, inter alia, that the ruling failed to differentiate between legal employment and economic employment. In this sense, the fact that the economic employer could terminate the secondment agreement and, in the end, was the one to bear the costs of the payment of salaries made by the legal employer led to the conclusion that Centrica India was the real and economic employer of the seconded personnel.[644]

Decision: The Court sided with the tax authority. It was emphasised that the foreign enterprises were not to be held accountable for any errors or omissions of the seconded employees, since the Indian company was the one bearing all the risks and receiving all the benefits from their activities.[645] More importantly, although the costs of their remuneration were also to be borne by Centrica India, it was the foreign enterprises that paid their salaries and kept the employees under their retirement and social security plans; as a result, no employment relationship existed between the secondees and Centrica India.[646] Thus, in fact, it was only possible to terminate the secondment agreement between Centrica India and the foreign companies.[647] The Court dismissed

[643] ibid, paragraph 3.

[644] ibid, paragraphs 10 and 28.

[645] ibid, paragraph 34.

[646] ibid.

[647] It is worth citing the Court's conclusion on the very nature of the transaction and respective payments: 'The mere fact that CIOP [Centrica India], and the secondment agreement, phrases the payment made from CIOP to the overseas entity as 'reimbursement' cannot be determinative. Neither is the fact that the

the appeal, concluding that the services were of a managerial nature and, considering the relevant provisions of both the treaties with the UK and Canada, held that the foreign enterprise had a service PE in India.[648]

(iv) – LFA and services performed abroad 1 - Linklaters LLP v Income Tax Officer[649]

Facts: Linklaters LLP, a foreign solicitor firm based in the UK without a fixed base in India, provided clients based in the country with legal services. In so doing, the taxpayer did not assess any income tax liability in relation to such services, which was contended by the tax authorities under the argument, inter alia, that there was a service PE in India according to Article 5 (2) (k) of the tax treaty with the UK.[650] Therefore, income arising from the aforementioned services should be liable to tax in India; the tax authority also considered as taxable income, as provided by the force of attraction principle in Article 7 of the treaty, the amount connected to services performed outside India to Indian clients.

Decision: Relevant to the present analysis, the ITAT sided with the tax authority. The court considered the taxpayer as having a service PE in India according to Article 5 (2) (k) of the treaty with the UK, concluding that the service PE was a deemed (i.e. fictitious) PE.[651] Therefore, and after considering that the taxpayer's services were not taxable under Article 13 (royalties and fees for technical services)[652] of the treaty, the income derived from the rendering of such services was taxable in the country as business profits. With regard to which profits should be taxed in India, the Court

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overseas does not charge a mark-up over and above the costs of maintaining the secondee relevant in itself, since the absence to mark-up (subject to an independent transfer pricing exercise) cannot negate the nature of the transaction.' ibid, paragraph 38.

[648] Centrica India presented a Special Leave to Appeal petition before the Supreme Court of India against the decision, which was dismissed. Centrica India Offshore Pvt Ltd New Delhi v. The Commissioner of Income Tax, Supreme Court of India, Petition for Special Leave to Appeal n. 22295/2014, Decision date: 25.10.2014. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017.

[649] Linklaters LLP v Income Tax Officer – International Taxation Ward 1 (1)(2), Mumbai, ITAT (Mumbai Bench), Cases ns. 4896/Mum/03 and 5085/Mum/03. Decision date: 16.6.2010. 13 ITLR 245.

[650] Although relevant in general, this subsection does not elaborate further on other points of the case, e.g. the point on the treaty benefits for partnerships based outside India.

[651] Linklaters LLP v Income Tax Officer (n 646), paragraphs 92 and 93.

[652] ibid, paragraph 98.

decided that all the fees charged in connection with projects in India were to be considered as subject to taxation in the country. In so doing, it based its decision on the 'directly and indirectly' wording of the UK tax treaty. The conclusion should be, following the Court, that the force of attraction as embedded in Article 7 of the convention also leads to the inclusion in the PE's taxable profits of the fees charged with regard to services performed outside India[653] by the head office or other enterprise of the same group.[654] Finally, the decision held that, after a lengthy consideration of the origins of the arm's length principle as applicable to PEs in opposition to its application in the transfer pricing arena,[655] the fiction of hypothetical independence was not to be observed in regard to independent entities' revenue adjustment.[656] As a result, and under the ITAT interpretation of Article 7 (2), the revenues earned are to be taken at actual figures, with no adjustments being permitted.[657]

(v) – LFA and services performed abroad 2 – ADIT v Clifford Chance[658]

Facts: The current case bears great similarities with the previous ruling on Linklaters LLP, even though the decision reached a diverging conclusion on the issues under analysis by the ITAT. Clifford Chance, a foreign solicitor firm based in the UK without a fixed base in India, provided legal consultancy services with regard to different projects in India.[659] In order to perform part of its services, its personnel (partners and

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[653] ibid, paragraphs 139ff, p. 346ff.

[654] ibid, paragraph 142: '[…] the entire income from professional services sourced from India, whether in respect of the services rendered in India or outside India, is taxable in India.' ibid, p. 347. The present analysis does not pay attention to the discussion on the differences between 'furnishing' and 'rendering' services carried out by the ITAT. On this matter, see paragraph 100, pp. 332ff.

[655] ibid, paragraphs 118ff, p. 340.

[656] ibid, paragraph 125, p. 342.

[657] ibid, paragraph 130: '[…] the very plea of the assessee proceeds on fallacy that arm's length price adjustment can be made in respect of the transactions with the clients of the assessee. The revenues earned by the assessee are to be taken at actual figures and no adjustments are permissible in the same.' ibid, p. 344.

[658] ADIT v Clifford Chance, ITAT (Mumbai Bench), Case n. 2060-61/Mum/2008, Decision date: 13/5/2013. Available at <https://www.itat.gov.in> accessed 1 October 2017.

[659] ibid, paragraph 2.

employees alike) visited the country on several occasions. The taxpayer understood that its income tax liabilities were limited to services performed in India; as a result, it filled its tax return for one year only (fiscal year of 1998/99). In doing so, Clifford Chance relied on Article 15 (Independent personal services) of the treaty India signed with the UK (1993).[660] With regard to the following periods, the taxpayer's position was that it was not liable to income tax in India since its personnel did not stay in the country for more than 90 days. The tax authority assessed the taxpayer's liability for the periods after 1998/98 on the grounds that Article 5 (2) (k) (Service PE) applied to the case. Therefore, the taxpayer's profits for services rendered in India or outside the country fell within Article 7 since they were directly or indirectly attributable to the PE in India.[661] Clifford Chance appealed to the CIT(A), which decided that Article 15 was to be applied in such circumstances.[662] The tax authority appealed this decision to the ITAT (Mumbai Bench).

Decision: The ITAT held in favour of the taxpayer. The court, expressly referring to the ruling in the Linklaters case, disagreed with the tax authority arguments. According to the ITAT, the changes in the domestic regulation, with retrospective effect, carried out by the Finance Act 2010 (on Section 9 of the Income Tax Act) was not applicable to the taxpayer's activities. The court concluded that the income derived from the services provided by Clifford Chance did not fall within either clause (v) (income by way of interest) or clause (vi) (income by way of royalty) or clause (vii) (income for technical services) of Section 9(1), which were the provisions affected by such an amendment.[663] On the attribution of profits to the PE in India, the tribunal considered

[660] Article 15 (1) of the treaty with the UK (1993) reads as follows: 'Income derived by an individual, whether in his own capacity or as a member of a partnership, who is a resident of a Contracting State in respect of professional services or other independent activities of a similar character may be taxed in that State. Such income may also be taxed in the other Contracting State if such services are performed in that other State and if: (a) he is present in that other State for a period or periods aggregating 90 days in the relevant fiscal year; or (b) he, or the partnership, has a fixed base regularly available to him, or it, in that other State for the purpose of performing his activities; but in each case only so much of the income as is attributable to those services'.

[661] ADIT v Clifford Chance, ITAT (Mumbai Bench) (n 178), paragraph 4. The tax authority also based its assessment on Section 9 of the Income Tax Act as amended by the Finance Act 2010, and on the explanations to this regulation, that provide that 'the place of accrual of income from services is not the place where the services are rendered but the place where those services are utilized'. ibid.

[662] ibid, paragraph 5.

[663] ibid, paragraph 26. See Subsection 4.2.2 for the Indian domestic law.

that profits arising from services rendered outside India could not be regarded as profits directly attributable to the PE as provided by Article 7(2) of the treaty with the UK. Most importantly, it concluded that Article 7(1) and (3) are not akin to the force of attraction as provided by Article 7(1)(b) and (c) of the UN MC; as a result, the income could not be indirectly attributed to a PE in India either. Consequently, concluded the ITAT, the decision put forward in the Linklaters[664] case was incorrect.[665]

4.6.3 - South Africa

(i) Extension of the PE meaning – AB LLC v Commissioner of the SARS[666]

Facts: The taxpayer was a consultancy firm providing services to a client conducting business in the aviation sector, which was based in South Africa. The foreign company entered into an agreement with the local one to perform its consultancy services in 2007 and 2008, for which a payment was agreed for a fixed amount plus success fees. As part of the agreement, the US company sent its personnel to South Africa, who, in total and under different schedules, were in South Africa for more than 183 days in a twelve-month period. The tax authority assessed the tax liability of the taxpayer on the grounds that it had a service PE in South Africa in accordance with the provisions of the South Africa/US tax treaty (1997), notably under Article 5(1) and (2)(k),[667]the income derived by the US entity being accordingly attributed to the PE under Article 7(1). In what is relevant here, the taxpayer challenged the tax assessment by arguing that, in fact, the service PE provision contained in Article 5 (2)(k) depends on the fulfilment of the

[664] On the effects of the Clifford Chance ruling with regard to the one in Linklaters, see Suhas Sagar, 'How "Limited" Is Limited Force of Attraction? An Analysis of the Relevant Case Law and the Potential Implications of the OECD/G20 BEPS Initiative' (2017) 71 Bull Int Taxation 5.

[665] It was held that Article 7(1) of the UK treaty, read with Article 7(3) of the same convention, is materially different from Article 7(1) of the UN MC. ibid, paragraph 35.

[666] AB LLC v Commissioner of the SARS, Johannesburg Tax Court, Case n. 13276, Decision date: 15.5.2015. 17 ITLR 911.

[667] Article 5 (1) matches the OECD MC. Paragraph (2) (k) of Article 5 provides for a service PE as follows: '(2)The term "permanent establishment" includes especially:[…] (k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve month period commencing or ending in the taxable year concerned.'

requirements laid down by Article 5 (1), which was not the case. It also contended that the attribution of profits to the PE with regard to the success fees was inadequate since they were paid in 2009 only, after the taxpayer had left the country.

Decision: The court sided with the tax authority on this case. It was contended by the respondent that once the requirements of Article 5 (2) (k) of the treaty with the US are met, nothing remains to be discussed regarding the presence of a PE in South Africa.[668] The tax court agreed with such reasoning, stressing that the 'includes specially' wording in Article 5(2) results in the service PE being part of the definition contained in Article 5(1).[669] Therefore, and resorting to the US Technical Explanation, the tax court concluded that there is not a necessary link between the Paragraph (2) deemed-PE provision and the fixed-base PE as provided by Paragraph (1).[670] Nevertheless, the decision went further by stating that even if the requirements of Article 5(1) were to be met, there was a case for the PE's presence in the country. According to this line of reasoning, the fact that the taxpayer's personnel was present in its client's boardroom during the period of the contract shows that the defining characteristics of a PE as put forward by Article 5(1) were met.[671] Finally, the Court decided that the fees received by the US entity in 2009 were also to be attributed to the PE, thus being subject to tax in South Africa. The Court concluded that, even though the taxpayer had already left the country by 2009, the success fee was also as a result of its operation in South Africa during the contract period. As such, the income received in 2009 was considered as deferred income and therefore fell under Article 7(1) of the treaty with the US.[672]

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[668] AB LLC v Commissioner of the SARS, (n 663), paragraph 20, p. 942.

[669] As put by the Court: 'On this analysis, as soon as an enterprise's activities fall within the ambit of art 5(2)(k) it becomes liable for taxation in the non-resident country. There is no need for a further or separate enquiry as to whether the requirements of art 5(1) have been met.' ibid, paragraph 30, p. 944.

[670] AB LLC v Commissioner of the SARS, (n 663), paragraph 39, p. 947. On the critics to the application of the US Technical Explanation on the issue, see the Editor's Notes to the case. ibid, p. 914. Also, Johann Hattingh, Commentary to the case. ibid, p. 926.

[671] According to the Court, the taxpayer performed, at least in part, its services from a fixed place of business in the country, which leads to a conclusion for a PE. ibid, paragraph 43, p. 948.

[672] ibid, paragraph 49, p. 951.

(ii) Oceanic Trust Co Ltd v Commissioner for South African Revenue Service[673]

Facts: The taxpayer, a trust established in Mauritius doing business in the re-insurance sector in South Africa, was assessed by the tax authority for its income tax liability in the country.[674] The SARS based its assessment on the understanding that the place of effective management (POEM) of the trust was, in fact, in South Africa, thus triggering the trust residence in the country according to the domestic legislation and to the relevant provisions of the treaty with Mauritius.[675] As a result, the taxpayer sought a declaratory relief from the High Court on the grounds that it was not based, and did not have a PE, in South Africa. It was highlighted that the trust's deed of settlement established that all the trust's affairs were conducted in Mauritius. In addition, according to the same document, it was pointed out that its principal place of business was in Mauritius.[676] The taxpayer's view was that it is not possible to confuse the place where business activities occurred, and where part of its business was carried out, with the effective place of management under analysis.[677] With regard to the existence of a PE in South Africa, the taxpayer stressed the fact that nobody had or habitually exercised a general authority to conclude contracts in the country in its name; therefore, there was not a case for a PE there.[678]

Decision: The Court sided with the tax authority. Accordingly, the taxpayer did not establish that its place of effective management was in Mauritius and not in South Africa, as claimed in its application.[679] On the existence of a PE in South Africa, the High Court returned to the concept of permanent establishment as provided by the domestic legislation, which referred to the meaning of PE as provided by Article 5 of

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[673] Oceanic Trust Co Ltd v Commissioner for South African Revenue Service, Western Cape High Court, Case n. 22556/09, Decision date: 13.06.2011. 15 ITLR 173.

[674] The applicant (Oceanic Trust Co Ltd), a company registered and incorporated under Mauritian law and with its principal place of business in Mauritius, was the sole trustee of Specialised Insurance Solutions (Mauritius) (SISM). Ibid, paragraph 1, p. 175

[675] ibid, paragraph 16, p. 178.

[676] ibid, paragraph 3, p. 175.

[677] ibid, paragraph 48, p. 188.

[678] ibid, paragraph 34, p. 184.

[679] ibid, paragraph 58, p. 193.

the OECD MC. [680] In the court's view, such a definition requires a place in the country where the business of the taxpayer was wholly or partly carried out, which could even be a place of another entity.[681] In analysing the facts of the case, it concluded that this was not the case for the application of Paragraph (6) (independent agency) of Article 5, since the South African companies were conducting the business (at least partly) and making decisions on behalf of the trust.[682]

(iii) Secretary for Inland Revenue v Downing[683]

Facts: An individual, previously domiciled in South Africa, moved to Switzerland.[684] His assets consisted mainly of a portfolio of shares, which, according to the South African regulation, had to remain in the country. As the individual was absent from South Africa, his assets in the country were handled by a firm of financial advisors and by a stockbroker; the former held the individual's power of attorney and was in charge, inter alia, of keeping his shares and of collecting the respective dividends, while the latter was in charge of the share portfolio's management. The changes in the portfolio of shares were made entirely by the stockbroker, who had a 'free hand and made changes in the portfolio, both sales and purchases, without prior reference to the respondent'. [685] The tax authority assessed the taxpayer's income tax liability with

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[680] ibid, paragraph 61, p. 194. The High Court stressed that the important categories to be analysed in the case with regard to the concept of PE were those included in Paragraphs (1) and (2) ('a' to 'c') of Article 5. ibid, paragraph 63, p. 195. On the concept of PE as provided by the South African domestic law, see Subsection 4.2.3.

[681] ibid, paragraph 64, p. 196.

[682] ibid, paragraph 66, p. 196. Such is the High Court's conclusion for a PE: 'In my view, the applicant has not made out the case for the declaratory it seeks namely that the business SISM [the trust] conducted in South Africa was not wholly or partly carried on through a fixed place of business in South Africa.' ibid, paragraph 67, p. 196.

[683] Secretary for Inland Revenue v Downing, Supreme Court of Appeal, Case 1975 (4) SA 518 (A), Decision date: 19/08/1975. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017.

[684] The ruling on the Downing case is acknowledged as a leading decision for South Africa's case law mainly for its role I n the interpretation of treaty provisions on the matter. On the issue, see Johann Hatting, 'South Africa – Downing v. Secretary for Inland Revenue, 19 August 1975 (Summary)'. IBFD's Treaty Case Law Collection. Available at <www.ibfd.org> accessed 1 October 2017. According to the author, '…the Appeal Court also expressly reiterated the stated general approach to the interpretation of double tax treaties by recognising the existence of an international tax language. The case is also clear authority for reliance on the OECD Model Tax Convention and its commentaries and international precedent as useful aids to interpret the meaning of provisions contained in double tax treaties'. ibid.

[685] ibid.

regard to the years 1966-1968 as income derived from the disposal of shares. The taxpayer appealed to the Special Court against such levy on the grounds the amounts received were of a capital nature and that, according to the tax treaty between South Africa and Switzerland, the amounts resulting from the sale of shares were to be taxed in Switzerland only. Even though the Court found that the proceeds from the sales were to be deemed as income (not receipts of a capital nature), it decided the taxpayer was exempt from income tax in South Africa in accordance with the treaty's provisions. The tax administration appealed against this decision to the Supreme Court of Appeal on the grounds that the stockbroker was not acting in the ordinary course of his business, and that 'the facts indicated something more than the mere employment of a broker, acting in the ordinary course of his business'.[686] The focus point of the judgement revolved around the existence of a PE in South Africa from which the taxpayer carried out his business in the country.

Decision: The court held in favour of the taxpayer. It went through an analysis of Article 5 and Article 7 as provided by the convention with Switzerland, and accordingly considered the facts related to the case as put forward by the Special Court's ruling. In order to assess the taxpayer's liability, the decision paid attention to the treaty rule's requirements that the taxpayer had to carry on business in South Africa and, cumulatively, that such business had to be carried on through a PE. Since the question as to whether the taxpayer did or did not carry on business in the country was not part of the court's analysis, the decision then focused on the PE concept. The court found that the decision under appeal had correctly interpreted the treaty provisions (Article 5(4) and (5)).[687] Considering that the duties performed by the stockbroker were within his ordinary functions,[688] it held that the taxpayer did not conduct business through a

[686] ibid.

[687] Article 5 (4) of the treaty South Africa signed with Switzerland (1967 – terminated) deals with the agency PE, while Paragraph (5) refers to the independent agent PE. Both provisions are patterned after the 1963 Draft Convention.

[688] The court noted the following passage of the Special Court's judgment: 'The evidence established that Mr. Smith received no remuneration over and above the normal brokerage payable to a broking member of the Stock Exchange; that it was in the ordinary course of such a broker's business to manage portfolios for clients; that it was part of his duty as a broker, in the course of management of the portfolio, to buy or sell shares on behalf of his client'. Secretary for Inland Revenue v Downing, Supreme Court of Appeal (n 680).

PE in South Africa since the stockbroker acted as an independent agent within the meaning of Article 5 (5) of the convention with Switzerland.

4.7 – Findings from the compared countries' case law

The decisions on Article 5 and Article 7 referred to above show some similarities with regard to the interpretation of the tax treaty networks of the compared countries. The clearest one refers to the issues presented by the domestic regulation regarding the attribution of profits to the PEs; the Brazilian regulations on turning income from the rendering of services without transfer of technology into income to be dealt with by Article 21, thereby subject to taxation in the host country, is a good example. The Brazilian case law analysed in this chapter, to a great extent, reflects the absence of a set of rules that deals comprehensively with the attribution of profits to PEs in domestic law. In fact, as put forward in Subsection 3.2.1 and Subsection 4.2.1, the country has chosen to relegate the regulation of the PE threshold and the attribution of profits to PEs to a secondary position in comparison with the regulation of taxation of fees for technical services.

Through the imposition of a WHT on such fees, and via the tax policy as analysed in Subsection 4.4, Brazil broadened its tax base in a way that circumvented the PE issue; here, therefore, resides the flaw of the tax policy as adopted by the country. The level of red tape for the setting of a branch in Brazil, coupled with the absence of a clear regulation on the presence of PEs in the country, does not offer a viable alternative to foreign enterprises to do business in the country through a PE.[689] As a result, the foreign investor chooses to set up a subsidiary and enters into technical services agreements with its parent company. Thus, the reaction of the Brazilian tax authority in challenging such arrangements as adopted by the taxpayer, namely the imposition of WHT, undermines the PE concept since the presence of the enterprise in the country and the source of services provided to the subsidiaries are irrelevant. Therefore, case law analysis shows that the policy adopted by Brazil brings more uncertainty to investors since they do not count on clear domestic regulations on the PE concept and on the

[689] See Subsection 3.2.1.

attribution of profits to them. The treaty interpretations as carried out by the courts in some occasions (for example, the scenario in the PCI case - Subsection 4.6.1 (ii)), do not seem to offer a better scenario since they undermine the treaty policy as adopted by the country on the issue (relevant alignment with the OECD MC; virtually no service PE provision).[690]

The Indian case law provides for a rather different scenario. As shown by the analysis of the country's domestic legislation and by the treaty analysis in Subsection 4.3.2, India adopts a policy on the force of attraction rule that, to a great extent, broadens its tax base. In this sense, the case law dealing with the services rendered by foreign enterprises to Indian clients (although not performed in India) illustrates the problems of the interpretation of the domestic law and tax treaties on the matter; this was the scenario of the Linklaters and Clifford Chance cases.[691] In addition to the lack of predictability posed by the conflicting opinions as adopted by the court in those decisions, the stance of the Indian tax authorities on profits being 'directly or indirectly' attributable to the PE (as in the country's domestic legislation)[692] in fact extends the income tax incidence over services performed outside India; therefore, the inclusion of service fees in the PEs profits also circumvented the PE threshold, which gives legal uncertainty to the case.

As it happened with the Brazilian approach to taxation of services, given the need to protect its tax base, the Indian domestic tax policy, and the country's tax authorities' interpretation on the treaty network and domestic regulation, greatly deviate from the international tax regime and international tax practice. It can even be said that, to some extent, such policies in fact deviate from their tax treaty policy, demonstrating how ill designed those regulations are. This raises a considerable question regarding the need for a domestic set of rules on the allocation of profits to PEs more beneficial to developing countries and, at the same time, more coherent with those countries' tax policy as adopted at the treaty level.

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[690] See Subsection 3.4.1.

[691] Subsection 4.6.2 (v) and (vi).

[692] See Subsection 4.2.2.

It is also worth referring to the application of the TP rules in the case of attribution of profits to PEs in India. The Morgan Stanley, Convergys, and Centrica cases[693] illustrate the challenges posed by the complexity and by the contractual and factual analysis on the application of the arm's length principle in the PE arena as well as the level of discretion exerted by the tax authorities when assessing the amount of profits to be allocated to the PEs.

Finally, South Africa's case law presents particular features that deserve to be highlighted. The deficient regulation on the PE threshold as put forward by the country's domestic law[694] is reflected in the straightforward adoption of the PE concept as provided by the OECD MC (Oceanic Trust case). Furthermore, the South African judiciary in the AB LLC case resorting to the US Technical Explanation, a document produced unilaterally by one of the parties of the treaty in question, to some extent undermines the court's interpretation on the taxation of PEs. Again, the lack of a thorough approach by the country's domestic law on the PE threshold seems to affect the interpretation of the country's courts on the matter.

4.8 - Conclusion

This chapter has detailed the compared countries' approach on the taxation of permanent establishments with regards to alignment, or lack thereof, of the paragraphs of Article 7 with the OECD MC. It has done so by analysing their domestic law and the wording of those countries' treaty provisions that depart from the OECD MC through the adoption of the UN MC pattern. The results of the comparison show that the compared jurisdictions' domestic laws adopt different approaches to the attribution of profits to PEs. It seems appropriate to conclude that Brazil's and South Africa's regulations do not offer a thorough approach on the matter, with Brazil adopting a few rules on agency PE and the South African legislation providing for the application of TP regulation in a rather brief way. Both countries do not adopt an AOA approach. On the other hand, the Indian regulation provides for the attribution of profits through the application of TP rules, therefore placing emphasis on the functions performed, asset

[693] Subsection 4.6.2 (i), (iii), and (iv).

[694] See Subsection 3.2.3.

uses, and risks assumed. This, however, does not mean that the country fully transplanted the AOA into its domestic legislation.

With regard to their tax treaty networks, all three countries mostly follow the OECD MC framework, which, to a certain extent, deviates from the pattern observed in Chapter 3. Again, one cannot affirm that there is coordination between the compared countries on Article 7. Nevertheless, it is noteworthy that, at the treaty level at least, Brazil, India, and South Africa do not adopt an approach that remarkably differs from each other. The only exception to this conclusion seems to be the adoption by India of the limited force of attraction in treaties where its counterpart is an OECD member country. One can even favour this argument when one considers the treaty counterpart and the origin of foreign direct investment into India's economy. All the same, when the comparison considers only the total number of treaties that adopt a force of attraction rule, one cannot conclude for a noticeable UN MC influence on the matter.

In addition to the treaty comparison, this chapter has also analysed the challenges presented before the courts that involved the application of Article 5 and Article 7. As put forward in Chapter 1 of this thesis, the intention of such an analysis is to highlight the important problems observed in relation to the taxation of business profits, as framed in the treaty networks, in the compared countries. The case law analysis has shown a series of tax issues arising from the interpretation of treaty provisions in India, notably Article 7 (1). The application of the force of attraction provision as provided by some of the country's conventions proved to be controversial in many instances, with the Indian courts even changing their approach when analysing similar appeals in a relatively short period of time. It was also observed that deviations from both the UN MC and the OECD MC on Article 7 proved to be problematic. This is the case, for example, of provisions extending the taxing rights of the host country with regard to profits directly or indirectly attributable to the PEs. Decisions such as this, coupled with other case law on the discretionary apportionment of profits to the PE, bring uncertainty to the interpretation of treaty provisions and, in the end, to the application of the separate entity principle and the arm's length standard required for the allocation of profits through Article 7. It is rather interesting though that Brazil's case law on Article 7 does not stem from any mismatch between the country and one, or even both, of the model conventions. The controversies noted mostly related to domestic regulation that

turned service fees into other income, as regulated by Article 21, thus also subject to taxation in Brazil. Among all the three countries, South Africa does not offer a case law set as controversial as the previous examples. All the same, the outcomes of its case law draws attention to the need for a very well-designed treaty network in order to avoid interpretative misunderstandings by the domestic courts.

The results of the examination carried out above show that the alignment (or the lack of) with international tax practice is not itself the key issue when it comes to the attribution of profits to PEs. For example, the Indian domestic legislation, to some extent, clearly adopts the TP regulation when taxing the business profits of PEs; however, due to the tax authority's interpretation of such rules in some cases, such a policy does not offer a great level of legal certainty to the taxpayer. The same goes for the interpretation of the domestic legislation and the treaty provisions on the force of attraction rule: there seems to be a clear mismatch between the intended broadening of the country's tax base via the treaty policy as adopted by India and its domestic law; such a result renders the tax policy on the issue inefficient. Finally, a similar conclusion can be drawn from the ill-designed tax policy adopted by Brazil. Even though the country adopts a policy that mirrors the OECD MC on Article 7, its approach circumvents the PE threshold. In so doing, Brazil does not offer a coherent legal system under which foreign enterprises can do business.

The thesis now moves on to the transfer pricing article analysis as adopted by the compared countries' tax treaty networks. A similar comparative structure is adopted as in Chapter 5.

CHAPTER 5

Taxation of Associated Enterprises – Article 9

5.1 Introduction

This Chapter analyses to what extent Brazil, India, and South Africa follow the OECD framework on the taxation of associated enterprises. Its main purpose is to examine the tax treaty networks on Article 9 and the domestic regulations of the compared countries on the matter. In doing so, this chapter focuses on the taxation of associated enterprises through the application of the OECD's arm's length standard as indicated, mainly, by the OECD Transfer Pricing Guidelines. Together with the findings of the previous chapters on the treaty policy of the compared countries on the PE concept and on the allocation of profits to PEs, the analysis of the countries' treaty policy on taxation of associated enterprises will complete the picture of the taxation of business profits within the scope of the thesis. Consequently, the question of whether a treaty policy deviates, and to what extent it can do so, from the OECD MC could then be addressed in the next chapter. In addition, the proposal for a transfer pricing framework that could be more beneficial to developing countries will also draw from the analysis carried out in the current Chapter; this time, the domestic regulation is central as the focus of the comparative analysis.

This Chapter is divided into six sections. First, it focuses on how Article 9 has evolved in the context of both the OECD MC and UN MC. Then, it examines the inclusion of the transfer pricing provisions into the countries' tax treaty networks, stressing the influence received from international tax practice. A comparative table highlighting the mismatches between the treaty networks and Article 9's wording is provided. The treaties' counterparties and the FDI origin jurisdictions are equally considered. Then, the chapter scrutinises the legal transplant of provisions dealing with transfer pricing into the countries' domestic legislation, highlighting the functional equivalence of each set of rules in comparison with both the UN's and OECD's approaches. In doing so, this Chapter pays a more detailed attention to the domestic regulation than the previous

ones. This is because domestic regulation on transfer pricing, coupled with the treaty provisions on taxation of business profits, orientates the allocation of profits to both associated enterprises and permanent establishments. It then moves to the analysis of key challenges presented before the courts of Brazil, India, and South Africa that involve the application of Article 9 and the domestic legal provisions on the issue. Such set of case law will offer the thesis a way of understanding some of the main problems faced by MNEs when investing in the compared countries. Such case law examination will work as a proxy for the problems of transfer pricing regulation, with its different features, as adopted by the compared countries. The final section of this Chapter concludes the analysis on Brazil's, India's, and South Africa's approach on the transfer pricing issue.

