Should Developing Countries Include Article 7 in Their Tax Treaties?

Os Países em Desenvolvimento deveriam incluir o Art. 7º em seus Acordos de Bitributação?

Sergio André Rocha
Professor of Tax Law at the Rio de Janeiro State University ("UERJ").
Founding Partner of Sergio André Rocha Advocacia e Consultoria Tributária.
The author can be contacted at sergio.andre@sarocha.com.br.

Abstract
This article analyses if and how the article 7 of the OECD and UN Model Conventions, which deals with the taxation of Business Profits, fits into the international tax policy of developing countries.
Keywords: OECD – UN – Model Convention – Business Profits – Developing Countries.

Resumo
Este artigo analisa se e como o artigo 7º das Convenções Modelo da OCDE e da ONU, que trata da tributação dos Lucros das Empresas, se encaixa na política fiscal internacional dos países em desenvolvimento.
Palavras-chave: OCDE – ONU – Convenção Modelo – Lucros das Empresas – Países em Desenvolvimento.

1. Introduction

Since the enactment of the first double tax convention ("DTC") model by the League of Nations, there have been lengthy discussions about allocating taxing rights among countries. This topic is especially controversial in situations involving developed and developing countries.

One of the most relevant distributive rules included in DTCs is established in the treaties' Article 7, which deals with "Business Profits". This provision is often presented as essentially a fundamental principle of international taxation –generally considered as one of the cornerstones of both the OECD and the UN Model Conventions.

To appreciate the importance attributed to this article by the OECD, it is worth quoting an excerpt from the Commentary on Article 7 of the OECD Model (2014).

> "This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention. *It*

> *incorporates the basic principle that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State*."[1] (Emphasis added)

The Commentary refers to the "basic principle" of permanent establishment as if, in fact, this were an absolute and universal criterion for allocating taxing rights rather than simply a model that protects certain interests of developed countries.

Some scholars support this view. According to Hemmelrath (1998):

> "'Permanent establishment principle': Art. 7 OECD MC and Art. 7 US MC allows the enterprise's State of residence to impose tax on the enterprise's business profits, unless the enterprise maintains in the other Contracting State a permanent establishment to which such profits are attributable. They thus preclude an enterprise from being taxed in the other Contracting State merely because the contracts on which the business profits are based were concluded in that State (as provided for under the domestic tax laws of some States, in particular common law States) [...]. This 'permanent establishment principle' laid down in Art. 7 – perhaps 'residence and permanent establishment principle' would be a more precise term – can be traced back to the earliest DTCs concluded by German States. It became the practice of other continental European States, and subsequently that of Anglo-American States as well, to adopt this principle for inclusion in their treaties."[2]

Calderón Carrero (2004) also describes the rule under Article 7(1) of the OECD Model as "one of the great principles of international taxation in relation to the taxation of business income". He adds that justification may be found in the fact that, "An enterprise of one contracting state that carries on business in another state does not participate to a significant extent in the 'economic life' of the other state, unless it operates in its territory through a permanent establishment."[3]

The same justification appears in the Commentary on Article 7 of the OECD Model, which states that, "The first principle underlying paragraph 1, i.e. that the profits of an enterprise of one Contracting State shall not be taxed

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1 *OECD Model tax convention on income and on capital*: commentary on Article 7 para. 1 (15 July 2014), Models IBFD.

2 A. Hemmelrath. *Article 7. Business profits* in *On double taxation conventions*, p. 399-400 (K. Vogel ed., Kluwer Law International 1998).

3 J. M. Calderón Carrero. *Artículo 7. La tributación de los beneficios empresariales* in *Comentarios a los convenios para evitar la doble imposición y prevenir la evasión fiscal concluidos por España*, p. 414 (J. R. Ruiz Garcia & J. M. Calderón Carrero eds., Fundación Pedro Barrié de la Maza 2004).

in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits".[4]

This justification ignores one of the main nexus elements in the international business environment: the presence of the consumer market.

Indeed, the development of a consumer market also requires state-driven investment and an infrastructure that allows cross-border transactions to take place. Therefore, it is possible to state that:

> – The allocation of taxing rights per Article 7 of the OECD and UN Models is not a basic or fundamental principle of international taxation.
> – As a matter of fact, the allocation established in Article 7 is just one of several possible allocation criteria. And it ignores a very relevant nexus element for developing countries: their consumer market.