5.2 First step: Evolution of Article 9 in the OECD and UN models

In order to accurately compare the evolution of the transfer pricing provisions contained in the compared countries' tax treaties, this chapter first puts forward the evolution of the OECD and UN models on the matter. Then, bearing in mind the evolution of the compared treaty networks, it pays special attention to Article 9, mainly from the appearance of the first OECD Model onwards (1963 OECD Draft MC).

Nevertheless, it is relevant to briefly highlight the evolution of provisions dealing with taxation of associated enterprises since the appearance of the first League of Nations draft model convention. The allocation of business income between associated enterprises was not addressed by a specific provision in the 1927 Draft MC since subsidiaries were considered as branches of the parent company.[695] After the emergence of the separate entity approach in the 1928 LN Draft MC, the 1933 Carroll Report put forward new underlying principles for the taxation of associated enterprises — that is to say, the separate accounting method and the arm's length principle.[696] Based on such an approach, Article 5 of the 1933 LN Draft MC was the first separate League of Nations MC provision to deal with taxation of associated enterprises. The

[695] Reimer and Rust (eds) (n 29), p. 606.

[696] ibid.

same wording is also found at Article VI of the 1935 LN Draft MC.[697] This provision's substance was later incorporated into the wording of the OECD model conventions. However, considering this chapter's focus on tax treaties in force, influences exerted by the League of Nations model conventions do not take a prominent role.

This section highlights the approaches adopted by both the OECD and the UN. Moreover, it is necessary to identify, from an historical perspective, how both organisations allocated business profits when it came to tax associated enterprise transactions. Equally, it is necessary to highlight when, and to what extent, the UN departs from the OECD's arm's length principle.

5.2.1 The OECD Model

5.2.1.1 The 1963 Draft Convention

The 1963 Draft Convention was the first model convention to have in its Article 9 the statement on the arm's length principle.[698] What subsequently became known as 9(1) was the provision dealing with taxation of transactions carried out by associated enterprises.[699] In the 1963 draft, the wording of Article 9 only provided for enterprises being considered as associated enterprises,[700] and for profit reassessments (primary adjustment) when that was the case,[701] in accordance with the arm's length principle.[702]

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[697] ibid, p. 607. Also, on the historical evolution of Article 9, see Eduardo Baistrocchi, 'Article 9 – Associated Enterprises' in IBFD, *Global Tax Treaty Commentaries* (IBFD 2017).

[698] See OECD Commentary on Article 9, 1 and OECD 2010 TP Guidelines, B.1, 1.6.

[699] It is worth noting that, according to the 1963 Draft Commentaries, Article 9 seemed 'to call for very little comment' apart from the need of the accounts rewriting process when appropriate. *OECD 1963 Draft, Annex II – Commentaries on the articles of the draft convention, Commentary on Article 9 on the taxation of associated enterprises.*

[700] The conditions were included in Article 9's letters *a* and *b* – that is to say, the control of the subsidiary by the parent company, or the same persons participating in the management, control, or capital of both subsidiary and parent company.

[701] On the problems posed by a possible imposition of a higher tax burden through enforcement of Article 9(1) in comparison with the one imposed by the domestic legislation, see Baker, *Double Taxation Conventions* (n 10), 9B.05, 9-2/1.

[702] The wording of the second part of the article provides for the scenario to be considered as triggering the profit adjustment between the associated enterprises. Subsequent models have the same wording at 9(1).

Therefore, the 1963 OECD Draft MC had no provision dealing with the appropriate adjustment of the taxes due in one of the contracting states (corresponding adjustment) when it was the case of the adjustment of profits in the other state.

5.2.1.2 The 1977 Model Convention

It took more than a decade for the OECD to change the wording of Article 9. Bearing in mind the risk of economic double taxation in case of the rewriting of the transactions' profits in one of the contracting states (Article 9(1)),[703] the 1977 MC provided for an appropriate corresponding adjustment in the other state through the insertion of paragraph 2 in Article 9. In doing so, the new Article 9(2) allowed the contracting states to make profit adjustments and to tackle the double-taxation problem.[704] Such is the present wording of the OECD's Article 9 since further versions of the OECD MC kept the same approach.

5.2.2 The UN Model

5.2.2.1 The 1980 Model Convention

As for the UN, in the late half of the 1960s it became involved in discussions on the desirability of a model that could provide an alternative for developing countries. Back then the driving concern behind the discussions carried out by several UN bodies was the need for a model convention that could serve as an instrument for the increase of foreign direct investment (FDI) inflow into such jurisdictions.[705] It was against this backdrop that the UN issued its first model convention in 1980.[706] Even though primarily focusing on the needs of developing countries, the 1980 UN MC's approach

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[703] Commentary on Article 9 of the 1977 OECD MC, paragraph 2. The Commentary goes even further. Although Article 9(2) does not provide for a secondary adjustment, the Commentary makes it clear it would be possible in accordance with domestic legislation. ibid, paragraphs 5 and 6.

[704] On the discussions for the inclusion of 9(2) into the OECD MC, see Veronika Solilová and Marlies Steindl, 'Tax Treaty Policy on Article 9 of the OECD Model Scrutinized' (2013) 67 Bull Intl Taxation 128.

[705] Mainly during the meetings of the UN Group of Experts on Tax Treaties between Developed and Developing Countries. See the *UN 1980 MC* (n 17), Commentaries, Introduction and *Part Two*.

[706] ibid, Introduction.

did not depart from the 1977 OECD MC when it came to the taxation of associated enterprises. Actually, even though the UN approach was based on the 1943 LN Mexico Model, which gave more attention to source taxation, the UN 9(1) did not deviate from the arm's length principle, as set out in Article VII of the Protocol attached to the model. This provision, while mirroring Article 5 of the LN 1933 Draft MC, has the same wording as Article VII of the Protocol attached to the 1946 LN London Model, which was the basis for the 1963 OECD Draft MC.[707]

As a result, the UN adopted the OECD's provision as recommended for bilateral tax treaties and the OECD's commentaries as the appropriate approach on transfer pricing and the arm's length principle.[708] Accordingly, the 1980 UN MC reproduced the exact wording of the 1977 OECD MC's Article 9.

5.2.2.2 The 2001 Model Convention

The clearest deviation from the OECD MC happened with the issue of the 2001 UN MC. Its 9(1) and 9(2) in general match the equivalent 1977 OECD MC's provisions, with slight changes in the wording of paragraph 1.[709] Apart from that, the 2001 UN MC included a paragraph 3 in Article 9.[710] That paragraph sets aside the application of Para 2 if legal proceeding 'resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default'.[711]

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[707] Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Wolters Kluwer Law & Business 2010), p. 95.

[708] *UN 1980 MC* (n 17), Commentaries on Article 9. Also UN, *UN 1979 Manual for the Negotiations of Bilateral Tax Treaties between Developed and Developing Countries* (UN 1979), Observations to Guideline 9.

[709] Following a previous draft amendment made by the Group of Experts in 1999, the UN 2001 MC rearranged the wording of paragraph 1. Such a change aimed at bringing the UN Model wording in line with the language of the OECD MC, and did not imply any departure from the latter. See *2001 UN MC* (n 46), Commentaries on Articles 9 and 5, p. 139.

[710] It should be noted that 9(3), or a similar provision, had already appeared in tax treaties concluded before 2001. See Wijnen and de Goede (n 16), p. 129. Surprisingly enough, it also highlights that, out of the total number of tax treaties concluded between 1997 and 2013 that contain UN's 9(3), 20% of the treaties signed between OECD countries have such provision. ibid.

[711] See *2001 UN MC* (n 46), Commentaries on Article 9(3), 9, p. 144.

The 2011 UN MC did not bring any further change to the wording of the 2001 UN MC's Article 9. Equally, its commentaries reflect the same approach as those of previous versions of the UN model convention. Nevertheless, it is worth noting that the 2013 UN Practical Manual on Transfer Pricing for Developing Countries (2013 UN TP Manual), while matching the OECD's stance on the arm's length principle as the broadly accepted standard to be followed,[712] presents a diverse perspective provided by some emerging countries on the matter. In such regard, its Chapter 10 sheds light on the TP frameworks adopted by Brazil, China, India and South Africa with particular reference to a few deviations from the broadly accepted content of the arm's length principle.

5.2.3 Appearance of Article 9's paragraphs

Having considered all the above, Table I provides the evolution and wording of the respective provisions on taxation of associated enterprises. As for the OECD and UN model conventions, it identifies each addition to Article 9 accordingly. It does not show Article VI of the 1935 LN Draft MC since it matches Article 5 of the 1933 LN Draft MC.

Table 5.1: Evolution of Article 9

<table>
<tr><td rowspan="7">M
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D
E
L</td><td colspan="2">P R O V I S I O N S</td></tr>
<tr><td colspan="2">Article 5</td></tr>
<tr><td>League of Nations 1933</td><td>When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.</td></tr>
<tr><td colspan="2">Article 9</td></tr>
<tr><td colspan="2">9(1)</td></tr>
<tr><td></td><td>1. Where:
(a) an enterprise of a Contracting State participates directly or indirectly in the</td></tr>
</table>

[712] The UN TP Manual refers to the OECD Commentaries and TP Guidelines as being in line with the UN MC position on the issue. UN, *Practical Manual on Transfer Pricing for Developing Countries* (UN 2017), especially at 1.3.9, p. 9 and at 1.4.2 11.

CONVENTIONS		
	OECD 1963	management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
	9(2)	
	OECD 1977	2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.
	9(3)	
	UN 2001	The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

5.3. Second step: Evolution of Article 9 in the countries' tax treaty networks

5.3.1 Appearance of the arm's length principle in the tax-treaty networks

The income tax treaty Brazil entered into with Sweden in 1965 marked the first appearance of the OECD's arm's length principle in the country's treaty network. Accordingly, its wording mirrored that of the 1963 OECD Draft MC. In the absence of any domestic legislation on transfer pricing at the time, one can say that Article 9 of the treaty with Sweden (1965) was the first reference to the arm's length principle with respect to Brazil. It is worth mentioning, however, that the treaty with Sweden (1965)

has never entered into force.[713] For this reason, the treaty with Japan (1967) is to be considered as the first one that introduced the arm's length principle[714] into Brazil's legal system.[715] All the same, the meaning of the arm's length principle was not clarified and its regulation was not put in place since the legislation on transfer pricing appeared only thirty-one years later. This scenario could have been different had the Brazilian courts issued judicial decisions that clarified the specific meaning of the arm's length principle.[716] However, such case law was produced only after the domestic legislation was enacted; therefore it did not contribute to the determination of the content of the arm's length principle before the latter half of the 1990s.[717]

As for India,[718] its income tax treaty with Sweden (1958)[719] dealt with the taxation of associated enterprises for the first time. In 1959, India signed three more tax treaties, all of which had a similar provision as the one in the treaty with Sweden.[720] Nevertheless, it is worth mentioning that in the case of inclusion of profits in one of the enterprises, the 1950 treaties provided for an adjustment in the income of the other enterprise, therefore slightly deviating from the 1933 LN Draft MC.[721] This trend — i.e. the inclusion of a corresponding adjustment sentence in the provision stating the arm's length principle — is not observed from the 1960s onwards.

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[713] See Sergio André Rocha, 'Brazil's Treaty Policy' (n 162).

[714] Article 6 of the treaty Brazil signed with Japan (1967) provides for the taxation of associated enterprises.

[715] On the relationship between tax treaties and the Brazilian legal system, see Alberto Xavier, *Direito Tributário Internacional do Brasil*. 6th ed. (Rio de Janeiro: Forense 2007), p. 255.

[716] On the importance of case law in providing the content of the ALP, see Eduardo Baistrocchi, 'The Transfer Pricing Problem: A Global Proposal for Simplification' (2006) (59) 4 Tax Lawyer 941.

[717] For a thorough account on the transfer pricing case law in Brazil until 2011, see I. Calich and JD Rolim, *Transfer pricing disputes in Brazil* in Braistrocchi and Roxan (eds) (n 49), p. 519–554.

[718] The treaties India signed with Pakistan (1947) and Sri Lanka (1956) did not contain Article 9's provision.

[719] Instead referring to associated enterprises, Article 4 of the treaty with Sweden refers to 'close connection' between the enterprises.

[720] Article 4 of treaties with Denmark, Germany, and Norway (1959).

[721] This is the case, for example, of the second sentence included into Article 4 of the treaty with Sweden (1958): 'In consequence the necessary rectifications should be made concerning the income of the other enterprise.'

The treaty with Austria, which India entered into in 1963, was the first one to be signed by the country after the appearance of the 1963 OECD Draft MC. This treaty followed the MC's wording, providing for the arm's length principle. The same pattern was followed regarding the treaties with Greece (1965), France (1969), and Egypt (1969).

Finally, South Africa first included an arm's length principle provision in the treaty signed with the United States in 1946. This treaty has a taxation of associated enterprises at its Article VII. In the next decades, South Africa entered into a series of tax treaties that also contained such provision not in Article 9 but in a different one. That is the case of Article 4 of the treaties with Zambia (1956), Grenada (1960), and Zimbabwe (1965).

5.3.2 Influence of the OECD and the UN models over time

Considering the above, the primary way of measuring the influence exerted by different models on the compared countries' treaty networks should focus on the inclusion or not of the provision contained in paragraph 3 of Article 9 (or respective articles). In other words, the starting point as a deviation from the OECD MC is the non-application of paragraph 2 in cases where one of the enterprises 'is liable to penalty with respect to fraud, gross negligence or wilful default' linked to the profit allocation between the associated enterprises. In addition, other deviations could be observed when, even after the appearance of paragraph 2 in the OECD MC, the compared countries decided not to include such provision into the treaties signed after 1977. Even in such a case, and supposing the country mostly follows the OECD's pattern, one should be careful in considering a country as deviating from the OECD MC influence.

Having said that, the analysis of Brazil's treaty network leads to the conclusion that it is fully influenced by neither the OECD nor the UN model conventions. Brazil has consistently entered into tax treaties that do not contain paragraph 2 in Article 9. The country has entered into thirty-three income tax conventions to date that are still in force since it signed its first tax treaty with Sweden in 1965. Moreover, Brazil signed twenty-six income tax treaties since the appearance of the corresponding adjustment provision in the 1977 OECD MC version. All of them contain an article that mirrors paragraph 1; absent, however, is any kind of provision dealing with profit adjustments in paragraph

2 fashion. Also, it is worth mentioning that Brazil has already officially put forward its disagreement[722] about the inclusion of the 9(2) provision in its tax treaties through its position in the OECD commentaries on Article 9.[723] As a consequence, and bearing in mind that both the OECD and the UN adopt the same corresponding adjustment provision in paragraph 2, one can conclude that Brazil's approach diverges from both model conventions from 1977 onwards. Such a position is perfectly understandable when one analyses the country's treaty network combined with its domestic legislation on transfer pricing, which is addressed below.

As for India, it has developed a treaty network that greatly differs from the Brazilian one regarding this issue. Amongst India's ninety-seven income tax treaties in force, thirty conventions have a sole provision dealing with the arm's length principle; therefore, they do not include any corresponding adjustment provision into their Article 9, or into an equivalent article. Of those thirty, only the treaties with Greece (1965) and Egypt (1969) were signed before 1977. The vast majority of India's treaties signed from 1977 onwards followed the OECD, containing therefore a corresponding adjustment provision. As a deviation from this pattern, India signed just four tax treaties with provisions mirroring the UN's paragraph 3 of Article 9. They are the income tax treaties signed with Canada (1996), Mexico (2007), Uruguay (2011), and Kenya (2016).[724]

Table 5.2: OECD and UN influence on the treaty networks (treaties in force)

	9(1)	9(2)	9(3)
Brazil	33	----	----
India	30	63	4
South Africa	9	65	5

[722] On the role played by non-members' positions included in the OECD Commentaries, see Alberto Vega and Ilja Rudyk, 'Explaining Reservations to the OECD Model Tax Convention: An Empirical Approach' (2011) 4 InDret Law Journal 1.

[723] *OECD Commentaries, Positions of Non-Member Countries, Position on Article 9, para 1*: *'Brazil, Russia, Thailand and Vietnam reserve the right not to insert paragraph 2 in their conventions'*. On the role played by the non-OECD members, see *OECD Commentaries, Non-OECD Economies' Positions on the OECD Model Tax Convention*, paragraph 2.

[724] The treaty with Uruguay reflects exactly the wording of the UN's Article 9(3). The treaties with Canada (9(4)) and Mexico (9(3)) have shorter versions, reading as follows: '*The provisions of paragraph 2 shall not apply in the case of fraud, gross negligence, or wilful default'*.

Finally, analysis of South Africa's treaty network shows a similar picture to India's approach. From 1977 onwards, South Africa's treaties have consistently followed the OECD MC by having at Article 9 a corresponding adjustment provision. Exceptions to this pattern are the treaties with Botswana (1977), Israel (1978), and Brazil (2003).[725] From the total of seventy-nine income tax treaties in force, only nine tax treaties contain a sole provision dealing with the arm's length principle. On the other hand, only five of them contain a provision reflecting the UN's 9(3).

5.3.3 Specific features in Article 9

In addition to the analysis carried out in the previous section, it should be noted that a few of India's and South Africa's treaties contain provisions in Article 9 that are not found in the OECD and UN models. That is the case, for example, for treaties that provide a statute of limitations provision regarding the enforcement of the arm's length principle and respective profits reassessment. Such provision is found in the treaty India entered into with Canada (1996).[726] In the treaty with Qatar (1999), such provision relates only to the profits adjustment under Article 9(2). As for South Africa, the statute of limitations provisions are found in the treaties signed with Canada (1995), Egypt (1997), Seychelles (1998), and Switzerland (2007).[727]

Provisions for the observance of the domestic law in cases where the tax authority needs to determine the profits to be taxed should also be highlighted. The treaty India signed with Australia (1991) states at 9(2) that nothing in Article 9 'shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a

[725] Article 9 of the treaty South Africa signed with Italy (1995) does not include a Paragraph (2) in the OECD MC fashion. However, Section 3 of the Protocol to the treaty provides for such a provision in a wording similar to Paragraph (2). The treaty with Italy (1995) is therefore considered as influenced by the OECD MC on the matter.

[726] Article 9(3) of the Canada treaty reads as follows: 'A Contracting State shall not change the income of an enterprise in the circumstances referred to in paragraph 1 after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the year in which the income which would be subject to such change would, but for the conditions referred to in paragraph 1, have accrued to that enterprise.'

[727] The treaties with Canada, Egypt and Seychelles include such a provision at 9(3). They also have a 9(4) following the UN 9(3). In addition, their 9(4) extends the UN's 'non application' pattern in case of 'fraud, wilful default or neglect' to the statute of limitations clause as well. In the treaty with Switzerland, only the statute of limitations provision should not be enforced 'in the case of fraud or wilful default' since this treaty does not follow the UN 9(3).

person'. The treaty South Africa entered into with Australia (1999) has also the same provision. Finally, a similar provision is found in the treaties India signed with Egypt[728] and Cyprus,[729] although in such conventions the tax administration is allowed to determine the tax liability 'by the exercise of a discretion or the making of an estimate by the competent authority of that State'.[730]

5.3.4 – Findings from the treaty policy comparative analysis

5.3.4.1 – The UN MC influence throughout Article 9

The analysis of the tax treaty networks of Brazil, India, and South Africa carried out in this thesis has shown these countries do not adopt a coordinated approach in various provisions dealing with taxation of business profits.[731] The same conclusion cannot be reached, however, with regard to the inclusion of Paragraph (3) in Article 9 of the compared countries' tax treaty networks; the presence of such provision as shown above is virtually irrelevant with respect to India, and not important concerning South Africa's conventions. Interesting though, due to its relevance, the level of influence of the OECD MC is the one that most draws attention. Roughly one-third of the treaties India has entered into, and are still in force, adopt a sole Paragraph (1), without providing for a secondary adjustment provision. The results for South Africa also are worth noting since more that 10% of its treaties adopt a similar pattern. In this respect, one could put forward an argument considering that many treaties these countries have entered into that do not have Paragraph (2) were signed before the 1977 OECD MC edition. Nevertheless, they could have been amended via a protocol, or other convention could have been signed to reflect the OECD MC's policy.

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[728] Article 10(2).

[729] Article 9(2).

[730] Both treaties provide for this discretion to be exercised consistently with the ALP. Article 10(2) of the treaty with Egypt additionally allows the revision of the tax liability in case the tax authority is further furnished with adequate information on the matter.

[731] See Subsections and 3.3.1 and 4.4.1

5.3.4.2 – Pattern adopted considering the FDI origin

As shown above, Brazil does not adopt an OECD MC pattern on Article 9 (2), therefore the comparison regarding the most important FDI origin jurisdictions is immaterial.

As for India and South Africa, the analysis of their tax treaty networks shows a different result. India is the jurisdiction that deviates the most from the OECD MC in respect to the top 20 counterparty economies. Eight tax conventions India[732] has signed with those countries that are still in force do not include a secondary adjustment provision in Article 9.[733] Rather interesting, the treaty with Mauritius (1982), the jurisdiction that occupies the 1st position among the most important FDI origin ones, does not provide for a secondary adjustment. The same happens with other important treaty counterparties, as is the case with the conventions signed with Germany (1995 – 6th position), Sweden (1997 – 13th position), and Spain (1993 – 15th position).[734] South Africa adopts the same pattern only with the treaty it signed with Germany (1973), which occupies the 4th position as of 2015[735] among the 20 most relevant FDI origin jurisdictions. [736]

5.4. Third step: Setting up the domestic TP framework

When enacting rules dealing with transfer pricing, all the three compared countries followed a similar pattern. First, as seen above, the arm's length principle was introduced into their legal systems through their tax treaty networks. Then, reacting to

[732] See, on the FDI flow into India's economy in 2015, the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: India, Inward Direct Investment Positions (Top 20 Counterpart Economies) (n 414).

[733] It is important to highlight that Hong Kong, a jurisdiction India does not have a tax treaty with, occupies the 18th position as of 2015 in the list of the most important FDI origin jurisdictions. ibid.

[734] The other jurisdictions are France (1992 – 11th position as of 2015), United Arab Emirates (1992 – 14th position as of 2015), Italy (1993 – 17th position as of 2015), and Belgium (1993 – 19th position as of 2015). ibid.

[735] See, on the FDI flow into South Africa's economy in 2015, the IMF's *Coordinated Direct Investment Survey (CDIS)*, Reporting Economy: South Africa, Inward Direct Investment Positions (Top 20 Counterpart Economies) (n 419).

[736] Bermuda, a country South Africa does not have a tax treaty with, occupies the 15th position as of 2015 among the most important FDI origin jurisdictions.

a specific international scenario regarding FDI inflow into their economies, they enacted domestic legislation, bearing in mind the experience of other countries and, mainly, inspired by the OECD approach on the issue. The subsections below demonstrate the similarities and differences between the countries' regulation on transfer pricing and taxation of associated enterprises. Moreover, they highlight to what extent such rules were influenced by the OECD and UN models and to what extent they fit the enforcement of the arm's length principle when protecting their taxing rights.

5.4.1 Brazil: Pre-fixed profit margins vs the arm's length principle

Before the 1990s, Brazil did not have a comprehensive set of transfer pricing rules dealing with the allocation of profits of international transactions based on the arm's length principle. The necessity of such regulation became evident when the economy began to experience an increase in foreign investment inflow during the 1990s. The numbers grew significantly from 1994 onwards, with slight decreases that reflected worldwide economic crises but did not jeopardise the continuity of capital inflow as a whole. In 1990, the FDI inflow into the Brazilian economy was approximately US$989 million dollars, reaching a US$2,150 million-dollar figure in 1994. Two years later, the FDI inflow into the country's economy more than quadrupled to US$10,792 million. In the late 1990s, it soared until reaching an impressive US$32,779 million in 2000. The government's concern was focused then on adequate profit allocation and prevention of tax evasion.[737] Therefore, there was no longer any reason to avoid regulation through provisions intended to prevent income shifting to other jurisdictions.[738]

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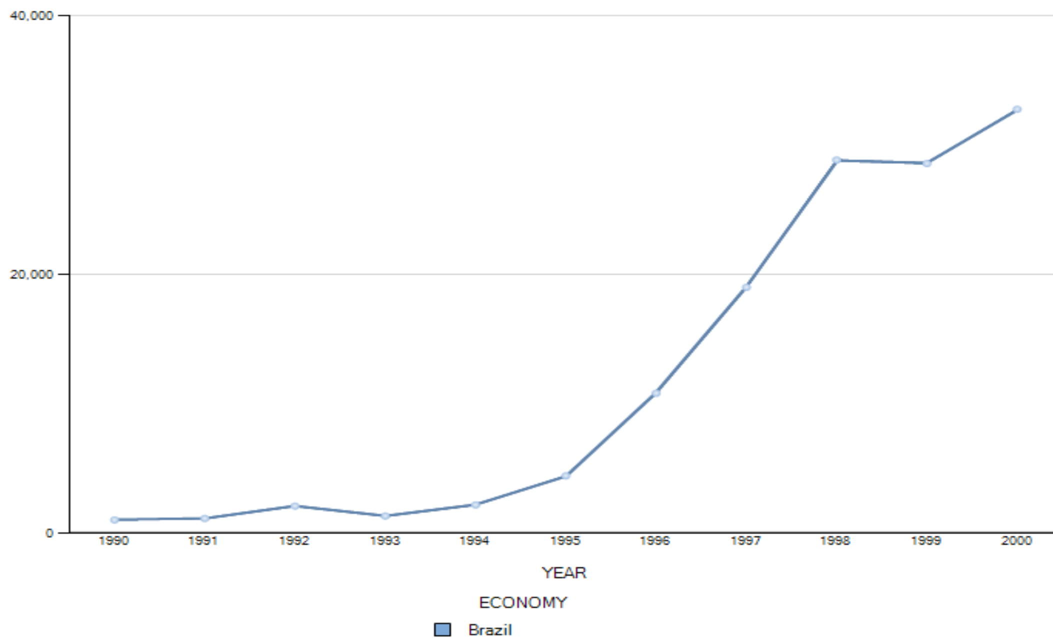
[737] Agostinho Toffoli Tavolaro, 'Tributos e Preços de Transferência' in Luis Eduardo Schoueri and Valdir de Oliveira Rocha (eds), *Tributos e Preços de Transferência – Vol 2* (Dialética 1999).

[738] Borkowski addresses developing countries' avoidance of TP controls: 'In the past, some developing countries avoided transfer pricing controls for fear of discouraging foreign investment, the existence of monopolies within the country, and a lack of administrative experience.' Susan C Borkowski, 'The Transfer Pricing Concerns of Developed and Developing Countries' (1997) 32 The International Journal of Accounting 321, 322. In the nineties the first two factors were no longer present in Brazil (the second is linked mainly to monopolies of state-owned companies).

Figure 5.1: FDI inflow into the Brazilian economy: 1990–2000



Source: United Nations Conference on Trade and Development (UNCTD): Foreign direct investment: Inward flows (US dollars in millions)[739]

Considering this scenario, Brazil enacted its TP regulation through Law 9,430 in 1996, with provisions dealing with international transactions involving tangible and intangible assets.[740] The Brazilian Congress enacted this statute based on a reasoning issued by the executive branch that supported the bill sent to the legislature. That document stressed the need to prevent profit allocation with regard to exports and imports as the reason for the statutory regulation on transfer pricing. Accordingly, the government intended to adopt the OECD standard on the issue.[741]Although in theory following the arm's length principle, Brazil has adopted a TP system based on pre-fixed profit margins asserted up-front in the transactions between associated enterprises.[742] In doing so, the Brazil TP regulation does not rely on later tests to verify whether the

[739] Available at <www.unctad.org> accessed 1 April 2016.

[740] For a thorough analysis of the transfer pricing regulation in general in the Brazilian legislation, see Luis Eduardo Schoueri, *Preços de Transferência no Direito Tributário Brasileiro* (Dialética 3ed 2013). See also Vivian de Freitas R de Oliveira, *Preço de Transferência como Norma de Ajuste do Imposto sobre a Renda* (Noeses 2015).

[741] Items 12 and 13 of the executive's reasoning.

[742] Article 23 of Law 9,430 defines associated parties.

taxpayer has appropriately assessed its taxable income;[743] therefore, it does not comply with the OECD standard at all.

At this point, it is also worth referring to the legislative debates in light of the passing of the bill that introduced the TP regulation into the country's domestic legislation.[744] One cannot find in such debates any reference to previous studies (e.g. fiscal impact assessment studies)[745] or other documents supporting the choice of particular profit margins to be observed with regard to specific economic sectors. Instead, the importance of an alleged alignment of the Brazilian legislation with the OECD approach was stressed once more.[746] The need for the increase in tax collection and the search for a fairer tax system[747] and the integration of Brazil's economy with the world's economy,[748] were again pointed out as reasons for the introduction of transfer pricing regulation in the country. Finally, the profit margins were to be considered indicative with regard to the profits to be allocated to the associated enterprises;[749] nevertheless, an explanation on how such parameters were set was absent from the legislative debates.

When dealing with the computation of profits to be taxed, the Brazilian system has as a starting point the traditional transaction methods put forward by the OECD TP

[743] This activity could provide elements to rewrite the taxpayer accounting if necessary. See OECD Commentaries, Article 9, paragraph 1, 2 and TP Guidelines, Chapter 1, B 1.7.

[744] Opinions to Bill n. 2.448-A of 1996, Lower House and the Senate of the Brazilian Congress. This document puts together all the written statements presented by the congressmen by occasion of the discussions on the regulation of income tax as proposed by the federal government's executive branch (TP regulation included). Available at <www. Camara.gov.br> accessed 5 September 2017.

[745] This thesis addresses the nature and importance of such studies with regard to the transfer pricing issue in Chapter 6.

[746] Opinions to Bill n. 2.9448-A (n. 58), Senator Mr. Edson Lobão, p. 79.

[747] Opinions to Bill n. 2.9448-A (n. 58), Deputy Mr. Roberto Brant, p. 5.

[748] Opinions to Bill n. 2.9448-A (n. 58), Deputy Mr. Roberto Brant, p. 2.

[749] Opinions to Bill n. 2.9448-A (n. 58), Senator Mr. Edson Lobão, p. 97. The same document highlights the need for the adoption of the transfer pricing regulation as a measure against profit-shifting practices. ibid, p. 96.

Guidelines.[750] With regard to imports, Article 18 of Law 9,430/96 sets out the Compared Uncontrolled Price Method, the Cost Plus Method, and the Resale Price Method, while Article 18-A[751] sets out the Imports with Price under Quotation Method;[752] the latter applies to transactions of commodities and resembles the Compared Uncontrolled Price Method.[753] It is relevant to highlight that such provisions sets out a series of pre-fixed profit margins to be observed regarding specific transactions between associated enterprises. That is the case, for example, with paragraph 12 of Article 18, which states that in the case of the Resale Price Method the profit margins should be considered, in general, as being 20%. The same article sets out a few exceptions, as is the case, for example, of the profit margins for the pharmaceutical chemicals and pharmaceuticals sector (40%) and for the metallurgy sector (30%).[754] As for the import of commodities, the country's domestic regulation stipulates that the price of the transaction shall be set as the average price of the daily medium quotes of goods and rights subject to public prices as established by eligible[755] stock exchanges.[756] The TP methods and respective economic sectors and statutory margins for imports (when applicable) can be summarised as follows:

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[750] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010* (OECD 2010), Chapter II, Part II.

[751] Paragraph 16 of Article 18 of Law 9,430/96 provides for the application of the Imports with Price under Quotation Method for transactions of commodities, while Article 18-A sets its framework.

[752] The Imports with Price under Quotation Method was introduced into the country's domestic legislation through Law 12,715/12. It is considered as being similar to the Six Method as put forward by Chapter II of the 2017 OECD TP Guidelines (see, particularly, Part II, Traditional transaction methods, B. Comparable uncontrolled price method, 2.18ff).

[753] On the Imports with Price under Quotation Method as adopted by the Brazilian domestic legislation, see Marcus Lívio Gomes and Débora Ottoni Uéde Mansur, 'The Brazilian 'Sixth Method' and BEPS Action 10: Transfer Pricing Control on Commodity Transactions' (2018) 25 (2) Intl Transfer Pricing Journal 1. Also, Marcos Aurélio Pereira Valadão, 'Transfer Pricing in Brazil and Actions 8, 9, 10 and 13 of the OECD Base Erosion and Profit Shifting Initiative' (2016) 70 Bull Intl Taxation 296.

[754] For a comprehensive explanation on the Brazilian TP regulation, see *Country Practices* of the *2013 UN TP Manual* (UN 2013), Chapter 10, p. 527–545 (n 19). Also, Ricardo André Galendi Júnior and Luís Eduardo Schoueri, 'Brazil' (2017) 102b CDFI, p. 191ff.

[755] Annex II of Normative Ruling n. 1,312/12 (amended by Normative Ruling 1,395/13) provides for a number of well-known stock exchanges that are to be considered for the pricing of the transactions with commodities. For instance, the London Metal Exchange (LME) and the Chicago Mercantile Exchange (CME) listed at items VIII and II of such annex, respectively.

[756] Article 18-A of Law 9,430/96 offers an alternative in cases where quotes of the imported goods and rights in such stock exchanges are absent. According to its Paragraph 4, the prices as established by independent data sources as provided by renowned research institutions are to be considered instead.

Table 5.3: Brazil's TP domestic legislation for imports

Statutory Method	Economic Sector	Statutory Margins/Prices
Comparable Uncontrolled Price Method	----	----
Resale Price less Profit Margin Method	Pharmaceutical chemicals and pharmaceuticals; tobacco; optical, photographic and cinematographic equipment and tools; dental, hospital, or medical machines, devices and equipment; extracting of oil and natural gas; and oil by-products.	40%
	Chemical; glass and glass products; pulp, paper and paper products; and metallurgy.	30%
	Other	20%
Cost-Plus Method	-----	20%
Imports with Price under Quotation Method	Commodities	Average price of the daily medium quotes or rights subject to public prices as established by eligible stock exchanges

As for exports, Law 9,430/96 lays down five methods to be observed by the taxpayer. According to Article 19, as a rule, the TP methods apply only to transactions by a Brazilian company where the export price is less than 90% of the average price of sales in the domestic market (by such company) of the same goods, services, or rights within the same taxable year and under similar payment conditions. The methods are the Comparable Uncontrolled Price Method, the Wholesale Price in the Country of Destination less Profit Margin Method, the Retail Price in the Country of Destination less Profit Margin Method, the Acquisition or Production Cost plus Taxes and Profit Margin Method, and the Exports with Price under Quotation Method.[757]

Three of them consider predetermined profit margins. The Wholesale Price in the Country of Destination less Profit Margin Method and the Retail Price in the Country of Destination less Profit Margin Method set fixed profit margins with regard to the transactions in the country of destination. On the other hand, the Acquisition or Production Cost plus Taxes and Profit Margin Method sets a fixed margin to be added

[757] Paragraph 9 of Article 19 of Law 9,430/96 provides for the application of the Exports with Price under Quotation Method for transactions of commodities, while Article 19-A sets its framework. The remaining four methods are established by Article 19.

to the costs of acquisition or production (plus taxes). As for the Exports with Price under Quotation Method,[758] it applies to export transactions of commodities and is not subject to the 90% of the sales price[759] in the domestic market threshold.[760] The TP methods and respective economic sectors and statutory margins for exports (when applicable) can be summarised as follows:

Table 5.4: Brazil's TP domestic legislation for exports

Statutory Method	Economic Sector	Statutory Margins/Prices
Comparable Uncontrolled Price Method	----	----
Wholesale Price in the Country of Destination less Profit Margin Method	----	Average sale price in the wholesale market of the country of destination, less local taxes and less a 15% fixed profit margin for the wholesale transaction
Retail Price in the Country of Destination less Profit Margin Method	----	Average sale price in the retail market of the country of destination, less local taxes and less a 30% fixed profit margin for the retail transaction
Acquisition or Production Cost plus Taxes and Profit Margin Method	----	15% profit margin to be added to the acquisition or production costs of goods, services or rights and to taxes in Brazil
Exports with Price under Quotation Method	Commodities	Average price of the daily medium quotes or rights subject to public prices as established by eligible stock exchanges

In addition to the methodologies indicated above, Law 9,430/96 also provides for TP rules regarding inbound and outbound loans between related parties. Such rules also adopt a fixed margins framework as patterned by the methods described above.[761] A spread rate, as established by the Minister of Finance, is added to the fixed margins as

[758] This method, as is the case of the method for import transactions of commodities, resembles the Compared Uncontrolled Price Method. See the *2013 UN TP Manual* (n 751), p. 541.

[759] Paragraph 4 of Article 19-A.

[760] Paragraph 5 of Article 19-A offers two alternatives in cases where quotes of the exported goods and rights in the stock exchanges are absent; the prices as established by independent data sources, as provided by renowned research institutions, or the prices as set by Brazilian regulatory agencies are to be considered instead.

[761] Paragraph 6 of Article 22 states the rates to be applied with regard to inbound and outbound loans.

stated by Article 22 (3.5% for inbound loans, and 2.5% for outbound ones).[762] The interest rates can be summarised as follows:

Table 5.5: TP rules for inbound and outbound loans

Transaction's currency	Interest rate to by applied
Loans in US Dollars with a prefixed rate	Market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in US Dollars
Loans in reais[763] with a prefixed rate	Market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in reais
Other cases	London Interbank Offered Rate (LIBOR) for 6-month deposits

It is also relevant to mention that the government is allowed to modify the profit margins as stated by Article 18 and Article 19.[764] In specific cases, following some prerequisites, the Brazilian Minister of Finance is authorised to redefine ex officio the profit percentages. This can also be done via a taxpayer request.[765] Nevertheless, to date, there is no known case of a reassessment of the TP statutory margins by the Minister of Finance.[766] Finally, it should be noted that Brazil does not allow the taxpayer to enter into an APA with the tax administration.

5.4.2 India: From sparse provisions to a comprehensive domestic regulation

Differently from the Brazilian scenario, India had already enacted basic transfer pricing provisions dealing with taxation of connected enterprises in the first half of the twentieth century. The 1922 Income Tax Act provided at its Section 42(2) for a recalculation of profits if the transactions between connected parties did not reflect the typical transactions between independent ones. During the 1960s, through the

[762] The spread percentiles are stablished by Ordinance 427/2013.

[763] It refers to the Brazilian currency, the Real, as adopted since 1994.

[764] According to Article 20 of Law 9,430/96.

[765] Article 20 refers to Paragraph 2 of Article 20 as the legal provision that authorises the taxpayer to provide data supporting diverse profit margins.

[766] See Galendi Júnior and Schoueri (n 751), p. 198; Ferreira (n 431), point 10.2.3.

enactment of the 1961 Income Tax Act, similar provisions were laid down. According to section 92, the tax authorities could adjust the profits in case the transfer prices did not reflect the reality due to the parties' connections. It is also relevant to mention that case law in India contains some decisions dealing with the taxation of profits in light of such infant regulations. Such decisions, therefore, dealt with the principles underlying the taxation of transactions between connected parties, even focusing on comparables when deciding on the amount to be levied. For that reason — and once more, differently from the Brazilian case — it seems fair to say that case law in India played an important role in establishing the content of some transfer pricing features even before the appearance of a thorough regulation on the issue decades later.[767]

Because of the intensification of the economic globalisation process in the last decades of the twentieth century, India was not immune from the need for a more comprehensive regulation on taxation of associated enterprises. The integration process of the Indian economy with the rest of the world deepened from the beginning of the 1990s onwards. Consequently, the FDI inflow into the economy increased significantly. In 1994, the FDI inflow into the Indian economy was approximately US$974 million, reaching US$2,633 million in 1998. In comparison with such amounts, the FDI inflow into the country's economy more than doubled, reaching US$5,478 million in 2001. The increase in the cross-border transactions and of the FDI inflow was therefore an obvious reason for the Indian government to consider a comprehensive TP regulation.[768] As a result, the legislation was amended in 2001[769] in order to provide for a comprehensive set of transfer pricing provisions that were able to tackle the erosion of the tax base in the country.[770]

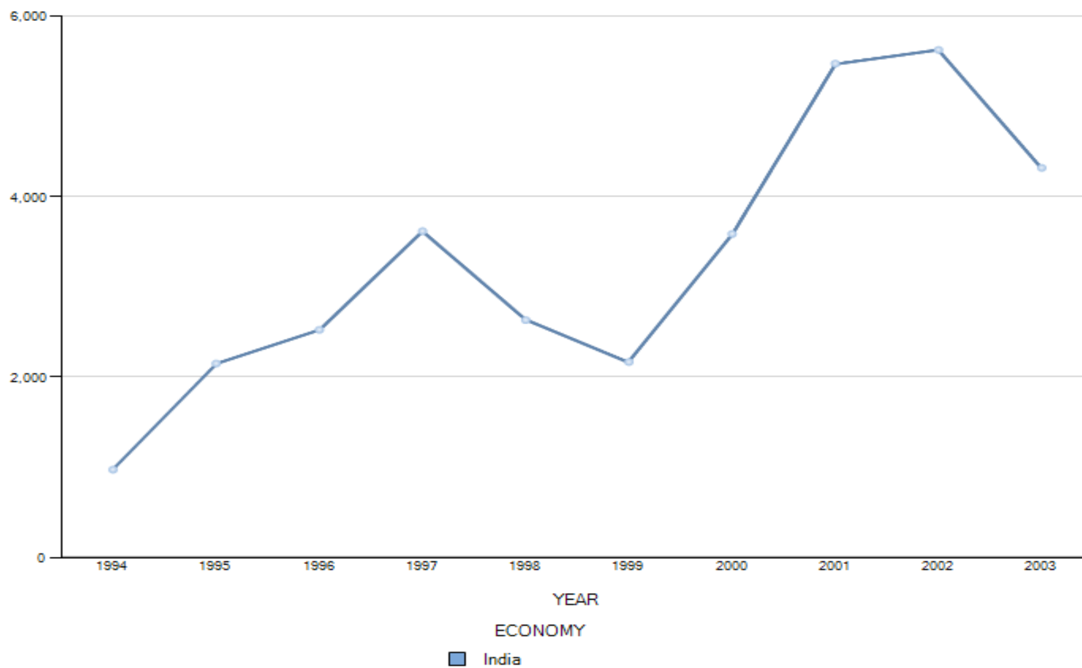
[767] Regarding such first rules and the importance of case law on transfer pricing issues previously to the enactment of the comprehensive regulation on the matter, see Mukesh Butani, 'Trasfer pricing disputes in India' in Baistrocchi and Roxan (eds) (n 49).

[768] ibid.

[769] The Finance Act 2001 introduced transfer pricing regulation in India. See Ajit Kumar Jain, 'Prioritizing Transfer Pricing Methods: And Indian and Global Perspective' (2015) 22 Intl Transfer Pricing Journal 167

[770] Butani (note 764), p. 588. According to the author, 'The motive was to ensure that with the increasing presence of multinational enterprises, arm's length profits are retained in India contributing to the revenue of the exchequer and preventing erosion of the tax base'.

Figure 5.2: FDI inflow into the Indian economy: 1994–2003



Source: UNCTAD: Foreign direct investment: Inward flows (US dollars in millions)[771]

Chapter X of the 1961 Income Tax Act now contains a set of sections that thoroughly regulates the taxation of transactions between associated enterprises, ranging from section 92 (which provides for any income from such transactions to be computed 'having regard to the arm's length price') to section 94A (which lays down special measures 'in respect of transactions with persons located in notified jurisdictional areas'). It should be said that, in general, India's approach follows the OECD standard. That is to say, the Indian legislation is based on the arm's length principle as stated by the OECD, therefore does not rely on other alternatives such as formulary apportionment or pre-fixed profit margins.[772] It is also necessary to emphasise relevant provisions contained in Chapter X, such as the meaning of associated enterprises —

[771] Available at <www.unctad.org> accessed 1 April 2016.

[772] For an account on the alternatives to the ALP, see Luis Eduardo Schoueri, 'Arm's Length: Beyond the Guidelines of the OECD' (2015) 69 Bull Intl Taxation 690. Also on an alternative proposal, see Hagen Luckhaupt, Michael Overesch and Ulrich Schreiber, 'The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal' in Wolfgang Schön and Kai A Konrad (eds.) *Fundamentals of International Transfer Pricing in Law and Economics* (Springer 2012), p. 91-121. This thesis comes back to this issue in Chapter 6.

section 92(A) — and the meaning of international transactions, encompassing transactions with both tangible and intangible properties – section 92(B).

In addition — and perhaps one of the most important features of such legislation — Section 92C lays down the methods for the computation of the arm's length price. Accordingly, the arm's length price should be identified through the most appropriate method among those listed in its sub-sections,[773] all of them reflecting the OECD TP Guidelines, namely the Comparable Uncontrolled Price Method (1(a)); Resale Price Method (1(b)); Cost Plus Method (1(c)); Profit Split Method (1(d)); and Transactional Net Margin Method (1(e)). In addition, subsection 1(f) provides for the choice of 'other method as may be prescribed by the Board'. As a consequence, Chapter X does not allocate specific methods to specific transactions. Nevertheless, when the transfer price is not specified in accordance with Section 92C, or any information and documentation is not kept or maintained adequately by the taxpayer, or even when the information or data used when assessing the profits are not reliable, the tax authority is allowed to determine the adequate arm's length price (Section 92C(3)). Once again, the divergences between India's and Brazil's regulatory designs are evident.

Maintenance of documentation related to the transactions is relevant to the legislation as well. Section 92D refers to the taxpayer's obligation to keep and maintain information and documentation in such regard. Further regulatory provisions on Section 92D set up the main documentation that should be kept by the taxpayer, such as documents on the nature and terms of the international transaction; on the functions performed, risks assumed, and assets employed by the associate enterprises relating to the international transaction; and on the methods employed to reach the arm's length price.[774]

Finally, it is worth noting that Chapter X also puts forward provisions on advance pricing agreements. Section 92CC allows the tax administration to enter into APAs with the taxpayer in order to specify the arm's length price or the manner in which such

[773] Even though Chapter X does not provide for hierarchy between the methods, case law in India has concluded for the existence of such a preference in specific circumstances. See Jain (n 766), p. 168.

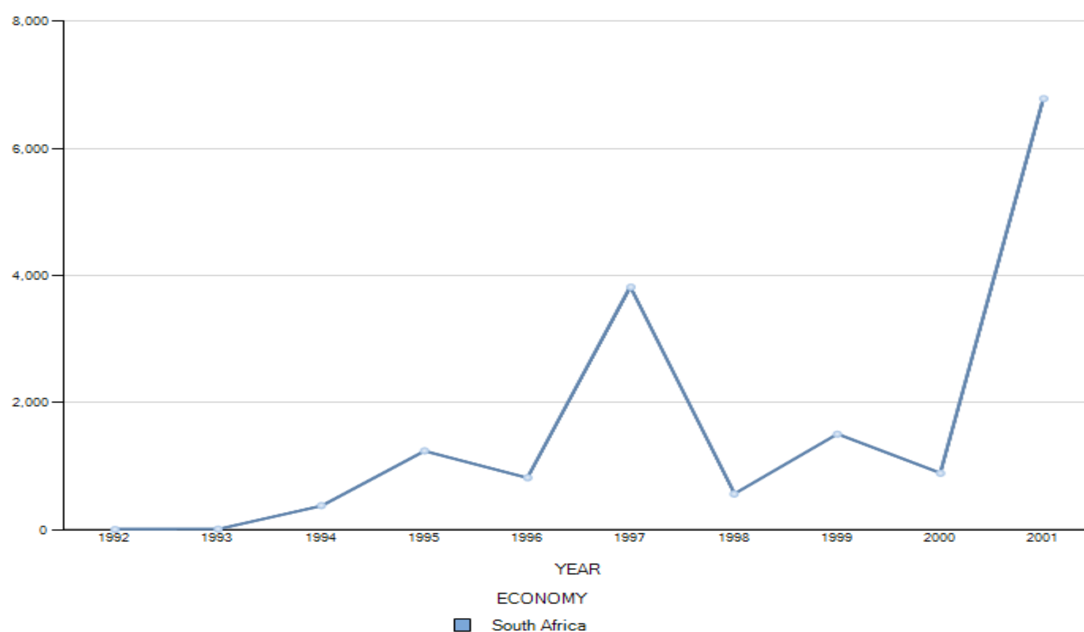
[774] Rule 10D specifies a great amount of information and documentation to be kept by the taxpayer.

price is to be determined. Additionally, section 92CD provides for the effect of the APAs.

5.4.3 South Africa: A post-apartheid regulation

South Africa did not follow a different path when the country was better integrated with the global economy. From the early years of the 1990s onwards, the country experienced an increase in the volume of international transactions. It is worth noting, however, that South Africa had a different starting point when compared with Brazil and India since the first years of the 1990s showed an almost insignificant FDI inflow, with foreign investors investing only US$4 million in the country in 1992. This number increased to US$3,817 million in 1997, with an almost 100 per cent increase by 2001, when it reached US$6,784 million. In this scenario, it was necessary to reshape South Africa's tax system in order to accommodate transfer-pricing regulation.[775] As a result, South Africa introduced in 1995 a set of provisions on the issue into the Income Tax Act 58 of 1962.[776]

Figure 5.3: FDI inflow into the South African economy: 1992–2001



Source: UNCTAD: Foreign direct investment: Inward flows (US dollars in millions)[777]

[775] See the Katz Reports at <http://www.treasury.gov.za> accessed 15 July 2017.

[776] Lee Corrick, 'Transfer Pricing Disputes in Africa' in Eduardo Baistrocchi and Ian Roxan (eds) (n 49), p. 790–831.

[777] Available at <www.unctad.org> accessed 1 April 2016.

Section 31 of the Income Tax Act 1962 is the statutory provision on transfer-pricing regulation, which deals with some aspects of the taxation of international transactions carried out by associated enterprises. It provides for the 'tax payable in respect of international transactions to be based on arm's length principle', which is applicable to both transactions involving goods and services dealing with tangibles and intangibles assets. Subsection (2) states that the taxable income should be calculated as if the connected persons had been dealing at arm's length, and at subsection (1) it defines the meaning of 'affected transactions'. It is also relevant to highlight that the Income Tax Act 1962 includes the meaning of connected persons at its Section 1 (*Interpretation*), being its subsection (d) the statutory provision that sets up the meaning of connected companies.

In addition to the statutory provisions of Section 31, one can find several focal points regarding transfer-pricing issues regulated by non-statutory instruments issued equally by the South African Government. This is the case of Practice Note 7, which was issued by the Commissioner for the South African Revenue Service in 1999. Among other things, it provides for the principles of comparability (item 8) underlying the application of the arm's length principle as stated by the OECD (item 7). The functions performed by the associated enterprises, risks assumed, and assets used also occupy a prominent position in its regulation (item 8.3.1).[778] Practice Note 7 also provides for the methods to be used when determining the taxable profits. It acknowledges the OECD approach as the one to be followed, endorsing the Comparable Uncontrolled Price Method, the Resale Price Method, the Cost Plus Method, the Transactional Net Margin Method, and the Profit Split Method.[779] However, although recognising all of them, it stresses the existence of a hierarchy among the methods based on the reliability of their results. Therefore, Practice Note 7 prefers the use of traditional transaction

[778] Item 8.3.1 of the Practice Note 7 reads as follows: 'The compensation for the transfer of property of services between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons'.

[779] Point 9.2.4.

methods, namely the Comparable Uncontrolled Price Method as the first alternative to be chosen.[780]

It is worth noting the importance given by the practice note to the documentation involved in the transactions between associated enterprises and the enforcement of the arm's length principle as well. It pays special attention to this at point 10.3 (Documentation Guidelines), which in general follows Chapter V of the OECD TP Guidelines. Item 10.3.6 lists a series of documents that are of special importance, such as the identification of the transactions and copies of the agreements entered into by the parties.

Finally, the South African regulation does not provide for a possible advance pricing agreement between the taxpayer and the tax authority.[781]

5.4.4 Compared features

Analysis of the compared countries' TP legislation shows they follow, to some extent, different paths when allocating and taxing business profits of associated enterprises. The most obvious mismatching refers to the pre-fixed profit margins put forward by the Brazilian TP regulation. Even though Law 9,430 provides for an adjustment of profit margins by the Ministry of Finance when appropriate (Article 20),[782] the framework adopted by Brazil greatly deviates from the OECD one. In this scenario, the comprehension of how the profit margins were set up, and what has been the economic sectors' response to such specific percentiles, takes special relevance. In this regard, India and South Africa do follow the OECD standard – that is to say, their respective legislation does not provide for upfront fixed profit margins.

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[780] Such is the wording of Point 9.3.4: 'As a general rule, the traditional transaction methods are preferred. Of these methods the CUP method is preferred, as it looks directly to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared.'

[781] Corrick (n 773), p. 826.

[782] See Subsection 5.4.1.

Other clear differences relate to the methods adopted by each country, and the way legislation imposes their observance. Again, Brazil offers a different approach in comparison with the other compared countries. In setting up specific methods for specific transactions upfront, the Brazilian legislation again deviates from the OECD standard. The same result is observed regarding which methods Law 9,430 puts forward, since it accepts only the traditional transaction methods. India's and South Africa's regulations, on this topic, follow a similar approach with slight mismatches. On the one hand, both countries adopt both the traditional transaction method and the transactional profit method. On the other hand, however, they differ from each other when it comes to the hierarchy to be observed between the methods. South Africa adopts the CUP method as the preferable one, while the Indian legislation does not provide for a hierarchy between the methods.

Comparison of additional features can equally be presented — for example, the emphasis placed on the documentation with regard to the associated enterprises' transactions. Even though the Brazilian legislation provides in general for the maintenance of documentation by the taxpayer, it does not put the same level of relevance on the documentation for TP regulation as India and South Africa do. The reason for this approach seems to be quite clear, since the pre-fixed profit margins alleviate the burden attached to documentation aspects regarding the computation of profits in OECD fashion. One can put forward the same reasoning with respect to the risks assumed and functions performed by each associated enterprise, and the assets involved. Fixed margins, in this sense, do not demand a deep analysis by the taxpayer of these aspects when computing the tax amount due. Once again, the path of the Indian and South African legislation diverges. Table 3 provides a comparison of such features alongside other items that seem to be relevant.

Table 5.6: Domestic legislation features

Features	Brazil	India	South Africa
Year of enactment	1996	2001	1995
Tangibles and intangibles	Yes	Yes	Yes
Pre-fixed margins	Yes	No	No
Methods	Traditional transaction methods	- Traditional transaction methods - Transactional profit methods	- Traditional transaction methods - Transactional profit methods
Statutory method allocation	Yes Considering the economic sector	No	No
Most appropriate method	No	Yes	Yes
Method hierarchy	No	No	Yes CUP as the preferred one
Emphasis on documentation	Low	High	High
Emphasis on functions, risks, and assets	Low	High	High
APA	No	Yes	No

5.5. Case law analysis: challenges to the TP regulation/Article 9

5.5.1 Brazil

As highlighted in subsection 5.4.1, the Brazilian domestic legislation on transfer pricing was enacted only in the second half of the 1990s. This fact alone could partially explain the low level of litigation observed to date. Only from then onwards the Brazilian tax authority started to assess tax liabilities based on clear statutory pre-fixed profit margins rules, hence evaluating the level of compliance of associated enterprises and their tax liabilities under the domestic TP regulation. Following such rationale, Brazilian taxpayers first challenged the tax administration's transfer pricing reassessments by the end of the 1990s, first before the administrative court and, then, before the judicial

tribunals.[783] In line with the appropriate administrative and judicial proceedings, the first rulings started to appear during the next decade, usually with the courts delivering them on a very narrow number of subjects.[784] The most important decisions can be arranged in the following manner.[785]

(i) Possible mismatch between the domestic legislation and the tax treaties signed by Brazil – CARF 101-96.665[786]

Facts: A pharmaceutical company was assessed with regards to the method used to identify the profits attributable to imports of medicines from its parent company based in Germany. The tax authority adjusted the transactions' profits through the Resale Price less Profit Margin method,[787] resulting in an additional tax liability. The taxpayer challenged the tax administration's stance on the profits on the grounds it did not follow the correct transfer pricing approach based on the arm's length principle; consequently, the company argued, it was in breach of the provisions set up by the treaty signed between Brazil and Germany,[788] notably Article 9 of that DTC.

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[783] The taxpayer is allowed to challenge a particular tax assessment before a federal administrative court, the Administrative Council of Tax Appeals (*Conselho Administrativo de Recursos Fiscais*). In case such court sides in his favor, the tax adjustment is reconsidered in order to declare the taxpayer not liable; otherwise, and assuming the taxpayer does not pay the due tax amount, the Tax Federal Attorney's Office can go ahead and enforce the taxpayer's liability in the judicial courts, where the taxpayer can defend himself. Also, subject to specific requirements, the taxpayer can challenge the tax assessment before the judicial courts even in the absence of the tax enforcement by the Federal Attorney's Office. On the administrative and judicial procedures regarding the tax liability enforcement, and the options at hand to the taxpayer, see Marcelo Natale and Carlos Nicacio, 'Chapter 5 - Brazil' in Bakker et al *Transfer Pricing and Dispute Resolution - Aligning strategy and execution* (IBFD 2011), p. 153 ff.

[784] Even though they are not linked to previous litigation, the Brazilian federal tax administration also has issued administrative rulings on the enforcement of TP rules. Such rulings are based on consultations put forward by the taxpayer. This subsection refers to them when appropriate.

[785] See Subsection 1.3 on the methodology elected for the case law analysis. For a thorough analysis of the Brazilian courts' rulings on international taxation, see Calich an Rolim, 'Chapter 4 - Tax Treaty Disputes in Brazil' (n 423).

[786] Decision n. 101-96.665, Conselho Administrativo de Recursos Fiscais, 1ª Câmara, Official Gazzete 17 April 2008. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

[787] On the Brazilian statutory methods, see Subsection 5.4.1.

[788] Brazil entered into a tax treaty with Germany in 1975. Its Article 9 mirrors Paragraph 1 of the OECD's one, with no Paragraph 2 being included. This DTC was later terminated by Germany. On the reasons for such a termination (TP issues included), see Ricardo André Galendi Júnior and Luís Eduardo Schoueri (n 67), p. 197. Also, João Victor Guedes Santos, 'Interpretative Treaty Override, Breach of Confidence and the Gradual Erosion of the Importance of Tax Treaties' (2015) 69 Bull Intl Taxation 17, p. 22.