It is clear that Article 7 unfairly reduces the legitimate scope of source country taxing rights, thereby harming developing economies, especially those that have virtually no outbound activity. In this context, it is fair to question whether developing countries should include Article 7, in its current wording, in their DTCs.

The analysis of the relationship between Article 7 of both the OECD and the UN Model Conventions and developing countries is the focus of this paper.

2. The inevitable "no" answer

There is no justification for developing countries to include Article 7 in their tax treaties. This provision reduces the source country's taxing rights when there is no permanent establishment there, and it forces such countries to apply the rather complex rules for attributing profits to a permanent establishment when one is present.

This blunt statement raises the following question: Why do developing countries include Article 7 in their DTCs?

An in-depth analysis of each country's motivation in this area requires empirical research, which the author has not conducted. However, an intuitive answer to this question might consider that developing countries include Article 7 in their DTCs because:

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[4] *OECD Model Tax Convention on income and on capital*: commentary on Article 7 para. 11 (15 July 2014), Models IBFD.

– As previously mentioned, Article 7 is generally presented as a basic principle of international taxation;
– DTCs are generally viewed as instruments for attracting foreign direct investment ("FDI") – even though there is no empirical evidence of the actual role of DTCs in attracting FDI; and
– Most developed countries would probably not be willing to sign a DTC without Article 7.

The question that results from the position that developing countries should not include the current wording of Article 7 in their treaties is: What should be the ideal allocation rights for taxing business profits?

3. Shared taxing rights

The question that derives from the previous comments is: If developing countries should not accept the exclusive taxation of business profits generated without the use of a permanent establishment in the residence state, what criteria should be used to distribute taxing rights regarding this type of income?

The answer to this question is clear: In the case of business profits – with or without the presence of a permanent establishment – taxing rights should be shared.

Therefore, Article 7 should not differ much from the structure of Article 10 of the OECD and UN Model Conventions. A proposed draft could be as follows:

"*Article 7 – Business Profits*
1. Business profits earned by a company that is a resident of a Contracting State in the other Contracting State may be taxed in the other State.
2. However, such business profits may also be taxed in the Contracting State where the paying entity is located. But if the beneficial owner of the business profits is a resident of the other Contracting State, the tax so charged should not exceed 10% of the gross amount of the business profits."

The proposed text has three merits:

– It deals with the unfair allocation of taxing rights in the case of business profits earned without the presence of a permanent establishment.
– It eliminates the identification need of a permanent establishment.
– It avoids the complex application of current Article 7 provisions regarding the allocation of profits to the permanent establishment – in cases where there is a permanent establishment.
– It serves as a deterrent against BEPS structures.

The proposed modification of Article 7 would result in a major simplification of the taxation of business profits, implying the elimination of the permanent establishment provisions in DTCs.

Four possible criticisms could be directed against this proposal.

The first is that the source country is not entitled to tax business profits when there is no permanent establishment, following the above-quoted OECD position.

The second is that source taxation on gross income could end up unfairly reducing taxation in the residence country.

The third is tax taxation on gross income is a distorted version of income taxation. In other words, disregarding costs and expenses incurred to generate the income would be unfair to the taxpayer.

The fourth would be that requiring tax withholding at source would be unenforceable in many cases, notably in business to consumer transactions.

The first objection, as previously noted, reflects a one-sided view of nexus in cross-border transactions, arbitrarily giving exclusive relevance to the infra-structure of the State of the provider and intentionally ignoring the importance of the infrastructure of the consumer market. Therefore, developing countries should not accept oppositions based on some type of inherent right of developed countries to tax business profits.

On the other hand, the second and third objections make complete sense. Indeed, taxation of gross income ignores the existence of actual income and poses a threat to a taxpayer's ability to pay. As a matter of fact, this is the risk posed by all kinds of simplified methodologies in taxation – they connect presumed facts with known ones.

However, the fact that source taxation on gross income poses these threats by no means indicates that it should not be used – as international practice proves. The concern here must be with the establishment of a reasonable rate, that guarantees a share of the tax revenues to the source country, without unfairly reducing the residence country's taxing rights or posing a risk to the taxpayer's ability to pay.