Decision: The administrative court stressed that the Brazilian transfer pricing legislation aims at the observance of the arm's length principle, even though it contains unique features when it comes to both the exhaustive list of methods in the taxpayer's hand and the statutory pre-fixed profit margins. As a consequence, the country's TP framework significantly deviates from the OECD's approach as put forward by the TP Guidelines. Nevertheless, the court ruled that such a unique approach regarding the taxation of transactions between associated enterprises did not breach Article 9 of the treaty Brazil entered into with Germany. In order to reach such conclusion, the court departed from the fact that Brazil's DTCs do not have a Paragraph 2 at Article 9, which is part of the country's tax treaty policy, even referring to the country's reservation on the matter.[789] Therefore, concludes the court, there is not a mismatch between the domestic legislation and the mentioned DTC, even though the domestic rules do not provide for the comprehensive ALP's observance.[790]

(ii) Use of an alternative method other than those provided for by the domestic legislation – CARF 103-22.016[791]

Facts: The taxpayer, a pharmaceutical company, imported active ingredients to be sold later into the domestic market as part of finished products.[792] In doing so, the taxpayer, based on a technical research carried out by a consulting firm, applied the TNMM method instead of the CUP method,[793] the former not being one of those provided for by the TP domestic legislation. The tax authority assessed the taxpayer's liability through the CUP method since the TNMM method was not part of the list of statutory options in the taxpayer's hand. The company challenged such profits adjustment on several grounds. According to it, the rejection of the TNMM as a method able to assess

[789] See Subsection 3.2.

[790] Decision, p. 8.

[791] Decision n. 103-22.016, Conselho Administrativo de Recursos Fiscais (CARF), 3ª Câmara, Official Gazette 5 July 2008. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

[792] This case analysis only describes part of the tax assessment related to the import of active ingredients. The tax authority also assessed the taxpayer's liability regarding import of already finished products to be sold into the domestic market, which raised other issues not included into this section.

[793] Comparable Uncontrolled Price method. See Subsection 5.4.1.

the tax liability was in breach of the tax treaty Brazil signed with Belgium, the reason being this tax treaty should be observed in place of the domestic legislation's provision with regards the concept and interpretation of the ALP. Consequently, the domestic legislation does not have a higher legal hierarchy over the Belgium DTC's provisions, and the statutory methods should be applied only in cases where the method observed by the taxpayer does not appropriately reflect the ALP. The taxpayer noted the fact that the TNMM method is one of the TP methods considered by the OECD TP Guidelines as reflecting the ALP. Therefore, any tax adjustment based on a different statutory method upon the taxpayer's import transactions is against the law since the TNMM mirrors the ALP.[794]

Decision: The court decided that, when assessing its tax liability, the taxpayer should follow one of the statutory methods put forward by the domestic legislation, any other option not therein contained being excluded. According to its ruling, such approach is in line with the enforcement of the principle of legality.

(iii) Resale Price less Profit Margin method and intangibles, administrative discretion, and the principle of legality - CARF 107-08.725[795]

Facts: The main controversy surrounding this court's decision also relates to the import of active ingredients to be later processed into products by the Brazilian taxpayer. In what is crucial to the current case law analysis, the tax administration's profits adjustment and the challenge put forward by the taxpayers concentrate on the adoption of the Resale Price less Profit Margin method by the latter. According to the tax authority, Normative Ruling n. 38/97[796] was the appropriate regulation to be observed with regard to the import of active ingredients by the taxpayer from associated

[794] Decision p. 4 ff.

[795] Decision n. 107-08.725, Conselho Administrativo de Recursos Fiscais (CARF), 7ª Câmara, Official Gazette 25 September 2008. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

[796] Normative Rulings (*Instruções Normativas - IN*) are a set of rules aiming primarily at the clarification of provisions contained in statutes enacted by the Brazilian Federal Congress on tax matters.

companies. As a consequence, other methods would be available to assess the taxpayer's liability, the Resale Price less Profit Margin being excluded.[797] Accordingly, the tax authority assessed the company's tax liability through the application of the CUP method, resulting in a higher amount of tax to be paid. The taxpayer challenged such profits adjustment, mainly putting forward the following arguments: (1) normative rulings cannot impose tax liabilities; on the contrary, their aim is to clarify the way tax laws should be enforced; (2) the imported goods did not go through any modification, therefore not falling under Article 4, §1 of Normative Ruling 38/97 where it provides for the exclusion of the Resale Price less Profit Margin as an appropriate method of profit assessment in such cases; (3) the provisions of Normative Ruling 38/97 do not match the statutory regulation on the matter, being the provisions of Law 9,430/96 the ones to be enforced; (4) as a result, the application of the Resale Price less Profit Margin method as provided by Law 9,430/96 is the correct one with regards to the imports under scrutiny.

Decision: The court sided with the taxpayer, deciding that the provisions of Law 9,430/96 are the ones to be enforced regarding the case under analysis, in place of the enforcement of Normative Ruling 38/97. The fact the imported active ingredients were later modified into a final product did not change the court's conclusion since, according to its opinion, the statutory provisions did not prevent the application of the Resale Price less Profit Margin method even in such circumstances. [798] As a result, the decision stressed that Normative Ruling 38/97 went beyond what was allowed by the law.[799]

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[797] Normative Ruling n. 38/97, Article 4, §1. Published on the Official Gazette on 5th May 1997.

[798] Note 81, p. 20 ff.

[799] Other decisions, which analyse similar cases where pharmaceutical companies challenged the tax authoritiy's profits adjustment, reached equal conclusions. See, e.g., CARF 101-94.859 and CARF 101-94.863, available at http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1. Accessed 1 July 2017. On the matter, see Natale and Nicacio (n 780).

(iv) Restriction of the choice of the method providing for a lower tax liability - CARF 101-94.888[800]

Facts: This case bears similarities with the previous one since it also relates to a tax assessment regarding the import of active ingredients by a pharmaceutical company. Following a similar path, the taxpayer entered into import transactions with an associated company and, in line with the statutory provisions, decided to assess its tax liability through the Resale Price less Profit Margin method with regards to a particular active ingredient. Nevertheless, its peculiarity relates to the tax assessment of the profits margins through the application of the Cost-plus method[801] with regards to a second active ingredient, equally imported from an associated company. As it happened in the previous case, the tax authority adjusted the profits through the CUP method with respect to the first active ingredient on the grounds Normative Ruling 38/97 did not allow the use of the Resale Price less Profit Margin method. With regards to the second active ingredient, the tax authority reassessed the profits equally through the CUP method, this time though on the grounds the taxpayer was not able to supply the tax authority with enough information to support its choice in favour of the Cost-plus method. The taxpayer challenged the Normative Ruling 38/97's enforcement, where it put forward similar arguments to the previous case. Concerning the choice of the Cost-plus method, the taxpayer stressed its complexity and adequacy for assessing the transaction price according to Law 9,430/96.

Decision: On Normative Ruling 38/97 and the Resale Price less Profit Margin method choice, it suffices to say the court reached a similar conclusion as in the previous decision. It is important, however, to shed some light on the court's decision regarding the taxpayer's adoption of the Cost-plus method. Notwithstanding the tax authority considered the taxpayer's choice in favour of the Cost-plus method was ill documented, therefore assessing the profits through the CUP method, the court decided the taxpayer was free to pick the method that provides for the lower tax liability. Therefore, once the

[800] Decision n. 101-94.888, Conselho Administrativo de Recursos Fiscais (CARF), 1ª Câmara, Official Gazette 1 June 2005. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

[801] On the Cost-plus method as adopted by the Brazilian domestic law, see Subsection 5.4.1.

taxpayer opts for a particular method, the tax administration cannot pursue a different assessment through a different one, unless it clearly demonstrates the inappropriate pricing practice by the taxpayer. The court even went further stressing that the choice of the most favourable method, as allowed by the law, strengthens legal certainty.[802]

(v) Comparables and the use of third parties' information – CARF 108-09.551[803]

Facts: In the present case, the tax assessment revolves around the same Normative Ruling 38/97 and the application, by the tax authority, of the CUP method to the import transaction. Its peculiarity, however, relates to the use of information that the taxpayer could not have access to at the time. The tax authority sought information from third parties through serving them with official notifications and, additionally, went through the examination of information it obtained unilaterally from official databases. The taxpayer put forward its appeal arguing the case analysis should depart from Article 9 of the treaties Brazil signed with Germany and France, countries of origin of the imported active ingredients. In doing so, occasional adjustments would only be possible in case of price distortions that did not observe the arm's length principle. Particularly on the use of information by the tax authority when adjusting the transactions' profits, the company stressed the fact that they were not available to the public at the time; thus the court should not accept such information as means of comparability. Finally, the taxpayer considered inadequate the fact the tax administration picked up only a tiny part of third parties' import transactions when adjusting the company's transfer pricing.

Decision: On the enforcement of Normative Ruling 38/97, the court reached the same conclusion highlighted in the previous cases. The court also sided with the taxpayer on the use of comparables by the tax administration. As the taxpayer did not have access to the information gathered by it, the adjustment was in breach of the law since that

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[802] ibid, p. 25. It is noteworthy, however, to stress that, according to the Court's understanding, the tax authority is not legally bound to pick up the method that most favors the taxpayer when assessing its tax liability. Such argument, however, ended up as immaterial since the tax authority was not able to produce enough evidence against the taxpayer's choice in favor of the CPL method. ibid, pg. 26 ff.

[803] Decision n. 108-09.551, Conselho Administrativo de Recursos Fiscais (CARF), 8ª Câmara, Official Gazette 3 June 2008. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

infringed the taxpayer's right to a fair hearing.[804] Consequently, the use of information obtained from unpublished official sources regarding imports comparable to the taxpayer's transactions turned out to be illegitimate.[805]

(vi) Tax administration choice for the method providing for the smallest adjustment –CARF 105-17.103[806]

Facts: The taxpayer, an agrochemicals producer company, entered into import transactions with an associated enterprise. The taxpayer assessed those transactions' transfer prices through the CUP, the Cost-plus, and the Resale Price less Profit Margin methods with regards to different imports. On what matters for the present analysis, the tax authority did not consider a report produced by an independent consultancy firm that, according to the taxpayer, correctly supported the choice of the Cost-plus method regarding the import of specific goods. In doing so, the tax authority proceeded in adjusting the company's tax liability, and picked the CUP method in opposition to the Resale Price less Profit Margin method; the latter was the one providing for the lowest profits figure.

Decision: The court considered that the consultancy firm's report, as presented by the taxpayer, did not comply with the legal provisions on the matter. As a result, the tax authority was allowed to reject its conclusions in favour of the taxpayer profits assessment. Furthermore, the court did not consider as necessary the use of the method that would provide for the least onerous tax liability. On the contrary, it decided that the tax authority, when adjusting the taxpayer's transaction profits, is not bound to the most beneficial method approach.[807]

[804] Note 800, p. 17 ff.

[805] ibid, p. 18.

[806] Decision n. 105-17.103, Conselho Administrativo de Recursos Fiscais (CARF), 5ª Câmara, Official Gazette 10 December 2008. Available at <http://idg.carf.fazenda.gov.br/jurisprudencia/acordaos-carf-1> accessed 1 July 2017.

[807] ibid, p. 14. The court reached similar conclusion in other appeals. See Natale and Nicacio (n 780), p. 156-157.

5.5.2 India

(i) Cost Contribution Arrangements and the benefit test - LG Electronics India Pvt Ltd v ACIT[808]

Facts: LG Electronics India Pvt Ltd was a wholly-owned subsidiary of a Korean company. In respect of the transactions carried out with its foreign associated company,[809] the taxpayer was assessed by the tax administration as liable to income tax with regard to its 'contribution towards global sponsorship of ICC World Cup Tournament'.[810] The taxpayer, its parent company, and a third enterprise, entered into an agreement to sponsor such cricket tournament aiming at promoting the sales of the LG group's products; the Indian company and its parent company agreed to share the costs of such sponsorship in a 40:60 ratio. The companies' TP report arrived at such ratio through the consideration of the sales growth attached to a better visibility of the group's products; the brand awareness growth; and the cricket tournament's viewer as spread out through 14 jurisdictions (India's population represented, according to the TP report, 65% of those jurisdictions' combined population).[811] The tax authority disregarded the assessment carried out by the taxpayer on the grounds that a better transfer pricing assessment in such a case should follow the ratio between the operating margin of the Indian company and the group's worldwide one. Thereby, based on available financial information of the taxpayer and of its parent company, the tax authority set the ratio of gross profits between the companies to 5.40:94.60.[812] An adjustment of the taxpayer's taxable income followed. The taxpayer appealed to the Commissioner of Income Tax, who held in its favour.[813] From that decision the Indian Revenue appealed to the ITAT.

[808] LG Electronics India Pvt Ltd v ACIT, I.T.A. N. 3823/DEL/2009, ITAT Delhi Bench. Decision date: 17 May 2013. Available at <https://www.itat.gov.in> accessed 1 August 2017.

[809] The decision refers to a list of 16 kinds of transactions the taxpayer had entered into with its Korean's parent company, ranging from the import of raw material and components to the purchase of business of LG Systems Ltd. Ibid, p.2ff.

[810] ibid, p. 3, paragraph 3.3.

[811] ibid, p. 5, paragraph 3.4, (c).

[812] ibid, p. 9, paragraph 3.11.

[813] ibid, p. 27, paragraph 15.

Decision: The tribunal sided with the taxpayer. The ITAT went through a thorough examination of data provided by the parties, and concluded that the sales of the entire LG group was not an appropriate basis to assess the benefits occasioned by the sponsorship of the cricket tournament. It arrived at the conclusion that 38% of the group's sales related to jurisdictions where the sport practice and the audience were relevant.[814] The Court also referred to sales increase in India by occasion of the cricket tournament sponsored by the taxpayer; according to data analysed in the decision, the taxpayer's sales in India increased around 35% in the financial year when the tournament took place, while the sales of comparable transactions decreased in the same period.[815] Finally, in what is relevant for this subsection's analysis, the ITAT also based its ruling on the OECD's TP Guideline's stance with regard to Cost Contribution Arrangements. Accordingly, since the interests of each company concerning such agreement should be set up from the outset, the costs allocation could not be carried out considering the gross margins as done by the tax administration.[816]

(ii) Comparables and the functional analysis approach – Mentor Graphics (Noida) Pvt Ltd v. CIT[817]

Facts: Mentor Graphics was in the business of developing software to be used by its US parent company.[818] The taxpayer's business was fully connected to the US company since all its products were later integrated into the latter's products. For the 2001-02 fiscal year, Mentor Graphics assessed its tax liability through the TNMM method with

[814] ibid, p. 29, paragraph 20.

[815] Referring to data on comparable transactions carried out by third companies in the same fiscal year, the Court concluded as follows: 'From the above table, it is seen that assessee's sales had increased by 35.04% during the financial year 2002-03 pursuant to the sponsorship of cricket event whereas the sales of comparables companies reduced by 15.49%. The above indicates that assessee derived significant benefit due to its advertisement expenses'. ibid, p. 33, paragraph 26.

[816] Such is the Court's position: 'In this regard, OECD states that each participant's interest in the results of the Cost Contribution Arrangement (CCA) activity should be established from the outset. The OECD also states that the goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate contributions in same proportions. Hence, the sales/gross margin which is a post event measure and which does not coincide with the expected benefit is not the right allocation key […]'. ibid, p. 34, paragraph 28.

[817] Mentor Graphics (Noida) Pvt Ltd v. CIT, High Court of Delhi, case n. 1114/2008. Decision date: 4 April 2013. Available at <http://delhihighcourt.nic.in> accessed 1 August 2017.

[818] The company also was in the business of exporting marketing support services to its parent company. Nevertheless, such activity was not subject to the tribunal's analysis. ibid, p. 5.

reference to the transactions with its parent-associated company. In doing so, it reached a profit level indicator of 6.99%. The Indian tax authority (Transfer Pricing Officer – TPO), however, disagreed with such profit assessment on the grounds that the chosen method was not the appropriate one, and that the comparables used were not adequate. As for the comparables, the TPO's arguments, *inter alia*, revolved around (1) the taxpayer's choice for some companies with substantially diverse turnovers; (2) the taxpayer's failure in using data of the financial year 2001-02, the relevant fiscal year for the case; (3) the absence of companies with different profiles as comparables since, according to the TPO, the TNMM method allows functional differences; and (4) the comparison with companies with higher ratios of trading and manufacturing activities than the taxpayer's.[819] As a result, and based on a parallel search for comparables and profits calculation, the TPO indicated that the 24.53% figure should be considered as the adequate profit level indicator.

Decision: After analysing the appeal against the profits adjustment carried out by the TPO, the ITAT ruled in favour of the taxpayer. The tribunal made clear that the setting up of the transactions' transfer prices is not an exact science, pointing out the need for a proper examination of such transactions. In the tribunal's opinion, the transactions were accurately scrutinised by the taxpayer, resulting in the adequate identification of the arm's length price. The court highlighted the fact that the taxpayer set aside thousands of companies whose business resemble its own, and had chosen comparables through the appropriate functional test. In doing so, the taxpayer considered the assets and risks involved in its business. Furthermore, the court noted that the tax administration failed when electing the criteria for searching for comparables, and that it had not specifically refused any of the taxpayer's ones.[820] The ITAT also made clear that all comparable transactions did not show a margin profit surpassing the one adopted by the taxpayer. Additionally, it concluded that the price assessment would be correct even when one profit level indicator, out of many considered, is lower than the assessee's.

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[819] ibid, p. 16.

[820] ibid, p. 23.

The High Court of Delhi, when analysing on appeal lodged by the TPO against the ITAT ruling, reached a different conclusion on the latter point though.[821] In its view, the ITAT made a mistake when it reduced the number of comparables to be scrutinised. Therefore, the position in favour of the selection of only one set of profit indicator as being able to establish the arm's length price, instead of several profit level indicators, was against the law.[822] However, the Delhi's court did not rule in favour of the price adjustment as proposed by the TPO since the taxpayer's profit indicator was still above the comparable transactions' ones.[823]

(iii) Differences with regards to functions performed and risks assumed affecting the comparability - Philips Software Centre (P) Limited v. ACIT[824]

Facts: Philips Software Centre (P) Ltd. was an Indian company providing services of software development to its associated companies, all of which were connected to the Philips group. The company, as a captive contract service provider entity, developed its products under exclusive instructions received from its associated enterprises. With regards to the fiscal year of 2002-03, the taxpayer established the price of its transactions based on a transfer pricing study,[825] concluding the transactions were at arm's length and therefore complying with the Indian transfer pricing regulation.[826] The tax administration (TPO), however, arrived at a different conclusion when assessing

[821] Mentor Graphics (Noida) Pvt Ltda v. High Court of Delhi (n 814), p. 9.

[822] ibid, p. 25.

[823] Such is the Court's ruling: 'The proviso to section 92C(2) is explicit that where more than one price is determined by most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices. To this extent the appeal is allowed. However, as pointed out above, if this principle is applied to the comparables suggested by the assesse (which have not been rejected by the Transfer Pricing Officer), the arm's length price suggested by the assessee would yet be acceptable in law.' ibid p. 26.

[824] Philips Software Centre (P) Limited v. ACIT, ITAT, case ITA n. 218/Bang/2008. Decision date: 26 September 2008.

[825] The taxpayer departed from a data analysis encompassing around 7000 Indian companies, narrowing down its comparable process through a series of qualitative and quantitative filters. As a result, 402 companies, all of which were involved in the same economic sector as the taxpayer's (computer software industry), were selected. Only 9 out of those 402 companies fulfilled the comparability criteria elected by the taxpayer. ibid, p. 4 ff.

[826] ibid, p. 3.

the comparable companies' profit margins, adjusting the tax liability using a mean profit margin of 21.14%, against the 6.61% as indicated by the company. The taxpayer appealed to the ITAT against the TPO tax adjustment on the grounds, inter alia, that (1) the data used by the TPO was not contemporaneous to the transactions under scrutiny; (2) that such data was not made available to the taxpayer; (3) that there was no evidence that the comparable companies picked by the taxpayer were deficient or insufficient; and (4) that the comparability carried out by the TPO did not appropriately considered the functions performed, assets employed, and risks assumed as should have been the case when assessing the transactions price.[827]

Decision: In its decision, the court duly considered the regulation on transfer pricing as encompassing both the rules laid down by the Indian set of statutes and the provisions contained in the Indian government's instructions and circulars; the latter ones also being binding upon the tax administration.[828] With that in mind, the court went through the analysis of the TP study carried out by the taxpayer, concluding in favour of its adequacy to the case under scrutiny. According to its ruling, the taxpayer's choice of the TP method, and the methodology chosen regarding market comparability, were correct. On the contrary, when analysing the arguments put forward by the tax administration against the taxpayer's TP assessment, the court held that the tax authority failed in providing any justification able to support the need for a profit adjustment. Such conclusion was based on the fact that the tax administration was incapable of refuting the adequacy of the taxpayer's methodology, data gathering, and data analysis.[829] Consequently, the adoption of the tax administration's own study, which was based on a 'cherry picking' process, was against the law. Such methodology led the tax administration to pick comparable companies making super-profits, which, according to the court, the tax administration intended to present as normalised profits. There was no rationale behind such comparability choice, having failed the tax

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[827] ibid, p. 2.

[828] More specifically, the decision referred to Circular N. 14/2001 issued by the Government of India's Central Board of Direct Taxes. Available at https://www.incometaxindia.gov.in. Accessed on 1 August 2017. See point 5.71 (ii) of the decision.

[829] Such was the court's conclusion: 'The TPO erred in disregarding the most appropriate method adopted by the assessee in the TP Study, and also in using the Prowess data base. The TPO did not provide any reason for deviating from the TP Study in respect of these matters.' Point 5.71(vi) of the decision.

administration when trying to normalise the profits of super profit companies.[830] Here it is important to highlight that the court, in order to conclude in favour of the adequacy of the TP study presented by the taxpayer, went through a lengthy and detailed analysis of the data and respective arguments presented by both parties. In doing so, and when adjustments are needed, the court stressed the prominent role of analysis based on the different functions, assets, and risks.

(iv) Importance of the contractual analysis – Sony India (P) Ltd v. DCIT[831]

Facts: Sony India (P) Ltd, a wholly owned subsidiary of Sony Corporation, was in the software development business in India. The company entered into transactions with foreign associated enterprises. The taxpayer and the Indian tax authority disagreed on several grounds regarding the transfer pricing adjustments carried out by the former. Among them, the tax authority raised issues on items of income and expenditure as considered by the company.[832] It was noted that the company had entered into an Advertisement Contribution Agreement with its associated enterprise (Sony Pacific), which contained a clause obliging the foreign company to reimburse 50% of the advertisement expenditure incurred by the taxpayer. The TPO disagreed with the nature of such arrangement, stressing that such cost could be part of a loan agreement or even being made through an equity contribution arrangement. In the TPO view, the amount incurred by the taxpayer would not have been considered as an operating expenditure; therefore they would not have been eligible as expenditure for the profit margin assessment. The TPO adjusted the taxpayer's liability accordingly.

Decision: The court ruled in favour of the taxpayer on the issue. According to its view, the Indian tax laws in general, and the transfer pricing regulation in particular, favour

[830] Point 5.71(x) of the decision.

[831] Sony India (P) Ltd v. DCIT, Decision ITA N. 819/Del/2007. Decision date: 23 September 2008. Here it is worth referring to the fact that the tribunal hearing encompassed a series of appeals to the Delhi tribunal by both the tax administration and the taxpayer. The issues considered in the current analysis relate only to the taxpayer's appeal aforementioned. On an appropriate explanation on this, see the court's decision and Editor's Note published at 11 ITLR 236.

[832] ibid, paragraph 97.

the contractual terms biding the parties when they enter into actual transactions. Therefore, the tax authorities are not allowed to re-write such transactions except in cases where it is proved they are sham or bogus, or in cases where the parties enter into agreements in bad faith to avoid and evade their tax liabilities. Also on this point, the court made it clear that the transactions entered into by the taxpayer and its associated enterprise did not square with the exceptions, and that there were no argument or dispute on the contrary by the tax authority. Consequently, one needs to carry out the comparability process bearing in mind the contractual terms of the transactions, such legal instrument being the one laying down the parties' share of responsibilities, risks, and benefits.[833]

(v) Diverse income categories and comparability – E-Gain Communications Private Ltd[834]

Facts: The taxpayer, a subsidiary of a US company, was an Indian company doing business in the software products development market. The whole of its operation was dedicated to providing services to its parent company, therefore being a captive outsourcing company. With regards to the 2004 and 2005 taxable years, the taxpayer found taxable profits representing a cost-plus mark-up margin of 5.16%. The tax administration reassessed the transactions profits upwards, adjusting the taxpayer's tax liability applying a 16.12% profit margin instead.[835] Such profit average was a result of a screening by the tax administration of twenty (assumed) comparable companies' transactions.[836] The company challenged the profits adjustment mainly on the grounds the comparable companies picked by the tax authority showed a diverse turnover from its own, and that they showed abnormally high profit margins. Also, the comparable companies had sources of income other than from the software development activity, which, according to the taxpayer, should not be taken into account when establishing the transactions' arm's length price. Finally, the taxpayer noted that all the risks were

[833] ibid, paragraph 101.

[834] E-Gain Communications Private Ltd. v. ITO, ITAT Pune Bench, ITA n. 1685/PN/2007. Decision date 10 June 2008.

[835] ibid, point 4.

[836] ibid, table provided at point 5.

borne by its parent company, and that its total turnover was connected to the supply made to the latter.[837]

Decision: The tribunal sided with the taxpayer. According to its ruling, the taxpayer was right when pointing to the turnover dissimilarities of specific comparable companies. According to the tribunal, the tax administration failed in not analysing such dissimilarities, which is aggravated by the fact that the companies pointed out by the taxpayer as non-comparable ones showed extraordinarily high profit margins. As a result, it was noted that another category of income (non-software development business income) could not be included in the comparison carried out by the tax administration. The court decided that those comparable companies' business did not entirely match the transactions under scrutiny since the taxpayer was dedicated solely to the software development for its parent company. [838]

5.5.3 South Africa

The analysis of South African case law on international tax issues does not offer any decision on the application of either Article 9 of the country's tax treaty network or its domestic legislation on the taxation of associated enterprises. Possibly, the fact that South Africa recently moved away from source jurisdiction to residence jurisdiction to tax[839] is a relevant factor for the lack of a large number of decisions on international tax issues;[840] therefore, the same assumption applies to the lack of cases[841] on the taxation of associated enterprises.[842]

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[837] Ibid, points 18 and 19.

[838] ibid, point 39.

[839] The reform of the South African tax system started in the 1990s, with the shift in the jurisdiction to tax from a source-based to a residence-based taxation system in the 2000s. See 2.3.3.

[840] On the adoption by South Africa of the residence jurisdiction with respect to income tax assessments from 1 January 2001 onwards, see Lynette Olivier and Michael Honiball, *International Tax: A South African Perspective, 2011* (5th ed, SiberInk 2011), p. 11. Also, on the broadening of the country's tax base and on the works carried out by the Katz Commission and by South Africa's National Treasury, see Trevor A Manuel, 'The South African Tax Reform Experience Since 1994' Address to the Annual Conference of the International Bar Association (2002). Available at < http://www.treasury.gov.za/comm_media/speeches/2002/2002102501.pdf> accessed 28 January 2018.

[841] Apart from challenges involving the taxation of associated enterprises, such fact could also explain the reduced number of cases on taxation of PEs. See 4.5.3.

[842] The bibliography reviewed on the South African international tax system did not provide for any case law involving TP discussions in the country's courts so far. The same result is noted with reference to

5.5.4 Challenges comparison – principles emerging out of the case law comparison

The examination of the decisions above on the interpretation of Article 9 of Brazil and India's tax treaty networks, and on their domestic legislation on the attribution of profits to associated enterprises, clearly shows how diverse the issues faced by the taxpayers in those jurisdictions are. In this sense, the transfer pricing frameworks adopted by each of those countries play a central part in the level and nature of challenges presented before the courts.

The Brazilian case law, to a great extent, follows a specific pattern. First, no overwhelming challenge to the pre-fixed profit margins as adopted by the country was observed. This seems to suggest that companies doing business in Brazil that are subsidiaries of foreign enterprises are not keen to insist on judicial positions against the statutory margins and methods. One can conclude, therefore, that the statutory margins and methods are not set to the detriment of the adequate assessment of the associated enterprises' profits and of their business as a whole. On the contrary, the level of litigation on the matter would most probably be higher than actually it is to date, and the level of FDI flow in the country's economy would decrease as a consequence of the inadequacy of the level of taxation on the associated enterprises.

Second, only particular features of the transfer pricing regulation were challenged before the courts, invariably involving the non-statutory regulation on the methods to be adopted by the taxpayer.[843] This suggests the domestic legislation, as a whole, does not provide for an entirely inadequate regulation on the matter. As a result, one can conclude that what is necessary are adequate, in some circumstances, specific legal norms geared to the reality of the cross-border transactions without a thorough rearrangement of the TP system. It is also important to highlight that the courts, when

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the main case law database consulted for this thesis. See the IBFD Tax Research Platform, Tax Treaty Case Law database. Available at <www.ibfd.org> accessed 28 January 2018.

[843] On the excesses of specific non-statutory rules in the Brazilian TP legal scenario, see Luis Eduardo Schoueri, 'Lower Court Decision on Use of Original Formula for Resale Price Method' (2011) 18 (2) Int'l Tr Pricing J. 142.

examining the limits of the non-statutory regulation, stressed the legal certainty inherent in a statutory profit margins system.

Third, it seems that only specific sectors were affected by ill designed legal rules. All the above considered, the case law analysis suggests that the Brazilian TP regulation, while not aligned with the international practice on the OECD's arm's length rule (as also recognised by the courts), is not entirely ill conceived.

On the contrary, the case law on India's TP regulation offers a completely diverse scenario. As highlighted in Subsection 5.4.2, India adopts a TP system that aligns with the OECD's. Such alignment, however, did not avoid a very high level of litigation on cases involving taxation of associated enterprises. The case law set analysed above clearly puts a considerable emphasis on functions performed, risks assumed, and assets used in the transactions between associated enterprises. Although such result is not a surprise for a country adopting an OECD pattern, the courts' interpretation of Article 9 and of the Indian domestic legislation raises the question as to whether a tax administration from a developing country that is not well equipped for transfer pricing assessments could keep up with highly complex international tax planning. The level, and intricacies, of the comparability process as shown by the court decisions, the high emphasis on the contractual analysis (and analysis of the facts involved), and the lengthy and complex data assessment all contribute to a system that is not entirely adequate for those tax administrations' needs. Once more, as was the case with regard to the courts' interpretation on Article 5 and Article 7, such a context raises a considerable question as to the need for a domestic set of rules on taxation of associated enterprises more beneficial to developing countries.

Again, it is worth stressing the influence of different decisions on documentation analysis.[844] The level of practicability as adopted by the Brazilian domestic regulation seems to be reflected in the country's courts. When the taxpayer challenged the tax administration's TP assessment based on documentation analysis (choice of a different

[844] On how heavily the determination of profits rely on documentation analysis, see the 2017 OECD TP Guidelines, Chapter V.

method based on a TP study carried out by a consultancy),[845] the Brazilian court stressed that the methods used by the taxpayer and respective statutory margins were the ones strictly provided by the TP regulation. In doing so, the court shifted the emphasis from the analysis of the TP study produced by the taxpayer to the practicability as provided by the statutory methods and margins. On the other hand, the Indian case law offers a different context. Quite often the courts referred to TP reports, [846] documentation related to the transactions between the associated enterprises,[847] comparisons between the agreements and actual transactions.[848] In such a context, one should not be astonished by the complexity (which leads to lengthy decisions) and by the sheer number of court decisions in India dealing with transfer pricing issues.[849] Once more, the high level of legal certainty as offered by a framework that does not focus on documentation analysis, as is the case of the statutory methods and profit margins, needs to be highlighted.

5.6 Conclusion

The findings of the analysis of the tax treaty networks of the compared countries indicate the clear deviation of Brazil's transfer pricing domestic regulation from the OECD standard. Also, Brazil's treaty network deviates from both the OECD and the UN models since it does not provide for corresponding adjustment as contained in 9(2). As a consequence, its treaties do not include any provision mirroring the UN's Article 9(3) as well. As for India and South Africa, their treaty networks follow with a great emphasis the OECD Model. Some slight deviations are observed – as the insertion of 9(3) in some treaties - without resulting in significant influence exerted by the UN Model. India's and South Africa's domestic legislation, in general, match the OECD's approach, although with some exceptions - this is the case e.g. of the preferable method in the South African legislation.

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[845] See Section 5.5.1 (ii).

[846] Section 5.5.2 (i) and (iii).

[847] Section 5.5.2 (ii).

[848] Section 5.5.2 (iv).

[849] On the number of decisions in India, see Chapter 1.

In addition, the differences between the countries' transfer pricing regulation are evident. Ranging from the Brazilian pre-fixed profit margins to the methods adopted by each country, the analysis above shows that the compared countries do not share a common framework when allocating business profits between associated enterprises. It could be assumed that, as emerging countries and part of the BRICS, it would be possible to reach a different conclusion. Such scenario was not confirmed.

Finally, the examination of key case law on the issue showed that the compared countries' regulation on TP is not subject to the same kind of challenges before the courts. Rather interesting, apart from the absence of relevant TP case law for South Africa, it is the court's decisions on Brazil's regulation that presents the lowest level of litigation. The country's case law is also the one that does not present the most intricate set of issues to be resolved by the courts. In fact, it focuses on only a reduced number of specific features of the domestic legal provisions. In this sense, the analysis of Brazil's case law shows the adoption of a pre-fixed profit margins system on taxation of associated enterprises does not cause a high level of challenges before the courts on the matter.

CHAPTER 6

A Transfer Pricing Framework for Developing Countries: A Regulatory-based, Pre-fixed Profit Margins System

6.1 Introduction

The previous chapters examined the tax treaty networks of Brazil, India, and South Africa on the taxation of corporate profits. Also, when appropriate, they paid special attention to the domestic regulations in those countries on the taxation of associated enterprises. Drawing on those results, the thesis now turns its focus to a proposal for a transfer pricing regulation for developing countries. Therefore, Chapter 6 will discuss whether a transfer pricing framework that does not align with the OECD's could be appropriate and beneficial for developing countries. The chapter puts forward a regulatory-based, pre-fixed profit margins framework that is able to offer developing countries a set of rules designed, to a great extent, to mitigate the administrative burden borne by tax administrators of those countries. At the same time, the proposed framework offers a TP system to foreign investors that has predictability as one of its most important features.

This chapter starts by putting the analyses previously carried out together. Section 6.2 frames the compared countries' tax policies into the functional analysis formula as presented in Chapter 1. In so doing, it summarises the findings of the thesis so far that will serve as a background for the intended TP framework. Research sub-questions (i) and (ii) are addressed in Section 6.2. Next, Section 6.3, the core of this chapter, elaborates the regulatory proposal for developing countries for taxation of cross-border transactions between associated enterprises. Section 6.3 is divided into six subsections ranging from the need to establish the economic background where the TP rules are supposed to be applied, the proper design of a fixed-profit margins TP framework, to the consideration of the framework as an entry-level, provisional system. Subsection 6.3.2 compares the thesis' proposal with the formulary apportionment method on

taxation of business profits; its features are highlighted and weighed against the structure of the proposed system.

Section 6.4 assesses the need for a consistent application of TP rules with respect to the treaty and domestic provisions. It sheds light on the benefits of an alignment between the approach adopted by the treaty parties on Article 9 and the TP regulation established by the domestic legislation on the issue. Additionally, the need for the treaty commentaries and the works on TP carried out by the OECD and the UN, namely the OECD TP Guidelines and the UN TP Manual, to include guidance on a pre-fixed profit margins system, as developed below, is addressed. Section 6.5 follows with the implications of the proposed system to the allocation of profits to PEs.

Finally, Section 6.6 addresses the work carried out by the OECD and the G20 on the BEPS Project. It looks at the main features and results of Actions 8-10 and 13 of the OECD/G20 BEPS Project on transfer pricing. The appropriateness of the OECD/G20 BEPS Project's outcomes for developing countries is assessed with regard to the TP issue, with the proposal put forward in this chapter considered accordingly. Section 6.7 presents the conclusion.

6.2 A Diverse Approach on Taxation of Corporate Business Profits: The Compared Countries' Experience

As put forward in Chapter 1,[850] this thesis departed from the balance needed between the attraction of FDI by developing countries and the appropriate level (according to those countries' understanding) of taxation on international transactions and respective revenue collection. The result of such a scenario, if achieved, has a positive impact on those countries' economies and fiscal balance. In this sense, the analytical framework chosen was based mainly on the examination of the domestic legislation and of the treaty policy adopted by Brazil, India, and South Africa with regard to Article 5, Article 7, and Article 9. Such a task, as carried out in the previous chapters, identified the level

[850] See Chapter 1, Section 1.1.

of influence of the model conventions' provisions that were designed to benefit the host country. The outcomes of this comparative process then enable this thesis to assess the adequateness of a proposal aiming to offer a different approach on taxation of corporate business profits, considering the international tax regime that has the separate entity principle and the OECD's arm's length principle as the underlying framework. Thus, the purpose of the current subsection is to assess the analytical results of the previous chapters through the application of the comparative formula as presented in Chapter 1.[851]

The functional analysis of the compared countries' legal systems can be summarised through the *[a a1 B1]* formula, where "a" denoted a particular problem that Brazil, India, and South Africa, as developing countries, face with regard to taxation of business profits; "a1" represents a particular legal system; and "B1" denotes a particular solution.[852] Of note, the previous chapters examined (i) how the compared countries set up the PE threshold in their domestic legislation and tax treaties, (ii) how they framed their domestic law and tax conventions with regard to the allocation of profits to PEs, (iii) and what are their approaches to taxation of associated enterprises as underlined by the OECD's arm's length principle. The commonalities and differences shared by the compared jurisdictions and the solutions presented by their tax systems are highlighted below, with the solutions to the problems, considering the influence of each model convention on the compared countries' treaties. The formula's results, thereby, answer the research sub-question (i) as put forward in Section 1.3 of Chapter 1: *What is the level of influence of the OECD MC on the compared countries' tax treaty networks with regard to taxation of business profits?*

(i) Granting taxing rights to the host country - the PE threshold

As highlighted in Chapter 3, the treaty parties can choose Article 5 in the OECD MC fashion or adopt a wider PE threshold to follow the UN MC approach. This raises the question of which set of provisions the compared countries included in their tax treaty networks on the matter. The following summarises those countries' solutions:

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[851] See Chapter 1, Section 1.4.

[852] On the functional approach method and respective comparative formula, see Chapter 1, Section 1.4.

Functional formula: (a) How to grant taxing rights to the host country with regard to the enterprise's activities? The Brazilian legal system *(A1)* adopts the OECD MC as a pattern for its treaties in most of the paragraphs of Article 5 *(B1)*,[853] the Indian legal system *(A2)* mostly follows the UN MC on the PE threshold, with the service PE provision appearing in almost 50% of the country's treaties *(B2)*,[854] and the South African legal system *(A3)* is influenced by the UN MC with regard to only Paragraph (3) (a) and (b) *(B3)*.[855]

(ii) The amount of profits to be allocated to the PEs

Once the enterprise presence in the host country is established by the treaty provisions, the next challenge offered to the treaty parties is what amount of the enterprise's business profits should be allocated to the host country. Again, the usual choices are between the OECD MC and the UN MC.

Functional formula: (a) Which profits' amount is attributable to the PE? Brazil *(A1)* follows the OECD MC on Article 7 (pre-2010) *(B1)*,[856] India *(A2)* mostly adopts the OECD MC version of Article 7 (pre-2010), with important deviations observed on the limited force of attraction and the deduction of expenses rules (Paragraphs (1) and (3), respectively) *(B2)*,[857] and South Africa *(A3)* follows the OECD MC (pre-2010), with important deviations on Paragraph (3) though *(B3)*.[858]

(iii) Allocating profits between associated enterprises

The final analysis is related to the taxation of transactions between associated enterprises. Different from the previous analysis, however, the UN MC's provisions in

[853] See 3.3.1 (iii).

[854] See 3.3.1 (i).

[855] See 3.3.1 (ii).

[856] See 4.4.1 (i).

[857] See 4.4.1 (iii).

[858] See 4.4.1 (ii).

Article 9 do not differ to a great extent from the OECD MC's provision, with Paragraph (3) offering a minor deviation. For this reason, the domestic legislations of the compared countries take prominence in the analysis.

Functional formula: (a) What amount of profits connected to transactions between associated enterprises should be allocated to the enterprise in the host country? Brazil *(A1)* totally deviates from both the model conventions since it adopts Paragraph (1) of Article 9 only and, most importantly, taxes such profits through a pre-fixed profit margins system *(B1)*,[859] while India *(A2)* mostly follows the OECD MC since it includes Paragraph 2 in the majority of its treaties; however, important deviations were observed *(B2)*.[860] South Africa *(A3)* also follows the OECD MC approach, with some deviations *(B3)*.

The previous chapters also examined the treaty policy adopted by each country with respect to the most important FDI origin jurisdictions. They focused on the extent of the UN MC framework's influence on Brazil, India, and South Africa's tax treaty networks. Also, when appropriate, they shed light on the domestic regulations on taxation of business profits of cross-border transactions and on the challenges presented before the courts on the treaty provisions' interpretation. Such scrutiny thus provides a first approach to answer the second research sub-question: *Whether and to what extent the adoption of a transfer pricing regulation by developing countries that does not entirely mirror the OECD's one would be convenient for those jurisdictions?*

Even though the analysis on the treaties which the compared countries have signed with important FDI origin jurisdictions shows they followed the OECD MC in some cases, it is important to note the influence of UN MC on some provisions. That is the case, for example, of the policy India adopted with respect to Article 5. The adoption of a UN MC pattern throughout the country's tax treaty network was clear in the paragraphs of Article 5.[861] The scrutiny of the conventions signed with the important FDI origin jurisdictions shows a very similar picture; the UN MC's wording in Article 5 was

[859] See Subsections 5.3.2 and 5.4.1.

[860] See Subsection 5.3.2.

[861] See Subsection 3.3.1 (i)

adopted in the majority of the conventions India signed with those countries.[862] The same can be said with respect to Paragraph (3) of Article 7. Also, it is worth noting that India deviates to a considerable extent from the OECD MC on Article 9 since eight tax conventions with important FDI origin countries do not contain a Paragraph (2).[863]

South Africa's treaty network deviates from the OECD MC in several conventions signed with relevant FDI origin jurisdictions. In fact, its tax treaty network's approach towards the UN MC on the construction PE was replicated in the conventions with those countries, while it adopted a service PE provision in the UN MC fashion in seven treaties in the same list.[864] The Brazilian scenario follows the same approach; Brazil is influenced by the UN MC on the construction PE in the majority of treaties with the top 20 counterparty countries and follows the same convention on the insurance PE in eight of those conventions.[865]

Considering the above, the assumption that the ideal legal environment at the treaty level needed for FDI attraction is the one that aligns with the OECD MC did not materialise at all in the compared countries' treaty networks analysis. The deviations from the OECD MC on the taxation of business profits are not, in many cases, minor ones, and the treaty policy is consistent on several occasions, considering both the compared countries' tax treaty networks and the conventions signed with important jurisdictions where investors are based.

The most striking deviation, however, is observed at the domestic regulation level. One can say that Brazil's domestic legislation does not follow the OECD approach on the allocation of profits to PEs (regarding services without transfer of technology) and associated enterprises; on the latter, at the treaty level, the deviation from the OECD MC is also clear. Nevertheless, in general, the same jurisdictions have invested heavily in the country irrespective of the fact that it adopts a pre-fixed profits margin system. Equally, case law analysis shows that the litigation level on TP issues is relatively low,

[862] See Subsection 3.3.2 (ii).

[863] See Subsection 5.3.4.2.

[864] See Subsection 3.3.2 (iii).

[865] See Subsection 3.3.2 (i).

with cases presented before the courts usually challenging specific deviations occurring at the regulatory level. As shown, there is not an overwhelming discussion in the courts on the TP system (statutory margins included) as adopted by Brazil. As a result, one can conclude that such a system does not pose, automatically, as a clear deterrent for FDI attraction.

One could oppose such a conclusion on the grounds that the deviation from the provisions in Article 9 of the OECD MC[866] and the adoption of a domestic regulation that does not follow the international TP practice are not major issues in FDI since Brazil is a relevant market in which MNEs are willing to do business. Nevertheless, not only the domestic market is relevant for attraction of FDI but also other factors such as the host jurisdiction being a natural resource-rich country (exploration aiming at exports) or its population offering cheap labour force to be explored in specific sectors by MNEs. In both examples, the developing country could, as argued in this thesis, deviate from the international TP practice and, at the same time, benefit from the attraction of investments from MNEs that do not aim at their consumer market.[867]

With that in mind, a lack of alignment with the OECD MC on the taxation of business profits, given the OECD approach on the TP issue, seems to be possible. It seems that a deviation towards the UN MC or another pattern does not, per se, act as a deterrent to the FDI attraction into developing countries' economies. This provides a departing point to the answer to the second sub-question as quoted above.

The next section, while also approaching issues related to the second sub-question, considers how convenient the adoption by developing countries of a tax system that provides for the taxation of associated enterprises in a way that deviates from both the OECD the UN approaches would be. In so doing, it also answers the third and final sub-question: *How can an alternative transfer pricing framework derived from the thesis findings be built up?*

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[866] On the minor mismatch between the OECD MC and the UN MC and on the stance of the UN confirming the OECD's ALP as the standard to be followed, see Chapter 5.

[867] This thesis comes back to this point in Subsection 6.3.1 (i) (identification of the developing country's economic structure) and in Subsection 6.5.2 (examples of application of the proposed TP regulatory design to attribution of profits to PEs).

6.3 Deviating from the Current OECD's TP Framework – A Proposal for Developing Countries

6.3.1 Proposed transfer pricing regulation's design – A resettable pre-fixed profit margins system

Even though the compared countries share a position as jurisdictions that are keen to attract FDI, their TP regulation environments present several constraints when it comes to the taxation of international transactions. Nevertheless, the countries' legal systems and case law analysis above show that, to a certain extent, MNEs face diverse challenges depending on which of those markets they wish to do business with. Such a scenario cannot be viewed in a straightforward manner since the prevailing assumption is that countries that do not show a close alignment with the OECD TP approach are prone to losing leverage in the investment attraction game. It is against this backdrop that a TP framework different from the current ALP approach is put forward. Such a proposal departs from the adoption of a TP regulation having pre-fixed profit margins as its backbone,[868] with the proposal clearly inspired by the critique on the Brazilian experience without entirely mirroring its approach.

It is advocated that, in certain cases, a pre-fixed profit margins system could be more advantageous to both developing countries and MNEs alike than the OECD TP approach. Such an assumption is mainly based, on the one hand, on the need for legal certainty when MNEs face investment opportunities in developing countries' economies. Even though effective tax rates matter,[869] it seems that predictability plays

[868] For a thorough explanation of the Brazilian fixed margins system, which is the departing point of the TP regulatory approach as proposed in this thesis, see Section 5.4.1. The thesis' author published a paper on the Brazilian TP framework in 2014, were the need for a mechanism for the reassessment of the statutory margins was addressed. See Marcelo Ilarraz, 'Drawing upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-fixed Profit Margins or a Third Way?' [2014] B.T.R. 218, p. 233. Also, it is worth noting that Schoueri argues in favour of a proposal (rebuttable fixed margin method) based on the Brazilian system. See Schoueri, 'Arm's Length: Beyond the Guidelines of the OECD' (n 769), p. 706ff. However, the thesis proposal goes beyond both works, for it puts particular emphasis on the regulatory framework based on legislative assessments instruments and on its application also to attribution of profits to PEs.

[869] There are several legal and economic analyses showing that the source countries' tax burden does not always play the most prominent role in foreign investment decisions. In fact, it is part of a set of factors encompassing, inter alia, legal regulation, administrative practices, business conditions, and location-specific profit opportunities. See *Policy Framework for Investment, 2015 Edition* (OECD 2015). This

a more relevant role when companies consider investing in developing countries.[870] On the other hand, from such countries' perspectives, a simplified TP regulation encompassing statutory ex-ante profit margins could assuage the constraints faced by inexperienced tax administrations' personnel, lacking in expertise. Here, the administrative dimension of taxation takes a prominent position since one needs to bear in mind the hurdles to be overcome by tax officials when one is in the process of designing a tax policy that is able to deal with well-settled MNEs.[871]

In this sense, the effectiveness of TP regulation tailored for developing countries should be aimed at the enforcement of TP rules, which could as a result grant a continuous and satisfactory flow of revenue into the countries' coffers.[872] Although a level of tax collection as high as possible matters,[873] it cannot be ignored that highly complex international tax and investment schemes pose a real threat to any revenue collection; the OECD/G20 BEPS project provides a wealth of examples in this respect. Therefore, a regulation focusing on attracting foreign investment while granting a satisfactory level of revenue collection seems to be beneficial for developing countries as opposed to the mere alignment with the OECD approach.

Depending on the jurisdiction peculiarity, the design process of such an entry-level TP framework would display the following characteristics:

OECD's work even highlights the "location-specific profit opportunities" as the most important one among them. ibid, p.58.

[870] See Rogers and Oats (n 4). See also IMF/OECD, *Update on Tax Certainty – IMF/OECD Report for the G20 Finance Ministers and Central Bank Governors* (IMF/OECD 2018). This report points that 'tax uncertainty appears to have a more frequent impact on investment decisions' in African, Latin American, and Caribbean countries in comparison with other factors. P. 26.

[871] On administrative and compliance costs, see Jonathan Shaw, Joel Slemrod and John Whiting, "Administration and Compliance" in Sir James Mirrlees (chair), *Dimensions of Tax Design – The Mirrlees Review* (Oxford University Press 2010) 1106. See also Joel B Slemrod and Marsha Blumenthal, 'The Income Tax Compliance Cost of Big Business' (1996) 24 Public Finance Quarterly 411.

[872] On the increase in the tax revenue in developing countries as a means for a long-run growth, see IMF, *Revenue Mobilization in Developing Countries* (IMF 2011). Available at <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Revenue-Mobilization-in-Developing-Countries-PP4537 > accessed 15 November 2017.

[873] See Richard M Bird and Eric M Zolt, *Introduction to Tax Policy Design and Development* (World Bank 2006). Available at < http://www1.worldbank.org/publicsector/pe/pfma06/page2.htm > accessed 15 November 2017.

(i) Identification of the country's economic structure

The process of designing a TP regulation should include the economic structure of the respective jurisdiction. Developing countries differ from developed ones in this area. For example, based on a wealth of factors such as geography and climate, many resource-rich developing countries[874] rely mainly on the exploration of specific activities such as agriculture or the extractive industry.[875] It is also reasonable to say that the population living in developing countries could be considered potential consumers of goods produced and services provided by MNEs;[876] in some cases, the same population is a source of cheap labour force which is the key to investment decisions in some areas.[877] Therefore, it seems appropriate to assume that these jurisdictions, when attracting FDI into their economies, should be particularly concerned with designing their international tax framework with a focus on specific economic sectors.[878] In doing so, the tax administration and the lawmakers could narrow their analysis to the intricacies of transactions between associated enterprises doing business in such sectors.

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[874] On the international tax issues regarding the extractive industries sector see IMF, *Fiscal Regimes for Extractive Industries: Design and Implementation* (IMF 2012), p. 37-38. Available <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Fiscal-Regimes-for-Extractive-Industries-Design-and-Implementation-PP4701> accessed 15 November 2017.

[875] On the extractive sector as a major source of revenue for many developing countries, see Philip Daniel, Michael Keen, Artur Świstak and Victor Thuronyi, 'Introduction and overview' in Philip Daniel, Michael Keen, Artur Świstak and Victor Thuronyi (eds), *International Taxation and The Extractive Industries* (IMF/Routledge 2017).

[876] It is expected that around 85% of the world population will be living in developing countries by 2030. See United Nations Centre for Human Settlements (Habitat), *Special Session for an Overall Review and Appraisal of the Implementation of the Habitat Agenda* (2001). Available at <http://www.un.org/ga/Istanbul+5/bg10.htm> accessed 10 July 2018. In 2016, fourth fifths of the world population lived in developing countries. See UNCTAD, *UNCTAD Handbook of Statistics 2017 – Population* (UNCTAD 2017). Available at <http://unctad.org/en/PublicationChapters/tdstat42_FS11_en.pdf> accessed 10 july 2018.

[877] On labour costs as an important determinant for FDI, see Jan Hunady and Marta Orviska, 'Determinants of Foreign Direct Investment in EU countries – Do Corporate Taxes Really Matter?' (2014) 12 Procedia Economics and Finance 243. Also on the FDI determinants, with a particular focus on developing countries, see Luiz R de Mello Jr, 'Foreign Direct Investment in Developing Countries and Growth: A Selective Survey' (1997) 34 The Journal of Development Studies 1.

[878] The potential number of MNEs doing business in the country seems to be crucial in this sense. Borkowski points to the relatively low number of MNEs present in specific countries as a factor influencing the absence of profit-shifting assessment by their tax administration. See Borkowski (735), p. 327.

(ii) Setting up pre-fixed profit margins

At first glance, one could say that a pre-fixed profit margins system leads to a high risk of double taxation. The absence of a secondary adjustment provision in a country's tax treaty network as stated by Art 9(2) could even aggravate such a scenario.[879] Such assumptions, although showing some merits, could nevertheless be minimised to a large extent through the tax-designing process. First, the focus on specific economic sectors provides an opportunity to the tax administration and lawmakers for a deeper understanding of and, therefore, expertise in[880] the relevant international transactions. Second, and key for the present proposal, the enterprises investing in a country's economy should play an active role in a transparent process of establishing the statutory profit margins.

With this in mind, a pre-legislative impact study should be carried out in advance of any bill proposed to the legislature providing for the fixed profit margins.[881] This instrument, coupled with public consultation, would enable the tax administration, parts of the developing country government (lawmakers included), and society to engage in the discussion of the appropriateness of the proposed regulatory framework. Also, it is mandatory that the industry representatives and even third parties interested in the matter take part in this prior debate on the appropriate profit margins and assessment methods to be adopted. The conclusions of such discussions should then be made available to the public to strengthen tax transparency. Consequently, not only the TP margins and methods but also factors connected to the fiscal balance of the government,

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[879] On Article 9(2), see Section 5.2.

[880] This is even more relevant since the lack of experience of the tax administration is a factor that discourages developing countries from controlling cross-border transactions' prices. See Borkowski (n 735).

[881] On the impact assessment study as an instrument for the evaluation of regulatory policies, see Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation – Theory, Strategy, and Practice* (Oxford 2012), p. 315ff; Claudio Radaelli and Fabrizio de Francesco, 'Regulatory Impact Assessment' in Robert Baldwin, Martin Cave and Martin Lodge (eds.), *The Oxford Handbook of Regulation* (Oxford 2010), p. 279ff. Also, on regulatory governance in developing countries, see Martin Minogue and Ledivina Cariño, 'Introduction: Regulatory Governance in Developing Countries' in Martin Minogue and Ledivina Cariño (eds.), *Regulatory Governance in Developing Countries* (Elgar Publishing 2006), p. 3ff. On the regulatory impact analysis instrument as a tool for fostering inclusive growth, see Rex Deighton-Smith, Angelo Erbacci and Céline Kauffmann, 'Promoting Inclusive Growth Through Better Regulation – The Role of Regulatory Impact Assessment' [2016] OECD Regulatory Policy Working Papers.

to the projected tax collection, to the country's economic growth,[882] and to the compliance cost involved in the application/enforcement of the TP regulation are subject to scrutiny.

One could oppose the adoption of a pre-fixed profit margin system by certain developing countries (e.g. by low-income economies) on the grounds that such jurisdictions do not count on tax administrations (and on government structure in general) equipped to deal with international tax issues as might be the case of Brazil. Following such an argument, those countries would not be able to carry out economic and fiscal studies and design a TP regulation (based on such work) as the one proposed in this thesis. Nevertheless, the active participation of third parties in the pre-legislative impact study could fulfil such a TP expertise gap between the developing countries' tax administration and the MNEs, e.g. in the case of international institutions such as the IMF, the World Bank, and the UN. Besides assisting developing countries in the TP regulatory design and taking part in the pre-legislative impact study debate, those institutions can also assist their tax administrations on a continuous basis (even training tax officials through tax-tailored courses),[883] resulting in the enhancement of tax administration capabilities.

The analysis of the Brazilian TP regulation and case law provides a scenario worthy of further consideration. From the regulatory perspective, it is often said that the statutory margins encompass a profit range per industry.[884] Nevertheless, the way the profit margins were set up is not completely clear, which hinders the transparency of the design process of tax rules.[885] From the case law analysis, the Brazilian experience shows that the pre-fixed profit margin framework is not a problem by itself. Considering the level of FDI inflow into the Brazilian economy since the enactment of

[882] On the economic appraisal of the introduction of rules, see Robert Baldwin, *Rules and Government* (Oxford 1995), p. 193ff.

[883] For example, through a similar programme as the one offered by the IMF Institute for Capacity Development. See IMF, Capacity Development. Available at <http://www.imf.org/external/np/ins/english/index.htm> accessed 10 July 2018.

[884] See Chapter 10 of the *2017 UN TP Manual* (UN 2017).

[885] The fact that the Brazilian Congress did not discuss the matter during the debates on the bill dealing with TP regulation as proposed by the government is a good example of lack of transparency. See Subsection 5.4.1.

the TP regulation during the late 1990s,[886] one could have expected a far higher level of tax litigation revolving around the statutory margins issue. On the contrary, one of the overly litigated points proved to be the government's approach on taxing the controlled transactions, mainly with regard to the TP methods, in a discretionary way, where they strictly followed the statutory provisions.[887]

Finally, it is relevant to put forward a proposal that could benefit both tax collection and the MNEs' investment decisions. In this sense, and since the present proposal aims to create an adjustable system, it is assumed that the margins should not be established in a way that could clearly lead to double (and unbearable) taxation, which could hinder the foreign investment inflow. Hence the need for a debate on an adequate range of margins. An acceptable, lower level of tax imposition on international transactions would be overcome in the long term by the consistency of revenue collection. From the MNEs' perspective, the pre-fixed profit margins would not prevent them from investment in the country since they could easily plan their tax arrangements in a more predictable and beneficial way in the long term.

(iii) Not a safe harbour regulation

The OECD's TP Guidelines, considering the difficulties presented by the arm's length principle's application in certain scenarios, has considered the adoption of a safe harbour system[888] on the taxation of associated enterprises in certain circumstances.[889] The OECD's work on the topic aimed to provide an assessment on how feasible an alternative TP regulation based on safe harbour rules could be. As a result, the revised 2017 TP Guidelines put forward an alternative that could suit countries with limited administrative resources and,[890] at same time, offer a more predictable tax environment

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[886] See Subsection 5.4.1.

[887] See the TP case law analysis, Subsection 5.5.1.

[888] On the concept of safe harbours as adopted by the OECD, see *2017 TP Guidelines* (OECD 2017), Chapter IV, E2, paragraph 4.101.

[889] The TP Guidelines note the negative view of the OECD on safe harbour rules in its first edition. See ibid, paragraph 4.96.

[890] For the special focus on developing countries of the OECD's work on safe harbours regulation, see "OECD approves the revision of Section on safe harbours in the Transfer Pricing Guidelines". Available

for MNEs to invest. In spite of that, the proposal put forward in this subsection bears no resemblance to the OECD's approach.

First of all, the current proposal of a TP system for developing countries has a mandatory, statutory regulation as its departing point that does not provide for a dual TP system. The OECD's proposal, on the contrary, is based on a system where the taxpayer can choose between a prescribed set of rules and the general TP regulation as applied to all associated enterprises' transactions. In such a context, eligible taxpayers could, at their discretion, pick up the set of rules that favours them the most. As a result, the OECD points out that less complex transactions could be taxed considering a pre-established profit base, which would significantly reduce the compliance burden on the taxpayers.