The fourth objection is only partially correct. It is true that in many cases the source taxation will be unenforceable – at least for a few more years, as withholding mechanisms evolve. However, the main target of our proposal is business to business transactions, such as the provision of technical services, insurance, equipment leases of all kinds, and other sorts of business profits. In these cases, it is the author's opinion that there would not be an enforcement problem.

It is worth noting that this simplified methodology could be reserved only for treaties involving developed and developing countries. If they want to continue applying the complex permanent establishment rules in their rela-

tions, developed countries should not change the current international tax regime.

It is well known that the UN Model Convention has fallen short in protecting the interests of developing countries in treaties signed with developed countries. The heart of the criticism in this area is that this Model kept the permanent establishment principle as the basis for the taxation of business profits. Almost four decades after the publication of the first UN Model, a change in the line herein defended would restore its proclaimed intent, which is to favor the "retention of greater so-called 'source country' taxing rights under a tax treaty – the taxation rights of the host country of the investment – as compared to those of the 'residence country' of the investor"[5].

4. Existing divergent practice

It is worth mentioning that international experience already presents us with policies aimed at reducing the importance of Article 7. For instance, this is the case with Brazil. Indeed, Brazilian treaties significantly reduce the relevance of Article 7 by:

> – Following the UN Model with respect to the treatment of insurance in Article 5
> – Keeping Article 14 as part of the country's treaty policy
> – Including the rental of industrial, commercial, and scientific equipment in the definition of royalties
> – Incorporating a provision in most of its protocols that includes technical services and technical assistance services in the concept of royalties.

Brazil is not the only country to pursue an alternative to the residence-based taxation established in article 7 regarding technical services. According to Pasquale Pistone, provisions in this sense are also found in treaties signed by Colombia, Finland, Germany, India, and Slovenia[6]. These divergent practices are potential triggers for double taxation cases.

In fact, there is no treaty concept of "technical service" and more often than not countries use domestic law definitions that are often not followed by treaty partners. The consequence of these cases is that the residence country might reduce the elimination of double taxation by the credit method.

The apparent focus on the taxation of technical services has led the UN to propose a change to its Model including a provision dedicated to the taxation of this type of income.

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[5] *UN Model double taxation convention between developed and developing countries*: Introduction para. 3.

[6] Pasquale Pistone. *General report* in *The impact of the OECD and UN Model Conventions on bilateral tax treaties*, p. 21-22 (Pasquale Pistone ed., Cambridge University Press 2012).

The UN's initiative to tackle the taxation of cross-border technical services should certainly be praised. However, there are more to business profits than just technical services. The technical services provision proposed by the UN deals only partially with the problem and keeps the notions of permanent establishment and fixed base as relevant. Moreover, de proposed definition of technical services would still leave some room for controversies regarding the qualification of income.

The alternative proposed in this paper eliminates the need for divergent practices, creating a uniform method for the taxation of business profits. In a scenario in which this type of income is taxed at source, the elimination of double taxation would follow the credit method as established in Article 23 of the models.

Therefore, in addition to being more equitable in allocating taxing rights and simplifying the application of tax regulations by the source country, the proposed alternative also prevents situations that might lead to double taxation.

5. Multilateral instrument

There could be a practical objection to the proposal presented in this paper: that it would be virtually impossible for developing countries to renegotiate bilateral treaties with developed countries.

A few years ago, this objection alone would send this proposal into the realm of utopia. However, the international tax regime recently underwent its most relevant review in decades due to the BEPS Project. As a result of this Project, multilateral treaties, which historically came in second place, finally got onto the map.

Hence, the implementation of the suggested change to bilateral tax treaties could be accomplished through a multilateral convention that could be used to change treaties signed by signatories to that convention.

It has been said that, as the OECD took over, there was little room for the UN in the field of international taxation. Scholars point out that the UN Model has lost its influence when compared to the OECD Model, which has become the standard in negotiating tax treaties. After contending that the OECD Model has been turned "into the expression of the internationally accepted tax treaty practice and the main source of tax treaty law around the world", Pasquale Pistone states that, "The opposite trend may be recorded in respect to the UN Model Tax Convention (hereinafter: UN MTC). Conceived to reflect the tax policy needs of developing countries, the UN MTC has gradually lost its importance for and influence on bilateral tax treaties over the past decades and is now, possibly also as a consequence of the stronger nego-

tiating powers of OECD member countries, rarely used as a pattern for bilateral tax treaties around the world"[7].