In fact, since the safe harbour proposal considers an eligible, dual TP system, it does not provide for a simplified regulation that could work for simple and complex transactions alike. On the contrary, a mandatory TP regulation works for both kinds of transactions, preventing a high level of discretion by the companies in cherry-picking the transaction it wants to enter into in accordance with the regulatory menu at its disposal.[891] In addition, the most complex transactions are the ones that pose a higher risk of profit shifting to be faced by developing countries; on the contrary, simple transactions that are easy to comply with do not offer intricate features to be assessed by those countries' tax administrations. Therefore, there is a need for a single system where tax administrations from developing countries can deal with all sorts of transactions under the same regulatory framework. This would also offer an opportunity for the administration personnel to enhance their capabilities in assessing TP issues over time.

Finally, the current proposal does not create an unequal scenario for taxpayers under the same circumstances. Again, the lack of discretion at the taxpayer's disposal on

at <http://www.oecd.org/ctp/oecd-approves-revision-section-e-tp-guidelines.htm> Accessed 1 October 2017.

[891] The OECD even identifies a potential opportunity for tax planning in the safe harbour environment: "For instance, if safe harbours apply to 'simple' or 'small' transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small". *2017 TP Guidelines* (n 885), Chapter IV, E.4.3, paragraph 4.122.

adopting a particular system plays a crucial role. All companies dealing with their foreign enterprises should comply with straightforward, statutory pre-fixed profit margins irrespective of the nature of the transactions and the taxpayer's condition.[892] Equally, a scenario where only a group of taxpayers could be singled out to enjoy the benefits of a separate set of TP rules could lead to a higher risk of corruption in the developing countries' tax administrations. Once more, there is a need for a set of rules at the statutory level that binds all those involved into transactions with associated enterprises, where the trade-offs between the companies and the government linked to the setting up of the profit margins take place via a transparent legal instrument, as above.

(iv) APA-like instrument: A unilateral reassessment agreement

The possibility of a company being overtaxed, coupled with the risk of double economic taxation, would be one of the strongest critiques against the adoption of a pre-fixed profit margins framework. To address this risk, the proposed TP regulation should provide for an instrument for the reassessment of the statutory margins and, if that is the case, the methods allocated to each industry's transactions. To some extent, this instrument resembles the APA, as put forward by the OECD and adopted by several developing and developed countries alike.[893]

The fact that domestic legislation provides access to an APA-like instrument is, in general, beneficial to the taxpayer. An agreement between the taxpayer and the tax authority/authorities, offers a greater level of certainty, where there is a certain level of controversy regarding the prices adopted by the associated enterprises. Therefore, it favours the taxpayer's long-term business planning, thus affecting investment decisions and the predictability of the tax authority's position on the matter.[894] Other significant

[892] The OECD also identifies competitive distortions as a possible negative outcome of the safe harbours rules. ibid, E.4, paragraph 4.110.

[893] For the definition and concept of advance pricing agreements, see the *2017 OECD TP Guidelines* (n 885), Chapter IV, F1, paragraph 4.134ff.

[894] On the benefits of the APA, see Michelle Markham, *Advance Pricing Agreements: Past, Present and Future* (Kluwer Law International 2012). The author points out to the certainty provided by the APA, which provides a remarked benefit to risk-averse companies. ibid, p. 282. Also, M Michelle Markham,

characteristics that favour its adoption are coordination with the authorities' views (bilateral/multilateral options) on the companies' transactions, mitigation of the litigation risk and related costs,[895] foreseeable legal compliance since the APA has a time-based validity, and the fact that the TP issues are dealt with between experts from both the sides of taxpayers and tax administrations.

Conversely, there are some disadvantages of APA adoption. APAs are regarded as resource-intensive, time-consuming instruments. Also, the process of information disclosure to the tax authority could lead to a non-intended outcome since data and documentation previously provided by the taxpayer could support late tax investigation.[896] Such results could even be aggravated in cases where bilateral/multilateral APAs involve developed and developing countries. Tax administrations of developing countries would most probably not have access to sensitive information unless provided by such APAs,[897] which could put the MNEs in a disadvantageous position.

The current proposal circumvents the hurdles in providing for a reassessment of the statutory margins and methods allocated. This adapted form of APA (its denomination being immaterial) is unique at various points. First of all, its departing point should be the circumstances connected to the study carried out previously on the statutory margins set up.[898] As the statutory margins and methods were reached through a previous collaborative debate on their conformity with possible scenarios, the information analysed should support an ex-post price agreement. Consequently, the complexity, time of negotiation, and costs involved are mitigated beforehand. This also diminishes the risk of a possible lack of expertise of the tax administration since it will be furnished with data and documentation on the respective industry's intricacies in advance.

'The Advantages and Disadvantages of Using an Advance Pricing Agreement: Lessons for the UK from the US and Australian Experience' (2005) 33 *Intertax* 214.

[895] Markham refers to it as the compliance lock-in. Markham, *Advance Pricing Agreements* (n 891), p. 285.

[896] ibid, p. 289.

[897] ibid, p. 288.

[898] See 6.1 (ii).

Second, it will not be necessary to carry out a thorough examination of the taxpayer's data and documentation. Again, as the tax administration already has enough information of the economic market under analysis, it is possible that the margins and/or methods of the reassessment process would point to specific issues; such a characteristic would diminish the taxpayer's information exposure and narrow the tax administration's focus of attention.

Third, it will be a unilateral instrument. The aim is to provide a less complicated, straightforward enforceable instrument. Participation of third parties could easily complicate the reassessment of margins and methods.[899] Occasional concerns with double tax incidence could be easily addressed by the parent company (usually a resident of a developed country). In fact, considering the way the current proposal is framed, this risk is greatly minimised. The same goes for a third party (usually a developed country) concerned with the shifting of profits that should otherwise have accrued to the parent company.

Finally, it is worth pointing to the need for a certain degree of flexibility when it comes to a possible change of the statutory provisions. The unilateral agreement instrument could either (i) have an effect similar to that of the APA, i.e. it can provide for the reassessment of the profit margins/methods prospectively, for a specific time period, enforceable on just one taxpayer, or (ii) lead to a change in the statutory margins and methods affecting an entire economic sector. Both outcomes will keep the country's tax policy in line with an intended regulatory framework that values the legal predictability, thus being beneficial to the attraction of FDI.[900] Such design flexibility depends purely on factors such as the size of the developing country's economy, the economic activities it relies on, and the number and characteristics of the MNEs doing business in the country in connection with a particular industry. Either way, it maintains its positive features.

[899] According to the OECD TP Guidelines, an APA can be negotiated between the taxpayer (and the respective associated enterprise(s)) and 'one or more tax administrations'. See the *2017 OECD TP Guidelines* (n 885), Chapter IV, F1, paragraph 4.134.

[900] Such scenarios provide certainty even for the continuity of the FDI inflow, preventing surprises on the establishment of transfer prices after massive investments in the county. On similar APAs' effects, see Johannes Becker, Ronald B Davies and Gitte Jakobs, 'The Economics of Advance Pricing Agreements' (2017) 134 *Journal of Economic Behavior & Organization* 255.

(v) Post-legislative scrutiny instrument

In addition to the lack of a clear and efficacious procedure for the revision of the profit margins at the taxpayer's end, which could avoid occasional excesses leading to double taxation, the absence of mechanisms of assessment of the TP framework in the developing host country could also lead to unforeseen, undesirable outcomes. The way in which the Brazilian TP regulation was framed shows a clear level of arbitrariness in relation to the margins adopted; the same can be said with regard to the methods chosen for each economic sector. Thus, there is a need for the domestic legislation to be designed in light of the insights provided by a previous regulatory impact assessment instrument, as proposed in Subsection 6.3.1(ii). However, the dynamics of the economic sectors targeted by the tax legislation and the untested level of profits legally attributed to the international transactions, coupled with technical constraints the tax administration could face, can cause a distortion in the revenue collection and regulatory outcomes desired by the lawmakers and the government. In this scenario, the provision for a post-legislative scrutiny instrument as an integral part of the TP legislation comes to the rescue.

Although adopted with more emphasis during the last decades only, the retrospective scrutiny of the legislation's effects is not a novelty at the national and international levels. Once a regulation is enacted, a substantive analysis of the outcomes pursued by the legislation should be an integral part of the legislative methodology adopted in a given legal system.[901] Such an evaluation can have as a starting point the critical examination of the legislation's regulatory and economic outcomes weighed against its goals as put forward by the pre-legislative impact assessment. In fact, one can even point to a direct link between the prospective and the retrospective evaluation of those

[901] Luzius Mader, 'Evaluating the Effects: A Contribution to the Quality of Legislation' (2001) 22 *Statute Law Review* 119. Mader identifies the retrospective evaluation of legislation as the seventh out of the eight analytical steps for a methodical approach on elaborating normative contents; the final one relates to the adaptation of legislation on the basis of retrospective evaluation. ibid, p.122.

results since they are complementary.[902] In this sense, the post-legislative scrutiny instrument works as a tool for determining whether the assumptions put forward by the pre-legislative study materialised and, if so, whether the outcomes are actual consequences of the legal provisions in force. In doing so, from a policy evaluation point of view, one can assess the (positive and negative) effects of the theoretical framework chosen by the lawmakers and the quality of the legislation enacted on the matter. Consequently, if this is the case, an amendment in the legislation can be proposed to ameliorate the particular regulation.

The adoption of such a proposed instrument tackles, to a great extent, the flaws identified in Chapter 5 with regard to the Brazilian TP pre-fixed profit margins system. From the taxpayer (and the society in general) perspective, the lack of transparency and lack of a well-designed, effective instrument at hand allowing the statutory profit margins to be refuted at the taxpayer's initiative seem to be the most prominent flaws. On the other hand, the absence of continuous analysis of the adequacy of the TP regulation by the government can hinder the establishment of an efficient legislation. Thus, we see the benefits of a proposal that allows the statutory margins to be reset and, at same time, offers an opportunity to the governmental bodies (as the tax authorities and Ministry of Finance) to enhance their technical capabilities through the analysis of the regulatory and financial outcomes.

The implementation of a retrospective scrutiny instrument in the TP arena, coupled with prospective impact assessment and the instrument to reset the statutory margins, turns the TP domestic regulation full circle. The present proposal is formulated considering three different stages that are essential for a TP system, as put forward throughout this Chapter.[903] The first stage relates to the definition of the TP framework to be adopted

[902] The link between the pre-evaluation report and the post-legislative review is also stressed on for the regulatory activity in the UK. See Lydia Clapinska, 'Post-Legislative Scrutiny of Legislation Derived from the European Union' (2007) 9 *Eur. JL Reform* 321, p.340.

[903] Mader identifies eight analytical steps for the elaboration of normative contents. The present proposal draws on Mader's approach when it identifies the stages for the formulation of a TP regulation. On the eight steps, they are: (v) the enactment of the legislation, (vi) the implementation of the legislation, (vii) the retrospective evaluation, and (viii) the adaptation of the legislation (when necessary). Mader (n 49).

by the developing country. In this phase, the role that specific economic sectors play in a country's economy should be evaluated. Equally, the particularities of a country's legal system, its tax administration capabilities, desired FDI inflow, and target tax revenue collection linked to those sectors' international transactions should be considered. As a result, the adequate normative instrument (and respective characteristics) is chosen, the legal provisions are designed, and a bill is presented before the legislature.[904] The second stage refers to the enactment of the TP regulation and its implementation. Once the bill is approved,[905] the adequacy of the regulation is exposed to a check since it can be measured against the tax levied on international transactions.[906] In other words, it is only in the implementation phase that one can identify whether the statutory margins in fact mirror, or are below, the ones of the actual transactions. Here, the instrument for margin resettlement plays a prominent role. The requirements by either a particular taxpayer or by taxpayers representing a specific economic sector provide a continuous assessment opportunity to the tax authority on the regulatory outcomes.

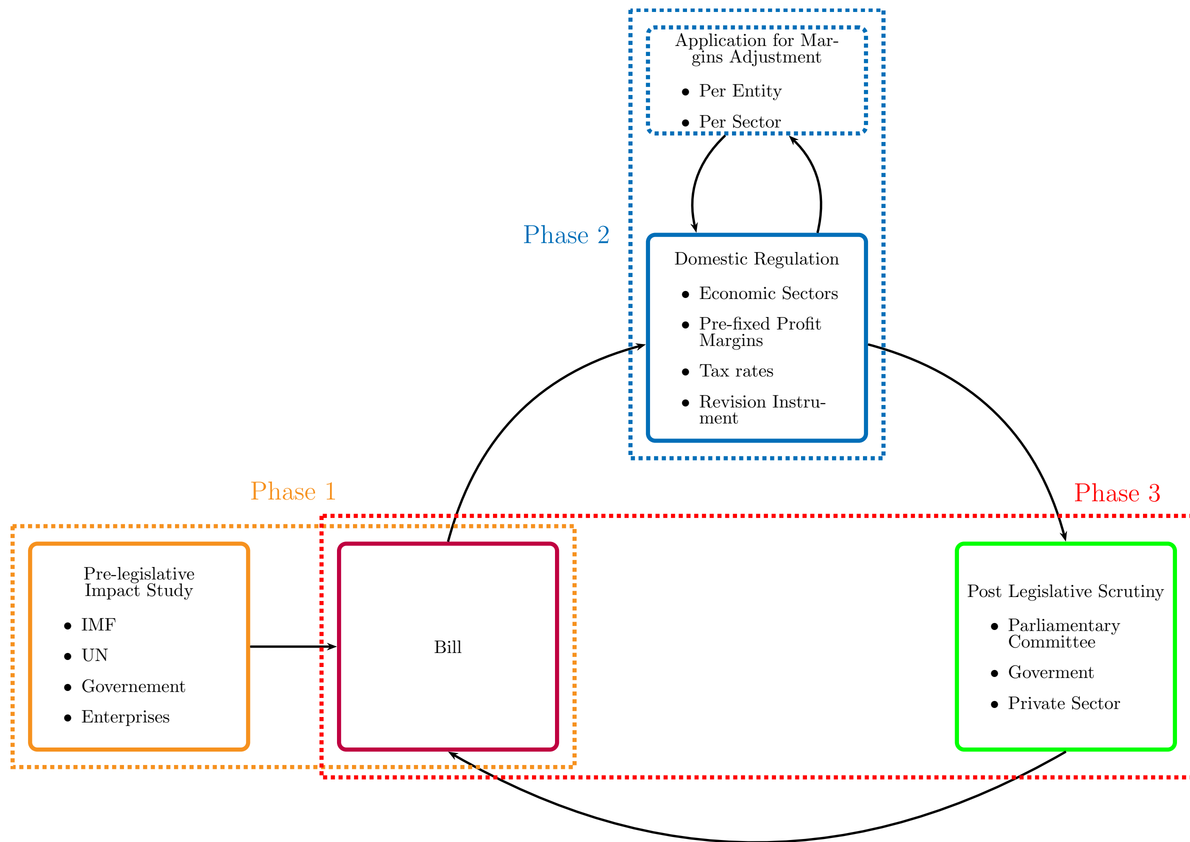
Finally, the third stage encompasses the implementation of the retrospective assessment instrument and, when necessary, the proposal for amendments of the legal provision. Furthermore, the first stage is initiated again and the process of evaluation of the efficiency of the TP regulatory framework follows all over again.

[904] This stage encompasses the first four analytical steps: (i) the analysis and definition of the problem to be solved, (ii) the determination/clarification of the goals to be achieved, (iii) the examination of the instruments or means to solve such problems and the election of a specific one, and (iv) the drafting of the legislation. Mader (n 898).

[905] The term "approved" is used here in its general meaning, encompassing both the passing of the bill in the legislative body and the respective approval by the executive body, if that is the case.

[906] This stage encompasses the fifth and sixth steps: (v) the formal enactment; and (vi) the implementation. Mader (n 898).

Figure 6.1: Post-Legislative Scrutiny Instrument



In terms of accountability, it is worth mentioning that the post-legislative scrutiny process offers the legislature and the government an opportunity to check how achievable the goals put forward by both the legislative committees and tax administration were when assessing the need for a new legislation. The outcomes of the TP regulation can then act as a proxy on how inconsistent a particular set of rules were when intending to tackle the problems identified previously by the prospective assessment.[907] The transparency in the legislative process is then enhanced, which helps prevent high-level corruption and interference of the private sector in public affairs.

As a final note on the topic, it is relevant to point out that the results emerging from such scrutiny should, most probably, not recommend an entire review of the TP legislation. In fact, some data on the level of acceptance of recommendations coming from post-legislative analysis in some jurisdictions suggest that the most part of the

[907] See Subsection 2.2 (i) and (ii).

recommendations are aimed at small- or medium-scale action.[908] Those categories are also the most successful ones when measured by their adoption by the government.[909] Consequently, once again, a TP regulatory process that starts with a prospective analysis of the problems and goals is important for a continuous/on-going assessment of the profit margins (when required) and culminates with a retrospective scrutiny of the results achieved. Such a proposal elevates the importance of the design to be applied to the regulation and to the margin ratios as set up by the legislation. With a complete reshuffle of the TP regulation being less likely, the room for improvement in the TP provisions seems to relate to minor adjustments. Thus, it is in the interest of all stakeholders that the taxation of associated enterprises is implemented as accurately as possible from the outset, which in the end gives the desired predictability in the field.[910]

(vi) Possible entry-level, provisional framework

The implementation of the current proposal should also consider a scenario where the developing country experiences a (positive) change in its economic scenario along the years. In this sense, it could pose as an entry-level, provisional framework that lays down the fundamentals for the TP regulation, with or without a pre-set timeframe. Nothing in the proposed TP framework deters a country, after a careful assessment of the reasons for adopting such a regulation model and its outcomes, from moving towards a model closely aligned with the international tax practice, i.e. towards the OECD's TP approach. After years of exposure to a more practical, simplified TP regulation as the one proposed herein, it seems safe to assume that a country's tax administration body would get used to the complexities involving cross-border

[908] This is the case for the UK, where those categories account for approximately two-thirds of the recommendations. On the topic, see Thomas Caygill, 'Post-Legislative Scrutiny: What Recommendations Are Committees Making, and Are They Being Accepted?'. Available at: <http://blogs.lse.ac.uk/politicsandpolicy/post-legislative-scrutiny-strength-of-recommendations/> accessed 17 December 2017. The author breaks his analysis of the strength of the recommendations into six categories, as follows: No Action, Small Action, Medium A Action, Medium B Action, Medium C Action, Large Action. ibid.

[909] The same dataset shows 39% of the recommendations being accepted, with a very reduced percentile attributed to the Large Action category. ibid.

[910] Some factors are suggested as reasons for weaker recommendations resulting from the pre-legislative scrutiny: internal political compromise, seeking compromise with the Government, and lack of evidence. ibid.

transactions. As a result, a better-trained tax administration is expected to emerge in such a country, which allows the implementation of a more complex ex-post TP regulation.

The adequacy of such changes, however, depend on a series of factors besides the tax authorities' capacity. A change in the country's economic mix and possibly accelerated GDP growth are a few of them. Also, the country's perception of a closer alignment[911] with the international tax practice could be another factor.[912] Nevertheless, a resettable pre-fixed margins system could be able to offer an adequate TP regulation in all the above scenarios since none of them would affect the proposal's positive features. Additionally, a possible lock-in effect could be envisaged, since the adoption of the proposed regulatory framework aims to achieve the intended level of revenue collection and low legal compliance cost at the same time. As a result, this could lead to a choice in favour of the maintenance of the previously adopted regulatory framework in detriment of one fully patterned after the OECD's approach.

6.3.2 The usual suspect: Benefits of the proposed TP framework vis-à-vis the formulary apportionment option

Apart from weighing the proposal against the current OECD's ALP system, a comparison can also be drawn between a resettable pre-fixed profit margins method and the formulary apportionment (FA) alternative. One can say that FA has been the usual alternative to the OECD's separate entity accounting approach for a long time, with its advocates usually pointing to its fairer allocation of profits between jurisdictions than the ALP.[913] The rationale behind the FA proposal is that the taxation

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[911] It is relevant to note that, from the lack of alignment perspective, Brazil's TP system is a possible deterrent to the country's accession to the OECD. On the matter, see Sony Kassam and Alex Parker, *Brazil's Tax System is a Barrier to the OECD Membership*, Bloomberg BNA's International Tax (30 August 2017). Available at <https://www.bna.com/brazils-tax-system-n73014463878/> accessed 10 September 2017.

[912] This is the case, e.g. for developing countries' aiming for accession to the OECD. Mexico is a good example of a country that went through a closer alignment with the international TP practice after its accession to the OECD. On the current country's TP regulatory landscape, see the *2017 UN TP Manual* (n 881), section D.4. Mexico Country Practices, p.603 ff.

[913] Avi-Yonah describes the critics on the FA system, and points to possible answers, while proposing the adoption of a kind of FA-based formula able to allocate residual profits. See Reuven S Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation' (2010) 2

of international transactions under such a framework would, presumably, better mirror the value creation in host countries, which would act as a deterrent for profit shifting opportunities.[914] In its essence, the FA alternative aims to allocate MNEs' profits through a pre-determined formula consisting of a set of combined elements such as costs, assets, payroll, and sales.[915] Such elements would be considered on a global level, thus allowing MNEs and tax authorities alike to identify the respective profits to be allocated to a particular jurisdiction.[916]

Bearing in mind its peculiarities and the fact that it completely deviates from the separate entity accounting method, it is not surprising that the OECD entirely disregards the FA as a feasible alternative to the current ALP system. Among its main arguments, the OECD points out that a global FA method would fail in preventing double taxation of international transactions since coordination between a large number of jurisdictions would be almost impossible to achieve; the same goes for the consensus required on the elements of a predetermined formula to be adopted by the MNEs.[917] The arbitrariness of a formula would lead to a disregard of the particular circumstances of the taxpayers, the market conditions, and the international transactions they enter into.[918] Also, its adoption would not bear in mind geographical differences and each company's efficiency.[919] Finally, the OECD points out that adopting an FA method would increase the compliance costs since the MNEs' data and information should be

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WTJ 3, p. 10 ff. See also Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56 Bull Intl Taxation 586.

[914] On a proposal for a unitary approach in the TP field and the benefits of a formulaic allocation of profits system, see Sol Picciotto, *Towards Unitary Taxation of Transnational Corporations* (Tax Justice Network 2012).

[915] For an assessment of the FA proposal, and additional alternatives, against the OECD's ALP, see Collier and Andrus (n 19), p. 282ff. Also on other proposals, see François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just don't Say Formulary Apportionment)' (2005) 53 Canadian Tax Journal 409; Lorraine Eden, 'The Arm's Length Standard – Making It Work in a 21st-Century World of Multinationals and Nation States' in Thomas Pogge and Krishen Mehta (eds), *Global Tax Fairness* (Oxford 2016).

[916] On the basic characteristics of the FA alternative, see the *2017 OECD TP Guidelines* (n 885), p. 39 ff.

[917] See Avi-Yonah (n 910).

[918] *2017 OECD TP Guidelines* (n 885).

[919] ibid, 1.29, p. 42.

considered on a global basis, resulting in a more burdensome approach in comparison with the separate accounting approach.[920]

Even against this background of FA as an alternative to the OECD ALP, one can determine how appropriate the adoption of a resettable pre-fixed profit margins system would be for developing countries. First of all, the current proposal does not intend to be a disruptive shift in the international tax regime; on the contrary, it takes as a starting point the current state of affairs. Unlike the FA case, the proposal is not meant for adoption at the global level, leading to the replacement of the ALP throughout. It aims, in fact, at the taxation of controlled transactions in developing country jurisdictions (also as an entry-level system) without the need for adoption by a third country. This framework allows such jurisdictions, when and if needed, to shift towards a fully-fledged OECD ALP model of taxation once it has all the administrative capabilities in place. Also, the same shift would be possible in case the country decides the pre-fixed margin system is not workable in its legal and market environments. In both cases, the developing country would have as a starting point the OECD ALP without setting out any disruptive approach.

Second, a worldwide consensus on the margins is not required whatsoever. Different from the FA method, there are no formulary elements to be agreed upon among jurisdictions. As mentioned above,[921] the pre-fixed profit margins are reached through an analysis carried out during a time period before the enactment of the TP statutory rules, with the participation of the industries' representatives and tax authorities. Other features connected to the TP regulation are also part of this discussion, as in the case of the methods to be allocated to diverse market sectors (if that is the case). As a result, there is no need for the inclusion of other jurisdictions' representatives into this debate.

Third, the industry participation argument also favours the proposed framework regarding the analysis of the taxpayers' circumstances, market conditions, and geographic differences of the countries where the MNEs engage in business. All these factors are assessed in advance while the margins are discussed between the parties,

[920] ibid, 1.27, p. 42.

[921] See subsection 6.1, point ii.

providing the taxpayers with an opportunity to put forward the market peculiarities and other characteristics they believe would affect the pricing of international transactions. Such collaborative action prevents occasional distortions in the profit margins.

In addition, a TP study carried out previously on the enactment of the statutory regulation[922] could serve as a base for future changes in the margins if that were the case. This serves as a safeguard against the risk of double taxation. Nevertheless, one can always point to the double taxation risk in a critical manner in order to disapprove any proposal deviating from the OECD's ALP. The present proposal, however, deals with such risks since the margins are to be set in a low-key manner. Once more, the margin revision possibility is paramount in securing a system that does not cause economic double taxation.

A final note on the legal compliance costs needs to be put forward. The OECD argues that the adoption of FA would lead to a more burdensome compliance requirement. The reason behind such an assumption is that the MNEs would be required to consider their worldwide operations when allocating profits to a particular jurisdiction. A resettable profit margin system would, however, have an opposite outcome. Since the TP statutory provisions, profit margins included, are set beforehand, this system ensures relaxed regulations for the MNEs to comply with. Also, the need for the analysis of factors involved in international transactions is limited to the developing country's jurisdiction. These features prevent high costs from being incurred by the taxpayers, considering the occasional reassessment of transaction prices by the tax authorities. Two factors can be highlighted as supporting this assumption: first, the proposal is designed, to a great extent, in such a way that it prevents discussions on the enforcement of rules;[923] second, in the case of disagreement on the transaction profits, the MNEs would already have the TP study and respective documentation at hand, again reducing the need for further costs to be incurred.

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[922] See Section 6.1, item ii.

[923] On one hand, the Brazilian experience can be referred to as an example where a similar regulation leads to a low level of discussion on the interpretation of TP rules. On the other, the Indian experience presents a high level of litigation and uncertainty on the interpretation of the TP rules. See Subsection 5.4.2.

6.4 Consistent Application of TP rules: The ALP at the Treaty Level and the Current Proposal

6.4.1 Benefits of the alignment of the domestic regulation with Article 9

Either a system built upon an already existing regulation based on the OECD ALP or an entirely new TP regulation would benefit from Article 9 embodying the current proposal. The risk of double taxation would be greatly minimised if the developing country enters tax conventions that grant taxpayers the ability to challenge the profit margin, which would lead to a possible adjustment in the statutory provisions. Even though the proposal is for a system with lower statutory margins than the average of the specific industry ones,[924] both treaty parties would benefit from a provision stating the need for an APA-like instrument to be at the taxpayer's disposal.

On the one hand, from the MNE's country of residence perspective, such an approach, with respect to Article 9, would prevent the host country from implementing an ill-designed legislation that could financially harm the associated enterprises. The Brazilian experience is a good example in this regard. Even though Brazil does not follow both the UN and OECD model conventions since its tax treaties do not contain a provision granting the right to secondary adjustment as stated in Paragraph 2,[925] the sole analysis of its tax treaty network could lead to the adoption of the ALP's core concept. It is the analysis of the country's domestic legislation though that brings to light the complete dissociation of its TP regulation from the principles guiding the arm's length standard, and it is at the domestic level that the problems with the Brazilian approach arise.[926] In this sense, one could even conclude that the country's domestic regulation is in constant breach of Article 9; the case law challenges and the fact that Germany has denounced its tax treaty with Brazil also on the grounds of the breach of Article 9 corroborate this assumption.[927] Article 9 allows the host country to implement a pre-fixed margin system and, at the same time, provides for an instrument to reset the

[924] Subsection 6.1, point ii.

[925] See subsection 4.1.

[926] See Subsections 5.1 and 5.4.

[927] ibid. On the tax treaty with Germany, and its termination, see Chapter 2, footnote 143.

statutory margins which would prevent the double taxation of profits that should be otherwise allocated to the parent company. In doing so, this proposed provision would keep the developing country's domestic legislation in line with the rationale underlying Paragraph 1 of Article 9.

On the other hand, from the developing country perspective, a coherent legal system providing for an approach to Article 9 in such a fashion would increase legal certainty.[928] The interpretation of the treaty provision would provide foreign investors with a scenario where the domestic legislation cannot set pre-fixed profit margins without statutorily allowing their revision at the same time, which also favours the courts' enforcement of the treaty rules on taxation of international transactions. In doing so, the domestic TP regulation and the country's tax treaty network as a whole would be more beneficial for attracting FDI with regard to the level of legal certainty.

6.4.2 An alternative at the treaty level

One cannot find a substantial divergence between the OECD and the UN on the approach adopted with regard to Article 9; in fact, the inclusion in the UN MC of Paragraph (3) does not present a significant deviation from the OECD MC. Nevertheless, the boldest stance the UN has taken with regard to the application of the arm's length principle has been, to a great extent, the inclusion of Chapter 10 (Country Practices) into its 2013 UN Practical Manual on Transfer Pricing for Developing Countries. Even the struggles facing the developing countries and emerging ones with respect to the application of TP rules were recognised. Additionally, the UN TP Manual considered that the countries' experiences provided for by Chapter 10 could be of interest to other countries.[929] Despite such an approach, the UN TP Manual did not put

[928] This thesis adopts the meaning of coherence as put forward by MacCormick: 'Thus the coherence of norms (considered as some kind of a set) is a matter of their "making sense" by being rationally related as a set, instrumentally or intrinsically, to the realization of some common value or values. This is also expressible as a matter of fulfilling some more or less clearly articulated common principle or principles.' Neil MacCormick, *Rhetoric and the Rule of Law: A Theory of Legal Reasoning* (Oxford University Press 2005), p. 193.

[929] Chapter 10's section on Brazil even put forward a few recommendations for countries willing to adopt a similar system as the one followed by Brazil. See *2013 UN TP Manual* (n 751), Chapter 10, 10.2.9, p. 372ff.

forward a clear option for the application of TP rules at the treaty level.[930] On the contrary, both the UN MC and the UN TP Manual endorse the OECD ALP.[931]

Considering such a scenario, it is unlikely that the UN MC, let alone the OECD's one, would adopt some wording in Article 9 that deviates to a considerable extent from its the current design. Therefore, the alternative seems to be the design of a possible protocol that developing countries could include in their conventions. The adoption of such a rule could avoid hindrances to the amendment of the model conventions and, most importantly, offer a higher level of legal certainty with regard to the interpretation of the treaties' provisions.

This protocol could function on two fronts: first, it could clarify the way profits should be allocated to enterprises in the host country via the pre-fixed profit margins; second, the protocol could establish that the taxpayers should be allowed to require the statutory profit margins to be revised by the tax authority and even establish the rough design of such a rule. On the one hand, a protocol designed in such a way would prevent challenges from arising before the courts against the pre-fixed profit margins; on the other hand, foreign investors would be provided with a more predictable legal environment, considering the tax provisions on the taxation of associated enterprises.

One could object to such a proposal on the grounds that as the pre-fixed profit margin system does not align with the OECD's arm's length standard, a protocol as mentioned above would not fit the interpretation of Article 9. However, the international practice on allocation of profits to PEs acts as a counterargument in this case. The wording of Paragraph (4) of Article 7 is a clear example where it considers the application of a formulary method in the allocation of profits to PEs, as contained in Article 7.[932] As put forward in Subsection 6.3.1, the present proposal does not pose as a disruptive system to be adopted by developing countries on TP regulation. Just to the contrary,

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[930] On the issue, see Jens Wittendorff, 'U.N. Transfer Pricing Manual - The Choice Between International Consistency and Conflict' (2012) 5 Tax Notes Intl 569. p. 575-6.

[931] See the *2013 UN TP Manual* (n 751), Chapter 10 – Country Practices, 10.1. Preamble by the Subcommittee on Transfer Pricing: Practical Aspects, 10.1.1, p. 357. The same position is noted in the 2017 edition of the UN TP Manual (n 881), p. 525.

[932] For the inclusion of Paragraph (4) of Article 7 (OECD MC pre-2010) in the compared countries' tax treaty networks, see Subsection 4.2.4.

the way it is designed, with a workable instrument allowing the statutory margins to be reset in case they do not reflect the actual transactions' profits, allows its application pari passu with the ALP.

6.4.3 An addition to the Commentaries and to the OECD TP Guidelines and UN TP Manual

Finally, on this point, developing countries and investors based in developed countries would also greatly benefit from an addition in the OECD's and UN's work on explanations of TP, endorsed by those organisations, on the application of a pre-fixed profit margin system as proposed in this thesis. On the one hand, from the developing countries' perspective, they would offer guidance on how to implement such a TP framework, with even a template on how to design the domestic regulation included in the UN TP Manual, for instance. Considering the relevant role played by the commentaries and the OECD TP Guidelines and UN TP Manual on the field, such an approach would set the rough boundaries for the regulation to be adopted, which would also offer material from which the courts could draw conclusions on the taxation of associated enterprises. On the other hand, from the investors' perspectives, such a guidance would offer information on how to comply with the domestic legislation. Again, given the relevance of such documents, this would help achieve legal certainty on the interpretation of TP rules.[933]

6.5 Uncharted Waters: The Proposal's Application to the Allocation of Profits to PEs

6.5.1 – Appropriateness of the current proposal to the PE issue

The question whether this proposal applies to the attribution of profits to PEs is of uttermost importance. In order to provide for a coherent approach to the separate entity principle, the domestic law of the source country could apply, if not an identical set of

[933] On the importance of the UN MC's Commentaries as an aid to the conventions' provisions interpretation, see Baker, *Double Taxation Conventions* (n 10), Introductory Topics, A.10, A-6.

rules, a similar set of tools to attribute profits as it is framed for the taxation between associated enterprises. This is even more evident after the evolution of the principles applied to the attribution of profits to PEs in the last decades, with a stronger emphasis on the AOA as adopted by the OECD MC.[934] The nature of the arm's length in the context of the PEs is not addressed at this stage.[935] Therefore, an in-depth analysis of discussions surrounding the possible different nuances on the arm's length principle in the application of Article 7 and Article 9 is out of the scope of the present thesis.[936]

Brazil's experience does not provide an insight to the application of the TP predetermined profit margin system with regard to the allocation of profits to PEs. Also, the issues observed in the Brazilian case law mostly refer to taxation of services without transfer of technology, which the domestic legislation treats under the concept of other income as in Article 21.[937] Nevertheless, it seems that the current proposal could also work for the taxation of PEs in developing countries.

All the elements included in the TP pre-fixed profit margins regulation could act as a source for the taxation of PEs in the host country. As such, in case a taxpayer understands the inadequacy of profit allocation through the margins as set up by the TP domestic regulation, it can require their adjustment via the same instrument used for the reassessment of the margins as in the case of taxation of associated enterprises. Such reassessment could, if that is the case, attribute profits to the PE within the limits of the profits it would have earned at arm's length.[938] They can depart from the TP studies produced prior to the enactment of the legislation and weigh their transactions against the information provided. As a consequence, the taxpayer can rely on legal guidance

[934] On the AOA and the analysis of the compared countries' tax treaty networks on the issue, see Subsection 4.3.1.

[935] In this respect, see Chapter 1 on the election of the analysis of Art 7 and Art 9.

[936] On the arm's length principle as contained in Art 7 (2) and Art 9 and the possible different nuances of it, see Kasper Dziurdź, 'Attribution of Functions and Profits to a Dependent Agent PE: Different Arm's Length Principles under Articles 7(2) and 9?' (2014) 6 WTJ 135.

[937] On the treatment of fees for technical services without transfer of technology in Brazil and the allocation of profits to PE in such cases, see Section 4.3.

[938] In this sense, the present proposal bears in mind the rationale that underlies the PE concept, i.e. the fact that the host country should be allowed to tax the profits of the PE within the limits of the risks assumed and assets used. On the fundamental rationales behind the PE concept, see the *2010 OECD Report* (n 453), B-2, p. 13.

that presents a higher level of legal certainty, while the tax administration can avoid the administrative burden of ex-post examinations of functions performed, risks assumed, and assets used; the Indian case law offers a glimpse on how complex litigation on the allocation of profits to PEs through the arm's length principle can be.[939]

The current proposal also tackles the issue of allocation of profits to PEs in case of furnishing of services without transfer of technology. Once more the key element here is the rebuttable instrument at the taxpayer's end.[940] The TP pre-fixed margin can work as a benchmark for the allocation of profits to PEs in the case of services furnished by the head office. In case the taxpayer disagrees with such an allocation, he can request a revision of the margins as above. This helps prevent the negative effects of taxing of gross income as in the case of the incidence of WHT[941] adopted by Brazil.

A thorough and clear regulation on the presence of the PE in the host country (which is not the case with the Brazilian legislation)[942] and the lack of an overwhelming level of red tape applicable to the setting up of PEs in developing countries (again, not the Brazilian case), coupled with a legal framework as the one proposed in this chapter, are able to deter the 'avoidance of PE' approach to the taxation of fees for technical services without transfer of technology. Such a regulation renders the adoption of a policy that taxes those fees under Article 12 (coupled with Article 21) of the UN MC irrelevant. Once the remuneration for such services and the PEs' profits in general are taxed under such a proposed framework (similar approach for both), the choices for profit shifting via service agreements and the reasons for protecting the tax base of the host country through the adoption of WHT in such cases are not sustained.

The following examples shed some light on the possible applications of the attribution of profits framework based on the proposal in this chapter. In order to be coherent with

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[939] On the Indian case law with regard to Article 5 and Article 7, see Section 4.5.

[940] A solution for the taxation of technical services based on a deemed tax base is mentioned in Bianco and Santos (n 578). The authors refer to a proposal put forward in G W Rothmann, 'Tributação dos Serviços Importados na Legislação Doméstica e Internacional do Brasil' in Fernanda Drummond Parisi, Heleno Taveira Tôrres and José Eduardo de Melo (eds), *Estudos de Direito Tributário em Homenagem do Professor Roque Antonio Carraza -Volume II* (Malheiros 2014).

[941] See Section 4.4.

[942] See Section 3.2.1.

the current proposal, the framework applied is the one designed in Subsection 6.3.1; in this sense, the pre and post-legislative assessment instruments are key to the success of the framework. In addition, the examples also put forward hypothetical scenarios that scrutinise the presence of a PE through the analysis of the host country's domestic rules and of the provisions as contained in Art 5 of its tax treaty network. Such an analysis is critical to the extent that only when a PE is identified can the host country tax its profits; therefore, the importance of the analysis lies in how narrow the PE concept is as put forward by the domestic legislation and by Art 5 considered together.

Following the identification of the PE, the examples then take the first step of the interpretation of the OECD MC's Art 7(2) as proposed by the AOA approach.[943] To some extent, the application of the current proposal to transactions between associated enterprises seems to work without major difficulties when compared with the challenges posed by the analysis of the dealings between the PE and the enterprise as a whole. The attribution of profits through the AOA could be even more challenging for those countries that, as the UN MC indicates, do not adopt the OECD framework on the issue.[944] Nevertheless, the adoption of the current proposal seems to be appropriate for those countries since, through the pre-fixed profit margins system, the UN MC's position on the 'deduction of expenses rule' as in its Article 7(3) turns out to be immaterial. Once the domestic legislation sets a percentile of the dealings to be considered as profits attributed to the PE, any expenses connected to the payments to the head office (or to other parts of the enterprise) cannot be offset against those profits.[945] In fact, the nature of the PE's expenses connected to its operation in the host

[943] The 2010 OECD Report clarifies what the two-step analysis consists of: 'First, a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, must be performed in order to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into deals with each other and transactions with other related and unrelated enterprises'. The second step is clarified as follows: 'Under the second step, the remuneration of any dealings between the hypothesised enterprises is determined by applying, by analogy, the Article 9 transfer pricing tools (as articulated in the Guidelines for separate enterprises), by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises'. *2010 OECD Report (n 453)*, B-2, p. 13.

[944] Even though the UN MC did not adopt the AOA, it is clear that profits should be attributed to the PE with regard to the dealings with its head office or with other parts of the enterprise as it were a separate entity pricing such dealings in the regular market. See the 2011 UN MC, Commentaries to Art 7, A. General Considerations, para 2.

[945] The UN MC makes it clear that Article 7(3) focuses only on the determination of the profits attributable to the PE. Therefore, it does not deal with which expenses are deductible when computing

country is to be considered in a collaborative way between the taxpayers and the tax administration in the pre-legislative impact study as put forward by Section 6.3.

For this reason, it does not seem adequate to disregard the first step of the AOA as it provides for an appropriate way to establish the 'PE fiction', even though it has its intricacies; such an argument thus applies to those countries that either follow the UN MC or the OECD MC to the point. In this regard, the functional and factual analysis, as proposed by the AOA, would establish the limits of the dealings of the PE with respect to the enterprise as whole. As a result, the PE would be considered a functionally separate and independent enterprise, which demands the profits be attributed to its dealings as a next step.

Next, the attribution of profits to PEs as proposed in this section parts company with the OECD framework. In this sense, the application of the current proposal meets the AOA half way through since the second step is disregarded and the pre-fixed profit margins are applied instead. As the AOA's second step relies heavily on the comparability analysis,[946] it seems fair to affirm that this phase does not entirely fit the needs of developing countries lagging behind the developed ones with respect to their tax administration capabilities. To a great deal, their tax administrations do not have appropriate tools and are not able to appropriately identify comparables in their economy, which is also the case for intense litigation on attribution of profits to PEs. In this respect, Indian case law analysed in Chapter 4 is a good example.[947]

6.5.2 - Examples of attribution of profits to PEs through a pre-fixed margins system

One can hypothesise the application of the pre-fixed margins to PEs in the following ways, bearing in mind the UN MC and the OECD MC with respect either to a narrow or to a broader PE concept. Here, it is important to highlight that the following examples

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the taxable income of the PE, which is a matter to be regulated by the domestic legislation. See the 2011 UN MC, commentary to Article 7, paragraph 18.

[946] See the *2010 OECD Report* (n 453), B-4, p. 20.

[947] See Subsection 4.6.2.

do not intend to cover all possible scenarios involved in the economic sectors selected for the application of the proposal to the attribution of profits to PEs. Notwithstanding, they provide an opportunity to demonstrate the process of application of pre-fixed profit margins to dealings between the PE and the head office.

(i) First example: resource-rich country, force of attraction rule

Facts

OilCo, a company resident in Country R (a developed country) and doing business in the oil and gas sector in various jurisdictions (upstream and downstream activities),[948] establishes an office in Country S (a developing country), namely in a resource-rich jurisdiction. Country S and Country R are the signatories of an income tax treaty that aligns with the OECD MC with regard to Article 5 and with the UN MC with respect to Article 7; therefore, it does not adopt the AOA. The domestic law of Country S provides for a limited force of attraction rule. The enterprise enters into a concession contract with the government of Country S (25 years-long agreement), which establishes that all the costs and risks are to be borne by the private company, which keeps the exclusive rights of operation and production. Additionally, the contract sets the obligation for the payment of royalties to the government.

OilCo's branch then carries out exploration activities and evaluation of the potential of particular oil fields (new economic sector in Country S), which leads to the identification of a promising site in Country S.[949] After intensive investment in constructing all the needed infrastructure in Country S, OilCo starts extracting oil on a commercial scale. Since the local government does not offer fiscal incentives to the installation of industrial facilities in the country (e.g. employment tax incentive schemes), on top of financial and market strategies, the company decides not to invest

[948] On the upstream (exploration and production) and downstream (e.g. refining, distribution, and marketing) activities of companies engaged in the oil and gas sector, see UN, *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries* (United Nations 2017), p. 14ff.

[949] The stages involved in an extractive project are as follows: contract negotiation and signature; exploration activities and evaluation; development of the infrastructure; extraction, production and export; and abandonment and decommissioning. ibid, 34-35.

in an oil refinery plant in Country S. As a result, all the crude oil produced in Country S is entirely exported to OilCo in Country R. OilCo then refines the oil into several by-products (petrol included) and sells them mainly to distributors in Country R and in other jurisdictions. As Country S also represents a consumer market to be explored by the company (not a huge market though), OilCo's branch sells the petrol produced in Country R to distributors in Country S. In such a case, all the marketing costs in Country S with regard to the sales of petrol to distributors are incurred by the PE. Nevertheless, when it fits its business strategy, OilCo sells petrol directly from Country R to other distributors based in Country S.

Regulatory framework

The example above offers a typical scenario for developing countries: an opportunity offered to foreign enterprises to explore a valuable commodity, which requires intensive investment and technical skills,[950] and to sell its products (petrol produced outside the country) to a relevant consumer market. That said, the framework as proposed in Subsection 6.3.1 is put in motion. First, the economic structure of Country S should be scrutinised in order to establish how relevant the development of the oil industry in the country is. Such an analysis should be carried out following the findings and before the initial extraction of the oil (preferably before the development of the infrastructure), with the participation of the government, the private sector, and international institutions.[951] As a result, the new regulation (tax included) provides an attractive legal environment for MNEs to explore the oil industry in the country, therefore attracting investment into its economy and, consequently, promoting its growth.

Also, access to information would not pose any insurmountable hurdle with regard to the design of regulations on TP and on attribution of profits to PEs. On the one hand, since the market is dominated by giants in the sector, the MNEs would for sure have all the crucial information on how profitable the production from the oil fields in

[950] On how crude is priced internationally, see Bassam Fattouh, 'An Anatomy of the Crude Oil Pricing System' [2011] Oxford Institute for Energies Studies.

[951] See Subsection 6.3.1 (i) and (ii).

Country S will be. On the other hand, international institutions such as the IMF, the UN, and the World Bank have the necessary technical capabilities to assist Country S in this regard in order to check how adequate the profit margins to be attributed to the operations are. Both the government and the private sector, acting in a collaborative way through the pre-legislative impact study and public consultations, would have the tools to defend their corners: the regulation would be designed in a way that avoids profit shifting from the source jurisdiction, therefore granting an acceptable level of income tax imposed on the PEs; at same time, the MNEs would do business in a predictable regulatory environment.

The regulatory framework should then contain the following features:

(a) Pre-legislative impact study gathering all the crucial information for the design of the regulation on TP and on attribution of profits to PEs in the oil sector;

(b) Passing of a bill through the legislature providing for:

(b.i) x% as a pre-fixed profit margin applicable to transactions between associated enterprises and to dealings between the PE and the enterprise in the oil sector,[952]

(b.ii) a particular TP method to be applied to the export of crude,[953]

(b.iii) an instrument in the hand of the taxpayer able to request for the reassessment of the fixed margin to better reflect the profitability of the oil sector (if that is the case),

and

(b.iv) a post-legislative instrument able to assess the results obtained with such a regulation, measured against the conclusions of the pre-legislative impact assessment as described in Subsection 6.3.1(v).

[952] For example, a method similar to the Resale Price less Profit Margin method (the percentile of the fixed profit margin being immaterial in the example) as provided by the Brazilian TP legislation. See Subsection 5.4.1.

[953] For example, a method similar to the Brazilian method on the export of commodities (Exports with Price under Quotation), which has as a benchmark for public prices as established by eligible stock exchanges. See Subsection 5.4.1.

Attribution of profits to the PE in Country S

The first requirement for the imposition of tax in Country S would be the existence of a PE in its territory. Here, the analysis of the domestic legislation, of Article 5 of the convention signed by the countries, and of the facts as provided by the example above are of uttermost importance. Assuming that the domestic legislation does provide for a PE in case an MNE establishes an office or a branch in Country S, the presence of OilCo constitutes a PE according to Art 5 (1) and (2). In addition, the functional and factual analysis shows that all the activities of research and extracting the oil were performed by OilCo in Country S, and the marketing activities with respect to the sales of petrol in Country S by the branch were all performed by the PE and the respective costs were borne by the PE.[954] Therefore, the functionally separate and independent enterprise fiction is well established, which demands the application of domestic law and Article 7 in order to attribute profits to the dealings of the PE with the head office as if it were a separate enterprise pricing the dealings in the regular market.[955] In this regard, the TP methods and margins as provided by the domestic legislation are to be applied to the oil export dealings and to the petrol import dealings.

As a result, the oil dealings (exports) follow the prices as established by well-known international commodity exchanges, while the petrol dealings (imports) fall under the fixed profit margins as provided by the TP domestic rules. The commodity method, in spite of not setting a statutory profit margin, provides for an attribution of profits to the PE without resorting to a complex comparative process.[956] On the other hand, the fixed profit margin for the dealings with petrol offers a predictable business environment (hence in favour of FDI), which equally reduces the compliance costs to be incurred by the PE.[957] Finally, the eventual sales of petrol performed directly by OilCo from

[954] See Subsection 6.5.1.

[955] In that respect, it is immaterial if the treaty adopts either the OECD MC or the UN MC since the latter also adopts the separate entity approach in its Article 7. See Subsection 6.5.1.

[956] Again the Brazilian TP framework provides for a good example to be followed since the country legislation sets which commodity exchange should be considered in this process. This reduces to a great extent the search for adequate comparables to be used. See Subsection 6.5.1.

[957] On the need for legal certainty, stability, and transparency in the tax regulation of the oil industry as factors that influence FDI in the sector, see the *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries* (n 945), p. 12.

Country R needs to be connected to the PE in Country S and profits need to be attributed to it accordingly through the process as referred to above.

(ii) Second example: technology sector, agency PE

Facts

TechCo, a company resident of Country R (a developed country), is an enterprise dedicated to the manufacturing and selling of electronic products. Having identified a large consumer base in Country S (a developing country), TechCo decides to set up a fully owned subsidiary in such jurisdiction (TechSub). TechSub will import the finished products as manufactured by TechCo and spare parts; it will not be involved in the development of new products or software to be integrated into the electronic devices though. However, due to the large extension of the country's territory and also due to market particularities in some regions, TechCo enters into an agreement with a local agent. According to this contract, the agent, who has no authority to conclude contracts on behalf of the principal, is in charge of keeping a stock of goods shipped from Country R by TechCo. The goods would then be distributed to dealers in the region of the agent as identified by TechCo. There is a tax treaty in effect between Country R and Country S, which provides for the existence of a PE and the attribution of profits to it following the UN MC's provisions. However, Article 12 of the treaty aligns with the OECD MC; therefore, it does not grant taxing rights to the host country with respect to payment of royalties, which are paid by TechSub to TechCo.

Regulatory framework

The regulatory framework applied to the scenario above follows identical steps as in the first example. In this particular example, however, the intangible asset owned by TechCo, represented by the intellectual property involved in the development of the electronic devices and operational software, is of crucial importance. As the charge for royalties could be prone to manipulation, agreements between parent companies and subsidiaries lead to justified concerns about tax administration in developing countries. Once again, the proposed TP framework comes in use since the expenses with royalties

are not to be offset against the statutory profit margins of the subsidiary. Bearing this in mind, the works connected to the pre-legislative assessment would properly consider the costs previously incurred by TechCo with R&D activities and set the profit margins accordingly. Finally, the domestic legislation should provide for the attribution of profits to the PE as provided by the TP methods and fixed margins set by the domestic legislation.

Attribution of profits to the PE in Country S

Example 2 deals with an agency deemed PE as provided by Art 5 (5) (b) of the UN MC.[958] Assuming that the domestic legislation considers that the activities of the agent as described in that treaty provision result in the existence of an agency PE, the profits related to the distribution of goods by the dependent agent in Country S should be attributed to the PE. The functional and factual analysis shows that with regard to the territorial area covered by the agent, it is appropriate to consider the activity of the agent as consisting of an independent and separate entity's activity. Consequently, the attribution of profits to such a deemed PE will then follow the same TP rules as provided by the domestic legislation with respect to the transactions between TechCo and SubCo. Again, the predictability factor and the low compliance costs incurred in the attribution of profits to the PE are benefited by such an approach.

(iii) Third example: pharmaceutical industry, R&D activities

Facts

PharmaCo, a company resident in Country R (a developed country), is dedicated to research in and to the manufacturing of drugs for the treatment of AIDS. When it fits its marketing strategies, PharmaCo also enters into licence agreements with third-party companies, which will then produce and commercialise the same drugs under different names in other jurisdictions. As part of its business strategy, PharmaCo decides to set a branch in Country S, a developing country that has signed a tax treaty with Country

[958] See Subsection 3.3.4.

R following the UN MC on Article 5 and on Article 7. The domestic law of Country S adopts a TP regulation following the statutory fixed margins approach as above,[959] which is also applicable to the attribution of profits to PEs. The expansion plan involving Country S is mainly a market-driven decision for there is an epidemic of AIDS in the country, and there is no other pharmaceutical MNE doing business therein with a focus on this disease. So far, the drugs of that kind produced by PharmaCo had been imported by independent distributors.

Once the operation in Country S is set in motion, PharmaCo identifies the need for a new drug to tackle a disease mutation, requiring more R&D activities. PharmaCo then decides to split the R&D activities between the head office in Country R and its branch, which is expanded to host a laboratory of PharmaCo with initial investment coming from the head office. Additional costs, such as acquisition of new instruments for the laboratory and hiring specialised staff, are to be borne by the branch. Among other activities, the branch is in charge of collecting samples in Country S and of performing preliminary tests in its laboratories.[960] As a result, a new drug is identified. Following Country S's regulation, the company requires the respective licence (for the sale of the drug in the local market) from the local health agency, which is granted. The new product is manufactured by PharmaCo in Country R. All the costs connected with marketing in Country S, such as those related to distribution activities, are to be borne by the branch.

Regulatory framework

The existent TP methods and margins (legislation already in force) apply to dealings with respect to the old drugs. Nevertheless, one cannot reach the same conclusion regarding the new drugs. It seems appropriate to assume that all the costs incurred with R&D (for the old drugs) were already incorporated in the prices of such products when

[959] The method applicable to the pharmaceutical sector being, for example, the Resale Price less Profit Margin method as in the Brazilian regulation (x% as the statutory profit margin). See Subsection 5.4.1.

[960] To some extent, the proceedings of licencing agreements of the new drug's patent would also raise concerns related to taxation of royalties, since they could be partially attributed to the PE. Such an analysis would depend on Country S's domestic legislation, on the provisions contained in Article 12 of its tax treaties, and on the residence of the contracts' parties. Such analysis is out of scope of this thesis though. For the scope of the present research, see Chapter 1.

they first reached Country S's market, with such costs being (generally) considered by the pre-legislative impact study for the pharmaceutical sector. This is not the case, however, for the new product jointly developed by the head office and the PE. As described in the example's facts, the PE carried out sample collection and preliminary tests in Country S. The PE also incurred additional costs with the laboratory personnel and research instruments; the head office, it is assumed, was in charge of additional laboratory procedures. For each phase, either the branch or the head office, used their facilities/assets and performed diverse functions. On top of that, the PE will make use of the new patent owned by PharmaCo when selling the new drug in Country S. Therefore, it is adequate to attribute the performance of functions and use of assets in the development of the new drug partially to the PE, which demands the attribution of profits to it in a distinct way in comparison with the other drugs manufactured in Country R.

Therefore, there is a need for a regulation that provides for a continuous reassessment of the margins by the tax administration[961] and for the reassessment agreement instrument.[962] On the one hand, the tax administration (having issued the licence for the new product) could conclude that the statutory margins need to be reassessed with respect to the new drug since the PE was also involved in the development of the intangible asset and will use it in Country S. As a result, the profits to be attributed to the PE in this case do not match the same figure applicable to dealings with the other drugs. Therefore, the regulation on the statutory margins should be amended accordingly. On the other hand, the taxpayer could ask for the margins to be reassessed, for instance, in case the market conditions for the new drug are not the same as those for the old ones. The previous documentation analysed on the occasion of the identification of the profit margins for the pharmaceutical sector, together with previous licencing contracts PharmaCo entered into with third parties in other jurisdictions, are the starting point for the reassessment of the statutory margins. Finally, the post-legislative scrutiny instrument should be put in motion (when due) in order to reassess the entire attribution of profits framework with respect to the pharmaceutical industry in Country S.

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[961] See Subsection 6.3.1.

[962] See Subsection 6.3.1 (iv).

Attribution of profits to the PE in Country S

It is assumed that the domestic legislation of Country S provides for the existence of a PE in case an MNE sets a branch in its territory and that profits should be attributed to such legal entity accordingly. Therefore, such legislation and Article 5 (1) and Article 7 apply to the case, meaning the PE threshold was passed and that Country S has the right to tax the profits as attributed to the PE. A straightforward functional and factual analysis is able to demonstrate the existence of the PE. The attribution of profits with regard to the sales of the old drugs manufactured by PharmaCo in Country R does not pose a great difficulty. The TP statutory margins for the pharmaceutical sector frame the amount of profits that should be attributed to the PE. As for the new drug, the new profit margins (as provided by the amended legislation) apply.

Hence, the attribution of profits to the PE in Country S can be summarised as follows:

(a) The application of the domestic legislation and of Article 5 of the treaty leads to the conclusion on the existence of a PE, which is supported by the functional and factual analysis of PharmaCo activities in Country S;

(b) As for the sales of drugs in Country S, profits should be attributed in the following way (considering the domestic legislation and Article 7 of the treaty):
(b.i) with regard to the old drugs manufactured in Country R, the existing TP regulation applies,
(b.2) with regard to the new drug jointly developed by the PE and the head office, the profit margins should be reassessed and profits attributed to the PE accordingly.

This last example provides a glimpse of the 'regulatory loop' as proposed in Subsection 6.3.1. Additionally, the examples above demonstrate that irrespective of the alignment of the treaty networks of developing countries either with the UN MC or the OECD MC, the protection of their tax base and the predictability needed when MNEs invest in those jurisdictions are enhanced. That is the case, for instance, of distribution of goods by the stock agent PE and the application of the limited force of attraction as in case of sales of the same products directly by the head office to consumers situated in

the jurisdiction of the PE. Not only was profit shifting prevented but also the MNEs could plan in advance the consequences of such dealings/transactions and predict with a great level of certainty the tax costs involved in those dealings/transactions. This also reduces the level of litigation on the application of rules regarding the attribution of profits when a country adopts a force of attraction rule in its domestic legislation and tax treaty network.[963]

6.6 Aligning Transfer Pricing Outcomes with Value Creation: A BEPS Check

The international tax regime's approach on corporate business taxation has been, in the last years, one of the main issues of the international tax agenda. The level of tax evasion observed in various areas of international taxation and the aggressive tax planning that lead to a significant level of erosion of tax bases worldwide have been areas of concern for governments of developed and developing countries alike. Bearing in mind such a scenario, the G20 and the OECD teamed up to address the base erosion and profit-shifting issue. The works on the OECD/G20 BEPS Project started in 2013,[964] with TP-related issues standing as one of the typical BEPS opportunities.[965] Bearing that in mind, the OECD set up the Action Plan on Base Erosion and Profit Shifting, which established at Actions 8-10 the goals to be pursued in the TP area.[966] Additionally, in what is more relevant to this subsection, Action 13 aimed at developing TP rules to enhance transparency for tax administration.[967]

The entire OECD's work on the matter was underlined by the arm's length principle[968] as the most appropriate standard to be adopted by tax administrations and taxpayers

[963] See, for example, Subsection 4.6.2 on the force of attraction case law in India.

[964] See the OECD's *Addressing Base Erosion and Profit Shifting* (OECD 2013).

[965] ibid, p. 39.