Regarding this author's proposal, an important role could be played by the UN. It could lead the initiative for the development of the multilateral convention –promoting this initiative and giving voice to those countries that lack muscle in the international arena.

This alternative would enable implementation of the author's proposal via the signing of a multilateral convention that would change hundreds of treaties at once, just like it is intended with the "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifiting".

6. This proposal includes all developing countries

The word "developing country" has an open interpretation. It includes countries with different levels of development and infrastructure. It is worth pointing out that this proposal would cover all developing countries, even those that are G-20 members, for example.

Indeed, even countries that have sophisticated economies and developed tax systems can be net importers of capital in the international trade of goods, services, and intangibles. Therefore, this author's proposal does not differentiate between "more developed" developing countries and "less developed" developing countries.

7. What if developed countries do not want to renegotiate?

One can easily argue that this author's proposal would suffer a great blowback from developed countries. Why would they renegotiate treaties that currently work in their favor?

This is a fair question. Indeed, it seems that arguments based on inter-nation equity might not be strong enough to convince developed countries to invert the rationale behind Article 7.

If this is the case, developing countries should not disregard entirely the possibility of terminating the tax treaties with those countries unwilling to renegotiate.

In 2005, German authorities visited Brazil willing to renegotiate parts of its treaty with Brazil. In view of the lack of interest of their Brazilian counterparts, they returned to Berlin and terminated the treaty. The absence of a DTC between these two countries in this past decade has not had any noticeable impact on trade and investments between them.

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[7] Pasquale Pistone. Tax treaties with developing countries: a plea for new allocation rules and a combined legal and economic approach in Michael Lang et. al. (eds.). *Tax treaties*: building bridges between law and economics (Amsterdam: IBFD, 2010), p. 413.

Some authors question whether double tax treaties are still needed in current times[8]. Double taxation is generally avoided by domestic law provisions, and tax transparency has its own multilateral convention. Thus, absence of a bilateral treaty may not be the end of the world. Brazil has never had one in force with the United States, and this did not prevent the US from being one of the largest foreign investors in the Country.

As previously mentioned, there are different versions of developing countries. Hence, perhaps not all of them would be in a position to threaten denunciation of their tax treaties. However, in cases where developing countries decide that this proposal is in their best interest –and developed countries are not willing to renegotiate their treaties –termination of the treaty might be their only leverage.

8. Conclusions

Given previous comments, several conclusions can be reached.

– It is time to review the so-called "permanent establishment principle" – at least in transactions between developed and developing countries.
– The current international tax regime regarding the taxation of business profits is unfair in allocating taxing rights in those cases where there is no permanent establishment. Moreover, it imposes a rather complex taxation regime on developing countries where there is a permanent establishment.
– Therefore, Article 7 of treaties between developed and developing countries should be modified to eliminate the permanent establishment requirement and establish the right to tax business profits at source in all cases.
– Such a change could be implemented through the signing of a multilateral convention intended to modify bilateral treaties.
– In addition to being more equitable and simplifying the application of tax regulations, this model also reduces the possibility of double taxation in cases where divergent practices of one country are considered not to be in accordance with the treaty by the other Contracting State.

The author's goal in this paper is not to present a final format of what this new model for taxing business profits should be – business profits in general, and not just technical services' income –, but rather just to raise the issue for discussion. It is time to fulfill UN's mission to develop a fairer system for the allocation of taxing rights between developed and developing countries.

[8] See John F. Avery Jones. *Are tax treaties necessary*, p. 37-74 (*The Tillinghast lecture 1996-2005*, NYU School of Law, 1997); Scott Wilkie and Robert Raizenne. *Are (these) tax treaties necessary?* in *Essays on tax treaties*: a tribute to David A. Ward, p. 393-409 (Gublielmo Maisto et. al. eds, IBFD 2013).

The original sin of the UN Model was to base its text on the OECD Model instead of being independently drafted. Entirely changing the logic behind Article 7 would be a good start.