[966] Actions 8, 9, 10 - Assure that transfer pricing outcomes are in line with value creation. On the aim of Actions 8-10, see the OECD'S Action Plan on Base Erosion and Profit Shifting (OECD 2013), p. 20ff. Individually considered, they deal with issues related to intangibles (Action 8), risks and capital (Action 9) and other high-risk transactions (Action 10). ibid.

[967] Action 13 – Re-examine transfer pricing documentation. ibid.

[968] See *Aligning Transfer Pricing Outcomes with Value Creation - Actions 8-10: 2015 Final Reports* (OECD 2015). Executive Summary, p. 9

alike[969] with regard to the evaluation of TP in international transactions.[970] As put forward above, the present proposal for a TP framework for developing countries is not framed in a way to disrupt the current international tax practice on taxation of profits of associated enterprises. On the contrary, it intends to provide countries with a low tax administration capability with a framework able to coexist with the current arm's length principle as adopted by the OECD. In this sense, this subsection analyses the way a resettable pre-fixed profit margins system tackles main concerns as put forward by the OECD/G20 BEPS Project.

The adequate allocation of profits considering the risks assumed by the associated enterprises and the actual activities carried out by them was of special concern in Action 9. Following the mandates of the actions on the development of more adequate TP rules, the Actions 9-10: Final Reports set a guidance for the application of the arm's length principle aiming to ensure, inter alia, that contractual transactions reflect the economic reality, resulting in the risks being allocated to the enterprises according to their involvement in the decision-making process. In addition, the Reports emphasised the tax administrations' powers in disregarding transactions showing commercial irrationality.[971]

Once again, the benefits of the current proposal for developing countries need to be highlighted against the 2017 TP Guidelines. The need for comparability inherent to the application of the arm's length principle[972] turns out, in many occasions, to be a difficulty for developing countries. As put forward in the 2017 TP Guidelines, the process of identifying the conditions and circumstances of the transactions that associated enterprises enter into requires a great level of understanding about the economic sector where they conduct their business; in this respect, the analysis of the

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[969] The G20/OECD BEPS Project is not immune to criticism with regard to its shortcomings. On the issue, see Reuven S Avi-Yonah and Haiyan Xu, 'Evaluating BEPS' (2017) 10 Erasmus L. Rev. 3. The authors point out to the OECD/G20 BEPS Project's failure in establishing new principles and rules. ibid, p. 6ff.

[970] See *Aligning Transfer Pricing Outcomes with Value Creation - Actions 8-10: 2015 Final Reports* (n 966), p. 10

[971] ibid, p. 13.

[972] On the issues involved in the second stage of the TP comparability analysis (searching for a comparable uncontrolled transaction), see Amir Pichhadze, 'The Arm's Length Comparable in Transfer Pricing: A Search for an "Actual" or a "Hypothetical" Transaction?' (2015) 7 WTJ 1.

risks assumed, functions performed, and assets used is crucial.[973] One can quite easily foresee the hurdles tax administrations from developing countries can face when examining the facts and technicalities involved in even more complex transactions carried out by MNEs. The assessment of the characteristics of goods and services transacted, of the economic circumstances where the transactions take place, and of the business strategies[974] pursued by the MNEs can prove to be rather burdensome to tax administration personnel that are not well qualified.[975]

The OECD's ALP application to the taxation of controlled transactions, as set by the 2017 TP Guidelines and the Action 8-10: Final Reports, does not bring a better approach developing countries can take to overcome their difficulties in taxing associated enterprises. One can say that it is even unrealistic to consider that the more emphasis on the transactions' economic substance is by itself of much help for those countries' tax administrations. The assessment of the financial capacity of the associated enterprises to bear the risk and exert control over it is essential to the application of the economic substance's analysis in the TP field.[976] This leads to the assessment of facts and circumstances involved in the transaction under scrutiny, which turns the TP rules' application into an evidence-based assessment task.[977]

In such a context, the current proposal, while working in an international tax environment dominated by the arm's length principle on the matter (and coexisting with it) again is considered adequate for developing countries. Since it has as a departing point a TP study that is set up prior to the introduction of the TP bill to the legislative body, all the considerations with regard to the economic market, kind of transactions the associated enterprises are involved in, and their business structure are analysed beforehand. In doing so, this pre-legislative study can supply the tax administration and

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[973] *2017 TP Guidelines* (n 885), paragraphs 1.34 and 1.43.

[974] On the 2017 TP Guidelines' approach on the importance of the assessment of the economic circumstances where the transactions take place, and the MNEs' business strategies, see *2017 TP Guidelines* (n 885), D.1.4, paragraph 1.110ff and D.1.5, paragraph 1.114ff.

[975] On the tax administration's assessment of the MNE's business strategy, see *2017 TP Guidelines* (n 40), D.1.5, paragraph 1.117.

[976] Marta Pankiv, *Contemporary Application of the Arm's Length Principle in Transfer Pricing* (IBFD 2017), p. 96.

[977] ibid, p. 96-7.

lawmakers with all the necessary information for the setting-up of the legal profit margins process. Therefore, the all-important allocation of profits to where value is created follows an ex-ante regulatory legal framework, with a set of instruments available to both the taxpayer and the tax administration to re-evaluate its appropriateness. All the OECD/G20 BEPS Project's inputs can be considered in this process, while the burdens imposed on the tax administrations regarding the ex-post evaluation of complex, controlled transactions' pricing can be avoided.

Finally, while the current proposal addresses the transparency issue,[978] it can also be benefitted by the OECD/G20 BEPS Project's work on Action 13.[979] Concerns regarding the harmonisation of documentation and compliance costs involved in providing adequate information to tax authorities are not a novelty in the TP area.[980] Responding to the need for a set of rules to enhance transparency for tax administration,[981] Action 13 put forward a three-tiered TP documentation framework.[982] This approach consists of the requirement for the MNEs (i) to provide tax administrations with a master file containing information on their global business and TP policies; (ii) to detail their transactions in a local file with regard to each jurisdiction with information on related party transactions, amounts involved, and the companies' TP determination; and, finally, to (iii) file a Country-by-Country Report annually with relevant information on their transactions.[983] Information as provided could be accessed by the tax administration of the developing country (subject to the signature of the Multilateral Competent Authority Agreement on the Exchange of

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[978] See Subsection 6.2.2 (ii).

[979] See *OECD/G20 Action 13: Transfer Pricing Documentation and Country-by-Country Reporting* (OECD 2013).

[980] On the approaches to transfer pricing documentation, see Christian Kaeser and Sven Bremer "Chapter 8: Transfer Pricing and Documentation Requirements" in Michael Lang, Alfred Storck and Raffaele Petruzzi, *Transfer Pricing in a Post-BEPS World* (Wolkers Kluwer 2016). Also, on transparency and TP documentation, see Hugh J Ault and Brian J Arnold, 'Chapter I – Protecting the Tax Base of Developing Countries: an Overview' in UN, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (United Nations 2017), p. 23ff.

[981] See *OECD/G20 BEPS 2015 Final Reports: Executive Summaries* (OECD 2015), Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting, p. 37.

[982] On the OECD's approach on TP documentation, see *2017 TP Guidelines* (n 885), Chapter V: Documentation.

[983] *OECD/G20 BEPS 2015 Final Reports: Executive Summaries* (n 979), p. 38.

Country-by-Country Reports), which can serve as a database for the comparability of the profit margins adopted at the statutory level.

Consequently, the profits informed with regard to relevant jurisdictions and relevant enterprises can be accessed and considered in case the tax administration intends to propose an amendment of the TP domestic regulation and reset the legal profit margins. Interestingly, it is worth following the developments of the country-by-country exchange of information in relation to Brazil, and, accordingly, its effects on the application of the country's pre-fixed profit margins framework.[984]

6.7 Conclusion

This chapter aimed to present a TP system that is appropriate and beneficial for developing countries in comparison with the one entirely based on the current OECD's arm's length principle. Based on the functional approach adopted by the thesis, it departed from the main findings of the previous chapters where Section 6.2 highlighted, through the application of the comparative formula as provided by Chapter 1, the level of deviation from the OECD MC of Article 5, Article 7, and Article 9 of the compared countries' tax treaty networks.

A proposal fit for developing countries on TP regulation was then put forward. Accordingly, Subsection 6.3 provided for the main features and regulatory concerns to be considered when a developing country intends to adopt a pre-fixed profit margins approach on the taxation of business profits. It was argued in this thesis that an alignment with international tax practice on the TP issue is not mandatory when developing countries intend to attract FDI from MNEs. As demonstrated, the Brazilian

[984] Brazil signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA) on 21/10/2016. See OECD's 'Signatories of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA) and Signing Dates'. Available at <http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf> accessed 10 January 2018. Brazil has already activated exchange relationships for country-by-country reporting with 51 jurisdictions. See OECD's "Country by country relationships". Available at <http://www.oecd.org/tax/beps/country-by-country-exchange-relationships.htm> accessed 10 January 2018.

experience on the topic provides a starting point for those jurisdictions that are willing to attract FDI and, at the same time, design a TP regulation that also benefits tax collection, transparency, administrative capability enhancement, and legal certainty. Among the characteristics of the TP regulatory framework, the pre-legislative impact study and the post-legislative scrutiny instrument, coupled with an instrument through which the taxpayer can request the reassessment of the statutory margins, pose as the main features of such a proposal. In adopting such a design, this legal framework avoids the main flaws of the TP regulation as adopted by Brazil.

Finally, the chapter also focused on the application of the proposed TP regulation to the attribution of profits to PEs in developing countries. As developed in Section 6.5, the thesis innovates by applying a statutory pre-fixed profit margin to dealings between the PE and the head offices. Through practical examples, the chapter highlighted the regulatory framework to be considered in such cases, which, together with the rules for the taxation of associated enterprises, provides for a coherent tax system aiming at deterring profit-shifting practices by MNEs doing business in developing countries.

CHAPTER 7

Conclusion

7.1 Introduction

The present thesis is situated in an institutional context, namely the international tax regime. Within this context, the work developed by the major international institutions on taxation of income derived from cross-border transactions play a central role. The evolving of the treaty model conventions for nearly a century has shaped the way developed and developing countries alike adopt and design rules on taxation of business profits. The process of shaping the international tax regime has not been immune to controversies though. The jurisdiction to tax issue has occupied a prominent place in the discussions of the way taxing rights should be allocated to treaty parties from the onset of the work on the model conventions. At that time, however, the main contenders for the right to levy income tax at source on such transactions were (as the current common classification name them) developed countries.

That scenario is not observed in the present times anymore. Developed and developing countries compete with each other in order to grant to their jurisdictions the allocation of the biggest share of the pie. This is the reality where the OECD MC and the UN MC come into play: on the one hand, the OECD MC puts forward a treaty framework where the taxing rights are granted to the residence countries to a great extent, while, on the other hand, the UN MC privileges developing countries (usually source countries) on the matter. The thesis considers this friction as a point of departure for the analysis of the treaty policy adopted by Brazil, India, and South Africa on the taxation of corporate business profits.

The choice of the legal systems of the compared countries is justified, mainly, for the role Brazil, India, and South Africa have played in the international scenario. They have been considered as developing countries for the most part of the last century, a period in which the majority of their tax treaties were signed. In the last decades, though, their leverage in the international scenario has been recognised mostly due to their

economies' remarkable pace of growth, which has positioned them as emerging nations. In that capacity, they form alongside Russia and China the BRICS countries, a group that have taken active participation in discussions surrounding the need for the international tax regime to be redesigned. Thus, the choice for the examination of their tax treaty systems in order to understand the pattern adopted by those countries with regard to the treaty rules on taxation of corporate business profits.

Bearing such a background in mind, the thesis sought to address the following research question: *to what extent can the experience of the BRICS countries in the taxation of business profits provide a different framework for developing countries?* As a way to address it, three sub-questions were formulated: *(i) what is the level of influence of the OECD MC on the compared countries' tax treaty networks with regards to taxation of business profits?; (ii) whether and to what extent the adoption by developing countries of a transfer pricing regulation that does not entirely mirror the OECD's one would be convenient for those jurisdictions?;* and *(iii) given that, how an alternative transfer pricing framework derived from the thesis findings could be built up?*

Chapters 2 to 5 focused mainly on how the tax treaty networks of the compared countries evolved, and on the influence exerted on them by the model conventions. In Chapter 2 (Evolution of the Income Tax and the Tax Treaty Network in Brazil, India, and South Africa), the level of their economic development was highlighted, with consideration to the BRICS's position in the international context. Next, the evolution over time of the income tax system as adopted by Brazil, India, and South Africa was examined, with Chapter 2 highlighting important features with regard to taxation of business profits in those jurisdictions. The chapter then moved to the scrutiny of the compared countries' treaty networks, where it put forward the similarities and differences of the treaty policy adopted by them. Its findings on the subject elucidate the question on the existence of a policy that could be, overall, coordinated with regard to the reach of their treaty networks. It is noteworthy that Brazil, India, and South Africa, despite showing similar concerns on international taxation as part of the BRICS, do not adopt the same policy on the size of their treaty networks and election of their treaty counterparties. This raises the question on whether it is, after all, necessary for developing countries to build up a substantial treaty network. Finally, Chapter 2 pointed

to the treaty policy adopted towards important FDI origin jurisdictions with respect to the compared countries. Again diverse approaches were identified.

Chapter 3 (Permanent Establishment – Article 5) introduced the scrutiny of individual treaty provisions. It had as a starting point the analysis of domestic legislation on the PE concept. Then, bearing in mind the differences between the OECD MC and the UN MC on the PE threshold as set up by Article 5, each of the chapter's subsections approached Article 5's paragraphs that show such deviation, starting by shedding light on the policy underlying the model conventions on the issue. The construction PE was approached with regard to the inclusion of assembly project and supervisory activities in the UN MC's version, as well as the lower time threshold in comparison with the OECD MC's one; the compared countries' treaties were compared accordingly. Chapter 3 then moved to the analysis of the service PE provision in a similar way. The examination of the influence of the model conventions on the exclusionary list rule presented in Paragraph (4), the agency PE, the insurance PE as provided by the UN MC, and the independent PE provision followed. The final part of Chapter 3 was dedicated to the assessment of the treaty policy adopted by Brazil, India, and South Africa with regard to the most important FDI origin jurisdictions. The results of the influence of the model conventions as noted throughout their treaty networks where compared with the conventions signed with those jurisdictions, which provided the thesis with a conclusion considering two diverse proxies for the alignment (or lack of) with the OECD MC on Article 5: the first one referred to the treaty networks themselves; while the second one bore in mind the most relevant treaty counterparts with regard to the attraction of FDI.

The thesis then turned its attention to the analysis of the allocation of profits to PEs. Chapter 4 (Attribution of Profits to Permanent Establishments – Article 7) started with the scrutiny of the compared countries' domestic legislation on the issue. Next, it analysed the OECD's and the UN's position on the Authorised OECD Approach. It briefly addressed the OECD's works on the matter, with particular reference to the allocation of profits to permanent establishments by way of the observance of the arm's length standard as provided by Article 9 and the TP Guidelines. The wording of Paragraph (2) of Article 7 was highlighted as provided by the 2010 OECD MC, and the compared countries' treaty networks assessed on the matter accordingly; none of those

countries adopted the AOA. The next four subsections of Chapter 4 went through the examination of the limited force of attraction; the explanatory provision on deduction of expenses as in Paragraph (3) of the UN MC; the formulary apportionment paragraph (UN MC and OECD MC pre-2010); and the allocation of profits in case of the purchase of goods by the PE for the enterprise. In each of those subsections the influence exerted by the model conventions was stressed with regard to the compared countries' treaties. Additionally on the tax policy adopted by those countries, Chapter 4 examined Brazil's approach on the taxation of services without transfer of technology. The country's policies as adopted at the treaty and the domestic regulation levels were highlighted. The final part of Chapter 4 shed light on relevant challenges presented before the courts with respect to the interpretation of Article 5 and Article 7. The case law analysis provided the thesis with a glimpse of the main problems faced by taxpayers and tax administrations alike when allocating profits to PE. Major differences on the topics discussed by the judiciary were noted.

Chapter 5 (Taxation of Associated Enterprises – Article 9) was the final substantive chapter dedicated to the comparative analysis of the tax policy as adopted by Brazil, India, and South Africa on the taxation of corporate business profits. The evolution of Article 9 in the model conventions over time was addressed. Next, Chapter 5 focused on the transplant of the transfer pricing provision into the compared countries' legal system via the tax conventions signed by them. The comparison of the tax treaty networks followed. Apart from the treaty provisions examination, an analysis of the countries' domestic regulation on transfer pricing rules was carried out. The case law assessment as provided by the final part of Chapter 5 stressed the strength and weaknesses of the TP regulation as framed by Brazil, India, and South Africa.

The thesis' approach in Chapters 3 to 5 offered a picture of the path adopted by Brazil, India, and South Africa in regard to the taxation of corporate business profits. The findings put forward in these chapters demonstrated that, while those countries do not adopt a coordinated treaty policy, they deviate from the OECD MC in respect to various provisions, to different degrees. In many cases, conventions were signed with OECD member countries that provided for a treatment far more beneficial to the source country on taxation of business profits than the one adopted by the OECD MC. Tax treaties that were patterned after either the UN MC and the OECD MC were signed

between relevant FDI origin jurisdictions and the compared countries. Such findings then provide the answer to the question on whether the alignment with the OECD MC (mainly with respect to the attraction of FDI) is mandatory. The answer seems to be negative. Given this, can developing countries adopt a TP framework that deviates from the international tax practice, is to say, from the current OECD approach? In this case, the answer seems to be positive.

It is based on such conclusions that Chapter 6 (A Transfer Pricing Framework for Developing Countries: A Regulatory-Based, Pre-Fixed Profit Margins System) is framed. It puts forward a proposal aiming at providing developing countries with a TP regulatory system that is focused on the legal certainty needed for FDI attraction and, at same time, is based on a simpler set of rules than the one offered by the OECD's TP framework. Also, this proposal privileges transparency and the due scrutiny by the governments of the fiscal and regulatory outcomes as intended by developing countries when they enact the TP legislation. The possible implications of the adoption of a pre-fixed profit margins system by developing countries with regard to the allocation of profits to PEs were also addressed, as well as the need for the model conventions to consider a protocol to be drafted on the application of Article 9. In addition, Chapter 6 proposes the adoption of guidance by the OECD and the UN to be included in their works on transfer pricing (namely the OECD TP Guidelines and the UN TP Manual) on the elements to be considered for the design of such a regulation. The final part of Chapter 6 weighs this TP proposal against Actions 8-10 and 13 of the OECD/G20 BEPS Project, identifying its benefits for developing countries in comparison with the current OECD ALP.

7.2 Drawing on a Comparative Functional Approach in the Field of International Tax Law

The subject matter of the thesis required the unfolding of the tax policy adopted by the compared countries with regard to taxation of PEs and of associated enterprises. Thereby, a thorough survey of the treaty provisions on those issues was required, which could offer a full picture of the path chosen by the countries in respect to the tax treaty model conventions. Nevertheless, an ordinary demonstration of the wording adopted

by each treaty signed by Brazil, India, and South Africa would not suffice to address the thesis's research question. Indeed, it was necessary to primarily identify the problems those jurisdictions, as developing countries, face with regard to the need for retaining a fair share of taxing rights on taxation of business profits; therefore the need to identify what are the underlying reasons for the mismatches between the OECD MC and the UN MC. The assessment of the policies adopted follows.

For that reason, the functional approach method was chosen as the most appropriate analytical framework for the task carried out in the thesis. A functional approach, departing from the identification of the problems shared by the chosen jurisdictions, is able to assess the solutions put forward by each of those subjects. In assessing such solutions, one can more accurately apprehend the options adopted by each jurisdiction under scrutiny. As a consequence, the solutions' responsiveness to the shared problem they intend to tackle can be assessed against each other; the pros and cons (flaws) of each of them can be highlighted. In this sense, the functional approach method fits the final purpose of the thesis of identifying differences and commonalities between the compared countries' policies, and, if appropriate, putting forward a regulatory TP framework for developing countries.

The choice of a functional approach method as explained above offers an authoritative analytical framework for the accurate identification of policy approaches to be adopted in various fields of the international taxation discipline. For instance, the consistency of the implementation of such policies, and the effects on the problems experienced by countries keen to be a FDI choice destination serve as guidance for the consideration of similar policies to be adopted. Consequently, any suggestion of a policy design departing from the usual approach on a specific subject is not built in the vacuum. Here the main contribution of the method chosen for the analysis: the more likely success of a policy design that considers the failures of previous solutions offered by the experience of compared jurisdictions.

7.3 – Contribution to the Debate on the Taxation of Corporate Business Profits

The thesis's contribution to the international taxation field is twofold. First, its analytical approach scrutinises the tax policy adopted by jurisdictions that built their tax treaty networks considering the dichotomy between the OECD MC and the UN MC. As they entered into tax treaties, the choices were between provisions that benefited most either the residence or the source country. Then the assumption of the need for alignment with the OECD MC should be put in check. Therefore, any results showing that a lack of alignment as above is possible without necessarily leading to a system deterrent to FDI (as was the case with regard the findings of the thesis) offers a new perspective on the taxation of corporate business profits.

Second, and equally relevant, the thesis contributes to the debate as to what extent the maintenance of the current ALP as framed by the OECD is actually mandatory. As pointed out by Chapter 6 of the thesis, the OECD/G20 BEPS Project's outcomes reiterate the ALP as the underlying principle for taxation of associated enterprises, therefore affecting the allocation of profits to PEs. Even though the work carried out by the OECD/G20 BEPS Project in the last four years is laudable, the lack of an alternative for developing countries that best fits their special features should be subject to a certain amount of criticism. For such a reason, research on proposals as the one put forward in this thesis, that are not disruptive of the international tax regime and, at same time, aim at improving the tax systems of developing countries, should gain relevance.

7.4 – Avenues for Future Research

The thesis faced many constraints. Among them, it is worth emphasising the limitation of the analytical framework's scope. The problems of taxation of business profits with regard to developing countries are not restricted to those faced by three jurisdictions only. Indeed, one can even affirm that a vast number of problems in the area are not related to those faced by Brazil, India, and South Africa. Nevertheless, apart from their condition as developing/emerging nations, those jurisdictions were also chosen as subjects for the comparative research for they play an important role in the international

tax debate. In the same vein, as pointed out in Chapter 1, the research focused on those three BRICS's due to practical reasons: the thesis's reach to those countries was circumscribed by time and space constraints. Also, the lack of a substantial amount of academic literature in English on the Russian and Chinese tax systems was a factor for the focus only on Brazil, India, and South Africa.

The findings of the thesis suggest a very interesting avenue for future research. It is necessary to identify, for instance, the rationale behind the adoption of particular patterns with respect to treaties with specific jurisdictions. Again for time and space constraints, the thesis did not carry out an analysis of the *travaux préparatoires* of treaties the compared countries entered into. For instance, the international tax audience would greatly benefit from research on the rationale behind treaties the BRICS have signed with relevant capital export countries.

Also at the treaty level analysis, an understanding on the reasons why developing countries did not signed conventions with important FDI origin jurisdictions seems to be of crucial relevance. In this aspect Brazil, among the compared countries, seems to be the most obvious example. As shown in the thesis, a few countries that Brazil does not have a treaty with have been, historically, important investors in its economy; that is for instance the case of the UK. Consequently, the relevance of future research intending to understand the motives for the adoption of such a policy from both countries' perspectives and, at the same time, aiming at presenting reasons why a treaty should (or should not) be signed between those two nations, seems to be relevant. Such a research endeavour would benefit from considering the position of politicians, government personnel, and investors alike from both countries through the carrying out of structured interviews. This was, however, out of the scope of this thesis.

Finally, it is necessary to look at the implementation of the outcomes of the OECD/G20 BEPS Project by developing countries, and how those policies affect fiscal policies and the attraction of FDI. A series of topics can be chosen in this task. For instance, taxation of intangibles, for it is one of the most challenging issues in the taxation of business profits. Further development of the TP framework proposed in the thesis, including the attribution of profits to PEs, will necessarily put an emphasis on this, as well as demand the examination of the provisions of Article 12. In addition, future research should

consider the effect exerted by Action 13 (transfer pricing documentation) on the taxation of associated enterprises as adopted by developing countries. Here, analysis on the level of transparency expected from such a measure could provide an indication on how beneficial the implementation of Action 13 would be to the taxation of international transactions in those countries. In both cases, the institutional legal context as explored in the thesis takes a prominent role.

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Annex I: Income tax treaties entered into by Brazil, India, and South Africa[985]

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
1930s						
1939						Southern Rhodesia
1940s						
1946						US UK
1947				Pakistan		
1950s						
1952						Southern Rhodesia
1955						Sweden
1956				Sri Lanka	Zambia	Canada
1958				Sweden		
1959				Denmark Germany Norway		Basutoland Bechuanaland Kenya South West Africa Tanzania Uganda Swaziland
1960s						
1960				Japan	Grenada Sierra Leone	Cyprus Gambia Mauritius Seychelles Trinidad and Tobago
1961				Finland		

[985] The first column refers to the year of the conclusion of the treaties. This table does not consider other than in force/terminated comprehensive income tax treaties signed by Brazil, India, and South Africa. This is the case, e.g. of the tax agreement signed between South Africa and Swaziland in 1932 (Farming Income Tax Agreement). It does not consider the SAARC Income Tax and Mutual Assistance Treaty (2005) for India as well. The search for income tax treaties for each country was carried out through the IBFD Tax Research Platform and the Tax Analysts databases. The following entries were used for the IBFD Tax Research Platform: Country (either Brazil, India, or South Africa); Collection: treaties; Treaty Subject: income/capital. IBFD Tax Research Platform. Available <www.ibfd.org> Accessed 11 January 2018. In the case of the Tax Analysts' database, the search was carried out through the following entries: Worldwide Tax Treaties; In-Force Treaties/Terminated Treaties; Treaty Type (Income Tax Treaties); Brazil/India/South Africa. See Tax Analysts. Available <www.taxanalysts.com> Accessed 11 May 2015. The cut-off date for the treaty analysis, and for the search on those platforms was 31/12/2017.

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
1962						UK
1963				Austria		
1965		Sweden	Greece			Zimbabwe
1967	Japan	Norway				Switzerland
1968						UK
1969			Egypt	France		
1970s						
1971	France	Portugal			Malawi	Netherlands
1972	Belgium	Finland				Swaziland
1973					Germany	
1974	Denmark Spain			Belgium		
1975	Austria Sweden	Germany				
1976				Malaysia		Transkei
1977						Bophuthatswa na Botswana
1978	Italy Luxembour g				Israel	
1979				Tanzania		Venda
1980s						
1980	Norway Argentina					
1981			Libya Zambia	UK Italy Singapore		Ciskey
1982			Mauritius	Sri Lanka		
1983	Ecuador Philippines			Finland		
1984	Canada			Syria		
1985			Thailand	Canada Kenya Korea (Rep.)		
1986	Czech Republic Hungary Slovakia		New Zealand Slovakia	Czech Republic Hungary Norway		
1987				Indonesia Nepal Romania		

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
1988	India		Azerbaijan Brazil Moldova Netherlands	Armenia Belarus Georgia Kazakhstan Kyrgyzstan Russia Sweden Tajikistan Turkmenistan Ukraine Uzbekistan		
1989	Korea (R.O.K.)		Denmark Japan Poland US	Germany		
1990s						
1990	Netherlands		Philippines			
1991	China (P.R.C.)		Australia Bangladesh			
1992			France United Arab Emirates			
1993			Belgium Italy Spain UK Uzbekistan		France Poland Romania	
1994			China (P.R.C.) Bulgaria Vietnam Mongolia Singapore Switzerland	Malta Cyprus	Hungary Taiwan (R.O.C.)	
1995			Germany Turkey		Belgium Canada Denmark Finland Italy Korea - R.O.K. Russia Sweden	Lesotho

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
1996	Finland		Canada Kazakhstan Israel South Africa		Austria Croatia Czech Republic India Norway Thailand	Mauritius Singapore
1997			Belarus Namibia Oman Russia Sweden Turkmenist an		Cyprus Egypt Indonesia Iran Ireland Japan Malta Uganda US	
1998			Czech Republic Morocco Portugal		Algeria Greece Luxembour g Namibia Pakistan Seychelles Slovakia	
1999			Austria Jordan Kyrgyzstan Qatar Trinidad and Tobago Ukraine		Australia Tunisia	
2000s						
2000	Portugal		Ireland		China Nigeria	
2001	Chile			Malaysia		
2002	Israel Ukraine				Belarus New Zealand Oman Rwanda UK	
2003	Mexico South Africa		Armenia Hungary Slovenia Sudan		Botswana Brazil Ukraine	

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
2004	Russia		Uganda		Bulgaria Ethiopia Ghana Kuwait Swaziland	
2005	Venezuela				Congo Malaysia Netherlands Tanzania Turkey	
2006	Peru		Botswana Kuwait Saudi Arabia Serbia and Montenegro		Portugal Spain	
2007			Iceland Mexico		Mozambique Saudi Arabia Switzerland	
2008	Trinidad and Tobago		Luxembourg Syria Tajikistan Myanmar			
2009					Mexico	
2010s						
2010	Turkey		Finland Mozambique			
2011			Colombia Estonia Ethiopia Georgia Lithuania Nepal Norway Taiwan (R.O.C.) Tanzania Uruguay			
2012			Malaysia Indonesia		Chile	

	Brazil		India		South Africa	
Year	In force	Terminated	In force	Terminated	In force	Terminated
2013			Albania Bhutan Latvia Macedonia Malta Romania Sri Lanka		Mauritius	
2014			Croatia Fiji		Hong Kong Lesotho	
2015			Korea (Rep.) Thailand		Cameroon Qatar Singapore United Arab Emirates Zimbabwe	
2016			Kenya Cyprus			
Total in force	33		97		79	

Source: IBFD, Tax Analysts